

FIRST RELIANCE BANCSHARES INC  
Form 10-Q  
November 14, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C.**

(Mark One) FORM 10-Q

QUARTERLY REPORT UNDER SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended September 30, 2014

OR

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-49757

FIRST RELIANCE BANCSHARES, INC.

(Exact name of small business issuer as specified in its charter)

South Carolina                      80-0030931  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

**2170 West Palmetto Street**

**Florence, South Carolina 29501**

(Address of principal executive  
offices, including zip code)

(843) 656-5000

(Issuer's telephone number, including area code)

State the number of shares outstanding of each of the issuer's classes of common equity as of the latest practicable date:

**4,738,370 shares of common stock, par value \$0.01 per share, as of October 31, 2014**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

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

**INDEX**

|   | <b>Page<br/>No.</b> |
|---|---------------------|
| <b><u>PART I. FINANCIAL INFORMATION</u></b>   |                     |
| Item 1. <u>Financial Statements (Unaudited)</u>   |                     |
| <u>Condensed Consolidated Balance Sheets - September 30, 2014 and December 31, 2013</u>   | 3                   |
| <u>Condensed Consolidated Statements of Operations – Three and nine months ended September 30, 2014 and 2013</u>                  | 4                   |
| <u>Condensed Consolidated Statements of Comprehensive Income (Loss) – Three and nine months ended September 30, 2014 and 2013</u> | 5                   |
| <u>Condensed Consolidated Statements of Shareholders’ Equity - Nine months ended September 30, 2014 and 2013</u>                  | 6                   |
| <u>Condensed Consolidated Statements of Cash Flows - Nine months ended September 30, 2014 and 2013</u>                            | 7                   |
| <u>Notes to Condensed Consolidated Financial Statements</u>   | 8                   |
| Item 2. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>                              | 24                  |
| Item 3. <u>Quantitative and Qualitative Disclosure about Market Risk</u>  | 44                  |
| Item 4. <u>Controls and Procedures</u>  | 44                  |
| <b><u>PART II. OTHER INFORMATION</u></b>  |                     |
| Item 1. <u>Legal Proceedings</u>  | 45                  |
| Item 1A. <u>Risk Factors</u>  | 45                  |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>  | 45                  |
| Item 6. <u>Exhibits</u>   | 45                  |

**FIRST RELIANCE BANCSHARES, INC.****Condensed Consolidated Balance Sheets**

|   | September 30,<br>2014<br>(Unaudited) | December 31,<br>2013<br>(Audited) |
|---|--------------------------------------|-----------------------------------|
| Assets  |                                      |                                   |
| Cash and cash equivalents:  |                                      |                                   |
| Cash and due from banks   | \$4,354,369                          | \$3,548,974                       |
| Interest-bearing deposits with other banks  | 20,207,489                           | 14,698,851                        |
| Total cash and cash equivalents   | 24,561,858                           | 18,247,825                        |
| Time deposits in other banks  | 101,409                              | 101,207                           |
| Securities available-for-sale   | 13,537,545                           | 12,144,843                        |
| Securities held-to-maturity (Estimated fair value of \$33,247,693 and \$36,951,934 at September 30, 2014 and December 31, 2013, respectively) | 32,626,235                           | 36,951,934                        |
| Nonmarketable equity securities   | 1,142,500                            | 1,594,900                         |
| Total investment securities   | 47,306,280                           | 50,691,677                        |
| Mortgage loans held-for-sale  | 2,568,011                            | 2,248,252                         |
| Loans receivable  | 252,090,858                          | 238,502,131                       |
| Less allowance for loan losses  | (2,900,341 )                         | (2,894,153 )                      |
| Loans, net  | 249,190,517                          | 235,607,978                       |
| Premises, furniture and equipment, net  | 23,475,800                           | 24,333,616                        |
| Accrued interest receivable   | 1,048,362                            | 1,129,881                         |
| Other real estate owned   | 2,009,212                            | 8,932,634                         |
| Cash surrender value life insurance   | 13,197,741                           | 12,945,693                        |
| Other assets  | 4,327,599                            | 1,169,368                         |
| Total assets  | \$367,786,789                        | \$355,408,131                     |
| Liabilities and Shareholders' Equity  |                                      |                                   |
| Liabilities   |                                      |                                   |
| Deposits  |                                      |                                   |
| Noninterest-bearing transaction accounts  | \$69,328,528                         | \$65,576,524                      |
| Interest-bearing transaction accounts   | 61,570,826                           | 46,046,043                        |
| Savings accounts  | 85,834,789                           | 86,247,410                        |
| Time deposits \$100,000 and over  | 37,137,622                           | 39,934,745                        |
| Other time deposits   | 38,453,965                           | 44,610,301                        |
| Total deposits  | 292,325,730                          | 282,415,023                       |
| Securities sold under agreement to repurchase   | 7,639,859                            | 4,876,118                         |
| Advances from Federal Home Loan Bank  | 17,000,000                           | 23,000,000                        |
| Junior subordinated debentures  | 10,310,000                           | 10,310,000                        |

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|   |                |                |
|---|----------------|----------------|
| Accrued interest payable  | 747,529        | 587,649        |
| Other liabilities   | 3,675,658      | 2,126,597      |
| Total liabilities   | 331,698,776    | 323,315,387    |
| Shareholders' Equity  |                |                |
| Preferred stock   |                |                |
| Series A cumulative perpetual preferred stock - 15,349 shares issued and outstanding at September 30, 2014 and December 31, 2013  | 15,179,709     | 15,145,597     |
| Series B cumulative perpetual preferred stock - 767 shares issued and outstanding at September 30, 2014 and December 31, 2013   | 767,000        | 769,894        |
| Common stock, \$0.01 par value; 20,000,000 shares authorized, 4,738,370 and 4,568,695 shares issued and outstanding at September 30, 2014 and December 31, 2013, respectively | 47,384         | 45,687         |
| Capital surplus   | 30,909,652     | 30,609,281     |
| Treasury stock, at cost, 35,176 and 29,846 shares at September 30, 2014 and December 31, 2013, respectively   | (205,512 )     | (201,686 )     |
| Nonvested restricted stock  | (426,091 )     | (32,138 )      |
| Retained deficit  | (10,315,250 )  | (14,447,907 )  |
| Accumulated other comprehensive income  | 131,121        | 204,016        |
| Total shareholders' equity  | 36,088,013     | 32,092,744     |
| Total liabilities and shareholders' equity  | \$ 367,786,789 | \$ 355,408,131 |

See notes to condensed consolidated financial statements

**FIRST RELIANCE BANCSHARES, INC.****Condensed Consolidated Statements of Operations****(Unaudited)**

|   | Three Months Ended<br>September 30, |             | Nine months ended<br>September 30, |              |
|---|-------------------------------------|-------------|------------------------------------|--------------|
|   | 2014                                | 2013        | 2014                               | 2013         |
| Interest income:                                    |                                     |             |                                    |              |
| Loans, including fees                               | \$3,461,473                         | \$3,246,099 | \$10,058,113                       | \$10,090,301 |
| Investment securities:                              |                                     |             |                                    |              |
| Taxable   | 278,023                             | 272,918     | 846,326                            | 935,158      |
| Nontaxable  | 28,512                              | 16,987      | 85,612                             | 16,987       |
| Other interest income                               | 27,200                              | 20,295      | 56,956                             | 73,230       |
| Total   | 3,795,208                           | 3,556,299   | 11,047,007                         | 11,115,676   |
| Interest expense:                                   |                                     |             |                                    |              |
| Time deposits                                       | 147,846                             | 376,271     | 562,813                            | 1,502,759    |
| Other deposits                                      | 31,971                              | 49,458      | 97,798                             | 173,446      |
| Other interest expense                              | 64,956                              | 122,005     | 244,194                            | 362,023      |
| Total   | 244,773                             | 547,734     | 904,805                            | 2,038,228    |
| Net interest income                                 | 3,550,435                           | 3,008,565   | 10,142,202                         | 9,077,448    |
| Provision for loan losses                           | 51,896                              | 609,808     | 97,826                             | 609,808      |
| Net interest income after provision for loan losses | 3,498,539                           | 2,398,757   | 10,044,376                         | 8,467,640    |
| Noninterest income:                                 |                                     |             |                                    |              |
| Service charges on deposit accounts                 | 421,013                             | 435,616     | 1,204,042                          | 1,252,816    |
| Gain on sales of mortgage loans                     | 287,752                             | 303,781     | 791,324                            | 877,822      |
| Income from bank owned life insurance               | 84,276                              | 86,908      | 252,048                            | 258,675      |
| Other charges, commissions and fees                 | 272,496                             | 271,658     | 807,392                            | 739,322      |
| Gain on sale of securities                          | -                                   | -           | 5,321                              | 33,917       |
| Other non-interest income                           | 100,038                             | 82,617      | 246,828                            | 252,043      |
| Total   | 1,165,575                           | 1,180,580   | 3,306,955                          | 3,414,595    |
| Noninterest expenses:                               |                                     |             |                                    |              |
| Salaries and employee benefits                      | 1,741,970                           | 1,939,545   | 5,395,856                          | 5,845,209    |
| Occupancy expense                                   | 372,572                             | 390,355     | 1,125,353                          | 1,123,502    |
| Furniture and equipment expense                     | 371,530                             | 435,846     | 1,178,101                          | 908,688      |
| Other operating expenses                            | 1,943,925                           | 3,283,492   | 4,699,215                          | 6,656,392    |
| Total   | 4,429,997                           | 6,049,238   | 12,398,525                         | 14,533,791   |
| Net income (loss) before income taxes               | 234,117                             | (2,469,901) | 952,806                            | (2,651,556)  |

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|  |             |               |             |               |
|--|-------------|---------------|-------------|---------------|
| Income tax benefit   | (3,211,069) | -             | (3,211,069) | -             |
| Net income (loss)  | 3,445,186   | (2,469,901)   | 4,163,875   | (2,651,556)   |
| Preferred stock dividends  | 362,610     | 254,449       | 857,595     | 752,944       |
| Deemed dividends on preferred stock resulting from net accretion of discount and amortization of premium | -           | 44,876        | 31,218      | 133,164       |
| Net income (loss) available to common shareholders   | \$3,082,576 | \$(2,769,226) | \$3,275,062 | \$(3,537,664) |
| Average common shares outstanding, basic   | 4,571,726   | 4,413,119     | 4,570,257   | 4,202,251     |
| Average common shares outstanding, diluted   | 4,665,290   | 4,413,119     | 4,648,535   | 4,202,251     |
| Income (loss) per common share:  |             |               |             |               |
| Basic income (loss) per share  | \$0.67      | \$(0.63)      | \$0.72      | \$(0.84)      |
| Diluted income (loss) per share  | 0.66        | (0.63)        | 0.70        | (0.84)        |

See notes to condensed consolidated financial statements



**FIRST RELIANCE BANCSHARES, INC.****Condensed Consolidated Statements of Comprehensive Income (Loss)****(Unaudited)**

|  | Three Months Ended<br>September 30, |               | Nine months ended<br>September 30, |               |
|--|-------------------------------------|---------------|------------------------------------|---------------|
|  | 2014                                | 2013          | 2014                               | 2013          |
| Net income (loss) from operations  | \$3,445,186                         | \$(2,469,901) | \$4,163,875                        | \$(2,651,556) |
| Other comprehensive loss, net of tax:  |                                     |               |                                    |               |
| Securities available-for-sale  |                                     |               |                                    |               |
| Unrealized holding gains (losses) arising during the period  | 7,988                               | (593,067 )    | (53,186 )                          | (1,735,378)   |
| Income tax expense (benefit)   | 2,716                               | (201,643 )    | (18,083 )                          | (535,587 )    |
| Net of income taxes  | 5,272                               | (391,424 )    | (35,103 )                          | (1,199,791)   |
| Reclassification adjustment for gains realized in net income from operations                       | -                                   | -             | 5,321                              | 33,917        |
| Income tax expense   | -                                   | -             | 1,809                              | 11,532        |
| Net of income taxes  | -                                   | -             | 3,512                              | 22,385        |
| Other-than-temporary impairment on available-for-sale securities                                   | -                                   | -             | -                                  | (70,000 )     |
| Income tax benefit   | -                                   | -             | -                                  | (8,678 )      |
| Net of income taxes  | -                                   | -             | -                                  | (61,322 )     |
| Other comprehensive income (loss) attributable to securities available-for-sale                    | 5,272                               | (391,424 )    | (38,615 )                          | (1,160,854)   |
| Securities held-to-maturity  |                                     |               |                                    |               |
| Amortization of net unrealized gains capitalized on securities transferred from available-for-sale | (13,697 )                           | -             | (51,939 )                          | -             |
| Income tax benefit   | (4,657 )                            | -             | (17,659 )                          | -             |
| Net of income taxes  | (9,040 )                            | -             | (34,280 )                          | -             |
| Other comprehensive loss   | (3,768 )                            | (391,424 )    | (72,895 )                          | (1,160,854)   |
| Comprehensive income (loss)  | \$3,441,418                         | \$(2,861,325) | \$4,090,980                        | \$(3,812,410) |

See notes to condensed consolidated financial statements



**FIRST RELIANCE BANCSHARES, INC.****Condensed Consolidated Statements of Shareholders' Equity****For the Nine months ended September 30, 2014 and 2013****(Unaudited)**

|  | Preferred<br>Stock | Common<br>Stock | Capital<br>Surplus | Treasury<br>Stock | Nonvested<br>Restricted<br>Stock | Retained<br>Earnings<br>(Deficit) | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total         |
|--|--------------------|-----------------|--------------------|-------------------|----------------------------------|-----------------------------------|---|---------------|
| Balance,<br>December<br>31, 2012   | \$ 18,199,743      | \$ 40,949       | \$ 27,991,132      | \$(182,234)       | \$(123,466)                      | \$(6,207,116 )                    | \$ 1,478,919  | \$ 41,197,927 |
| Net loss   |                    |                 |                    |                   |                                  | (2,651,556 )                      |   | (2,651,556 )  |
| Changes in<br>unrealized<br>gains and<br>losses on<br>securities           |                    |                 |                    |                   |                                  |                                   | (1,160,854)   | (1,160,854 )  |
| Expense of<br>auctioning<br>Series A and<br>Series B<br>Preferred<br>stock | (169,291 )         |                 |                    |                   |                                  |                                   |   | (169,291 )    |
| Accretion of<br>Series A<br>Preferred<br>stock<br>discount                 | 145,509            |                 |                    |                   |                                  | (145,509 )                        |   | -             |
| Amortization<br>of Series B<br>Preferred<br>stock<br>premium               | (12,345 )          |                 |                    |                   |                                  | 12,345                            |   | -             |
| Conversion<br>of Series C  | (2,293,000 )       | 4,709           | 2,614,513          |                   |                                  | (326,222 )                        |   | -             |

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|  |               |           |               |             |            |   |                |              |               |
|--|---------------|-----------|---------------|-------------|------------|---|----------------|--------------|---------------|
| Preferred stock to Common stock                      |               |           |               |             |            |   |                |              |               |
| Issuance of common stock                             | 5             | 997       |               |             |            |   |                | 1,002        |               |
| Net Change in Restricted Stock                       | 4             | (735)     | )             |             | 83,388     |   |                | 82,657       |               |
| Purchase of treasury stock                           |               |           |               | (19,400)    | )          |   |                | (19,400)     |               |
| Balance, September 30, 2013                          | \$ 15,870,616 | \$ 45,667 | \$ 30,605,907 | \$(201,634) | \$(40,078) | ) | \$(9,318,058)  | ) \$ 318,065 | \$ 37,280,485 |
| Balance, December 31, 2013                           | \$ 15,915,491 | \$ 45,687 | \$ 30,609,281 | \$(201,686) | \$(32,138) | ) | \$(14,447,907) | ) \$ 204,016 | \$ 32,092,744 |
| Net income   |               |           |               |             |            |   | 4,163,875      |              | 4,163,875     |
| Changes in unrealized gains and losses on securities |               |           |               |             |            |   | (72,895)       | )            | (72,895)      |
| Accretion of Series A Preferred stock discount       | 34,112        |           |               |             |            |   | (34,112)       | )            | -             |
| Amortization of Series B Preferred stock premium     | (2,894)       | )         |               |             |            |   | 2,894          |              | -             |
| Net Change in restricted stock                       | 1,685         | 298,343   |               |             | (393,953)  |   |                |              | (93,925)      |
| Issuance of common                                   | 12            | 2,028     |               |             |            |   |                |              | 2,040         |

stock

|                            |  |  |  |          |  |  |  |          |
|----------------------------|--|--|--|----------|--|--|--|----------|
| Purchase of treasury stock |  |  |  | (3,826 ) |  |  |  | (3,826 ) |
|----------------------------|--|--|--|----------|--|--|--|----------|

|                             |               |           |               |             |             |                |            |               |
|-----------------------------|---------------|-----------|---------------|-------------|-------------|----------------|------------|---------------|
| Balance, September 30, 2014 | \$ 15,946,709 | \$ 47,384 | \$ 30,909,652 | \$(205,512) | \$(426,091) | \$(10,315,250) | \$ 131,121 | \$ 36,088,013 |
|-----------------------------|---------------|-----------|---------------|-------------|-------------|----------------|------------|---------------|

See notes to condensed consolidated financial statements

-6-

**FIRST RELIANCE BANCSHARES, INC.****Condensed Consolidated Statements of Cash Flows****(Unaudited)**

|  | Nine months ended<br>September 30, |                |
|--|------------------------------------|----------------|
|  | 2014                               | 2013           |
| Cash flows from operating activities:  |                                    |                |
| Net Income (loss)  | \$4,163,875                        | \$(2,651,556 ) |
| Adjustments to reconcile net income (loss) to net cash Provided by operating activities: |                                    |                |
| Provision for loan losses  | 97,826                             | 609,808        |
| Depreciation and amortization expense  | 728,401                            | 623,828        |
| Gain on sale of available-for-sale securities  | (5,321 )                           | (33,917 )      |
| Impairment loss on available-for-sale securities   | -                                  | 70,000         |
| Impairment loss on premises  | 430,000                            | -              |
| (Gain) loss on sale of other real estate owned   | (135,094 )                         | 331,626        |
| Write down of other real estate owned  | -                                  | 1,403,712      |
| Discount accretion and premium amortization on available-for-sale securities             | 109,968                            | 246,007        |
| Disbursements for loans held-for-sale  | (19,467,773)                       | (23,514,839)   |
| Proceeds from loans held-for-sale  | 19,148,014                         | 28,310,995     |
| Decrease in interest receivable  | 81,519                             | 213,815        |
| Increase in cash surrender value of life insurance                                       | (252,048 )                         | (258,674 )     |
| Increase in deferred income taxes  | (3,437,913 )                       | -              |
| Increase in interest payable   | 159,880                            | 99,110         |
| Increase (decrease) in deferred compensation on restricted stock                         | (93,925 )                          | 82,657         |
| Increase (decrease) in other liabilities   | 1,586,613                          | (60,339 )      |
| Decrease in other assets   | 179,535                            | 1,381,037      |
| Net cash provided by operating activities  | 3,293,557                          | 6,853,270      |
| Cash flows from investing activities:  |                                    |                |
| Increase in time deposits  | (202 )                             | (254 )         |
| Net (increase) decrease in loans receivable  | (14,315,072)                       | 22,683,679     |
| Purchases of securities available-for-sale   | (8,469,638 )                       | (6,954,182 )   |
| Proceeds on sales of securities available-for-sale                                       | 5,295,529                          | 712,248        |
| Maturities of securities available-for-sale  | 1,694,737                          | 13,087,848     |
| Maturities of securities held-to-maturity  | 4,197,276                          | -              |
| Net decrease of nonmarketable equity securities  | 452,400                            | 242,400        |
| Proceeds from sales of other real estate owned   | 7,693,223                          | 4,243,364      |
| Purchases of premises and equipment  | (200,439 )                         | (363,098 )     |
| Net cash (used) provided by investing activities   | (3,652,186 )                       | 33,652,005     |
| Cash flows from financing activities:  |                                    |                |
| Net increase (decrease) in demand deposits, interest-bearing and savings accounts        | 18,864,166                         | (1,610,521 )   |
| Net decrease in certificates of deposit and other time deposits                          | (8,953,459 )                       | (51,505,217)   |

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|  |              |              |
|--|--------------|--------------|
| Net increase in securities sold under agreements to repurchase | 2,763,741    | 540,418      |
| Net decrease in advances from Federal Home Loan Bank           | (6,000,000 ) | -            |
| Expense of auctioning Series A and Series B Preferred stock    | -            | (169,291 )   |
| Issuance of common stock to employees                          | 2,040        | 1,002        |
| Purchase of treasury stock                                     | (3,826 )     | (19,400 )    |
| Net cash provided (used) by financing activities               | 6,672,662    | (52,763,009) |
| <br>   |              |              |
| Net increase (decrease) in cash and cash equivalents           | 6,314,033    | (12,257,734) |
| <br>   |              |              |
| Cash and cash equivalents, beginning of period                 | 18,247,825   | 38,062,903   |
| <br>   |              |              |
| Cash and cash equivalents, end of period                       | \$24,561,858 | \$25,805,169 |
| <br>   |              |              |
| Cash paid during the period for:                               |              |              |
| Interest   | \$744,925    | \$1,939,118  |
| Income taxes   | -            | -            |
| <br>   |              |              |
| Supplemental noncash investing and financing activities:       |              |              |
| Foreclosures on loans  | \$634,707    | \$4,602,690  |
| Net change in unrealized losses on investment securities       | (72,895 )    | (1,160,854 ) |

See notes to condensed consolidated financial statements

## Notes to Condensed Consolidated Financial Statements (Unaudited)

### **Note 1 - Basis of Presentation**

First Reliance Bancshares, Inc. (the “Company”) was incorporated to serve as a bank holding company for its subsidiary, First Reliance Bank (the “Bank”). First Reliance Bank was incorporated on August 9, 1999 and commenced business on August 16, 1999. The principal business activity of the Bank is to provide banking services to domestic markets, principally in Florence, Lexington, and Charleston Counties in South Carolina. The Bank is a state-chartered commercial bank, and its deposits are insured by the Federal Deposit Insurance Corporation (“FDIC”).

The accompanying condensed consolidated financial statements have been prepared in accordance with the requirements for interim financial statements and, accordingly, they are condensed and omit certain disclosures that would appear in audited annual consolidated financial statements. The consolidated financial statements as of September 30, 2014 and for the interim periods ended September 30, 2014 and 2013 are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation. The consolidated financial information as of December 31, 2013 has been derived from the audited consolidated financial statements as of that date. For further information, refer to the consolidated financial statements and the notes included in First Reliance Bancshares, Inc.’s Annual Report on Form 10-K for the year ended December 31, 2013.

### **Note 2 - Recently Issued Accounting Pronouncements**

The following is a summary of recent authoritative pronouncements:

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



statements.

In May 2014, the FASB issued guidance to change the recognition of revenue from contracts with customers. The core principle of the new guidance is that an entity should recognize revenue to reflect the transfer of goods and services to customers in an amount equal to the consideration the entity receives or expects to receive. The guidance will be effective for the Company for reporting periods beginning after December 15, 2016. The Company will apply the guidance using a modified retrospective approach. The Company does not expect these amendments to have a material effect on its financial statements.

In June 2014, the FASB issued guidance which makes limited amendments to the guidance on accounting for certain repurchase agreements. The new guidance (1) requires entities to account for repurchase-to-maturity transactions as secured borrowings (rather than as sales with forward repurchase agreements), (2) eliminates accounting guidance on linked repurchase financing transactions, and (3) expands disclosure requirements related to certain transfers of financial assets that are accounted for as sales and certain transfers (specifically, repos, securities lending transactions, and repurchase-to-maturity transactions) accounted for as secured borrowings. The amendments will be effective for the Company for the first interim or annual period beginning after December 15, 2014. The Company will apply the guidance by making a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. The Company does not expect these amendments to have a material effect on its financial statements.

In June 2014, the FASB issued guidance which clarifies that performance targets associated with stock compensation should be treated as a performance condition and should not be reflected in the grant date fair value of the stock award. The amendments will be effective for the Company for fiscal years that begin after December 15, 2015. The Company will apply the guidance to all stock awards granted or modified after the amendments are effective. The Company does not expect these amendments to have a material effect on its financial statements.

In August 2014, the FASB issued guidance that is intended to define management's responsibility to evaluate whether there is substantial doubt about an organization's ability to continue as a going concern and to provide related footnote disclosures. In connection with preparing financial statements, management will need to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the organization's ability to continue as a going concern within one year after the date that the financial statements are issued. The amendments will be effective for the Company for annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. 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 operation or cash flow.

### Note 3 - Reclassifications

Certain captions and amounts in the financial statements in the Company's Form 10-Q for the quarter ended September 30, 2013 were reclassified to conform to the September 30, 2014 presentation.

### Note 4 - Investment Securities

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

|                            | Amortized<br>Cost | Gross<br>Gains | Unrealized<br>Losses | Estimated<br>Fair Value |
|----------------------------|-------------------|----------------|----------------------|-------------------------|
| September 30, 2014         |                   |                |                      |                         |
| Mortgage-backed securities | \$10,711,904      | \$50,658       | \$85,787             | \$10,676,775            |
| Corporate bonds            | 2,782,832         | 47,938         | -                    | 2,830,770               |
| Equity security            | 30,000            | -              | -                    | 30,000                  |
| Total                      | \$13,524,736      | \$98,596       | \$85,787             | \$13,537,545            |
| December 31, 2013          |                   |                |                      |                         |
| Mortgage-backed securities | \$9,277,577       | \$87,635       | \$46,579             | \$9,318,633             |
| Corporate bonds            | 2,765,950         | 30,260         | -                    | 2,796,210               |
| Equity security            | 30,000            | -              | -                    | 30,000                  |
| Total                      | \$12,073,527      | \$117,895      | \$46,579             | \$12,144,843            |

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

|  | Amortized<br>Cost | Gross Unrealized<br>Gains | Losses    | Estimated<br>Fair Value |
|--|-------------------|---------------------------|-----------|-------------------------|
| September 30, 2014   |                   |                           |           |                         |
| U.S. Government sponsored agencies   | \$6,464,681       | \$139,970                 | \$32,871  | \$6,571,780             |
| Mortgage-backed securities   | 22,822,497        | 683,697                   | 181,692   | 23,324,502              |
| Municipals   | 3,153,198         | 198,213                   | -         | 3,351,411               |
|  | 32,440,376        | \$1,021,880               | \$214,563 | \$33,247,693            |
| Unamortized capitalization of net unrealized gains on securities transferred from available-for-sale | 185,859           |                           |           |                         |
| Total  | \$32,626,235      |                           |           |                         |
| December 31, 2013  |                   |                           |           |                         |
| U.S. Government sponsored agencies   | \$7,146,409       | \$80,707                  | \$156,131 | \$7,070,985             |
| Mortgage-backed securities   | 26,404,573        | 537,133                   | 210,365   | 26,731,341              |
| Municipals   | 3,163,155         | 17,569                    | 31,116    | 3,149,608               |
|  | 36,714,137        | \$635,409                 | \$397,612 | \$36,951,934            |
| Capitalization of net unrealized gains on securities transferred from available-for-sale             | 237,797           |                           |           |                         |
| Total  | \$36,951,934      |                           |           |                         |

At December 31, 2013, the Company transferred certain securities to the held-to-maturity category from available-for-sale, since the Company has the ability and management intends to hold these securities to maturity. At the time of the reclassification, the securities were carried at their estimated fair value of \$36,951,934, including net unrealized gains of \$237,797. The net unrealized gain is being amortized to other comprehensive income (loss) over the life of the underlying securities.

The following is a summary of maturities of securities available-for-sale and held-to-maturity as of September 30, 2014. The amortized cost and estimated fair values are based on the contractual maturity dates. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without penalty. Mortgage-backed securities are presented as a separate line, maturities of which are based on expected maturities since paydowns are expected to occur before contractual maturity dates.

|   | Securities Available-for-Sale |                      | Securities Held-to-Maturity |                      |
|---|-------------------------------|----------------------|-----------------------------|----------------------|
|   | Amortized Cost                | Estimated Fair Value | Amortized Cost              | Estimated Fair Value |
| Due after five years but within ten years | \$2,782,832                   | \$2,830,770          | \$-                         | \$-                  |
| Due after ten years                       | -                             | -                    | 9,548,137                   | 9,923,191            |
| Mortgage-backed securities                | 10,711,904                    | 10,676,775           | 23,078,098                  | 23,324,502           |
| Equity security                           | 30,000                        | 30,000               | -                           | -                    |
| Total                                     | \$13,524,736                  | \$13,537,545         | \$32,626,235                | \$33,247,693         |

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 September 30, 2014 and December 31, 2013.

### Securities Available-for-Sale

|                                     | September 30, 2014 |                   | December 31, 2013 |                   |
|-------------------------------------|--------------------|-------------------|-------------------|-------------------|
|                                     | Fair Value         | Unrealized Losses | Fair Value        | Unrealized Losses |
| Less Than 12 Months                 |                    |                   |                   |                   |
| Mortgage-backed securities          | \$6,456,812        | \$ 25,124         | \$1,999,360       | \$ 46,579         |
| 12 Months or More                   |                    |                   |                   |                   |
| Mortgage-backed securities          | 1,618,657          | 60,663            | -                 | -                 |
| Total securities available-for-sale | \$8,075,469        | \$ 85,787         | \$1,999,360       | \$ 46,579         |

### Securities Held-to-Maturity

|                                    |     |      |             |            |
|------------------------------------|-----|------|-------------|------------|
| Less Than 12 Months,               |     |      |             |            |
| U.S. Government sponsored agencies | \$- | \$ - | \$4,549,325 | \$ 156,131 |
| Mortgage-backed securities         | -   | -    | 5,011,313   | 210,365    |
| Municipals                         | -   | -    | 2,037,029   | 31,116     |
| Total                              | -   | -    | 11,597,667  | 397,612    |

12 Months or More

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|                                    |             |            |               |            |
|------------------------------------|-------------|------------|---------------|------------|
| U.S. Government sponsored agencies | 4,153,133   | 32,871     | -             | -          |
| Mortgage-backed securities         | 4,590,086   | 181,692    | -             | -          |
| Total                              | 8,743,219   | 214,563    | -             | -          |
| Total securities held-to-maturity  | \$8,743,219 | \$ 214,563 | \$ 11,597,667 | \$ 397,612 |

At September 30, 2014, four securities classified as available-for-sale and three securities classified as held-to-maturity were in a loss position as detailed in the preceding tables. The Company does not intend to sell these securities in the near future and it is more likely than not that the Company will not be required to sell these securities before recovery of their amortized cost. The Company believes that, based on industry analyst reports and credit ratings, the deterioration in value is attributable to changes in market interest rates and, therefore, these losses are not considered other-than-temporary.

During the first nine months of 2014 and 2013, gross proceeds from the sale of available-for-sale securities were \$5,295,529, and \$712,248, respectively. During these periods, gross gains totaled \$39,110 and \$33,917, while gross losses totaled \$33,789 and \$0, respectively.

**Note 5 – Loans Receivable and Allowance for Loan Losses**

Major classifications of loans receivable are summarized as follows:

|                           | September 30,<br>2014 | December 31,<br>2013 |
|---------------------------|-----------------------|----------------------|
| Real estate loans:        |                       |                      |
| Construction              | \$ 27,288,184         | \$ 24,175,347        |
| Residential:              |                       |                      |
| Residential 1-4 family    | 39,921,811            | 35,873,036           |
| Multifamily               | 3,696,152             | 4,312,057            |
| Second mortgages          | 4,430,141             | 4,245,778            |
| Equity lines of credit    | 20,801,799            | 21,270,126           |
| Total residential         | 68,849,903            | 65,700,997           |
| Nonresidential            | 102,306,351           | 104,378,485          |
| Total real estate loans   | 198,444,438           | 194,254,829          |
| Commercial and industrial | 31,067,012            | 32,486,848           |
| Consumer                  | 22,412,036            | 11,725,319           |
| Other                     | 167,372               | 35,135               |
| Total loans               | \$ 252,090,858        | \$ 238,502,131       |

The Company has pledged certain loans as collateral to secure its borrowings from the Federal Home Loan Bank. The total of loans pledged was \$85,072,091 and \$76,972,548 at September 30, 2014 and December 31, 2013, respectively.

The following is an analysis of the allowance for loan losses by class of loans for the nine months ended September 30, 2014 and the year ended December 31, 2013.

**September 30, 2014**

| <i>(Dollars in Thousands)</i> | Real Estate Loans |              |             |                     | Total<br>Real<br>Estate<br>Loans | Commercial | Consumer<br>and Other |
|-------------------------------|-------------------|--------------|-------------|---------------------|----------------------------------|------------|-----------------------|
|                               | Total             | Construction | Residential | Non-<br>Residential |                                  |            |                       |
| Beginning balance             | \$ 2,894          | \$ 303       | \$ 1,043    | \$ 1,382            | \$ 2,728                         | \$ 65      | \$ 101                |
| Provisions                    | 98                | (310)        | 595         | (381)               | (96)                             | (109)      | 303                   |
| Recoveries                    | 483               | 147          | 25          | 247                 | 419                              | 57         | 7                     |
| Charge-offs                   | (575)             | (6)          | (305)       | (224)               | (535)                            | (5)        | (35)                  |
| Ending balance                | \$ 2,900          | \$ 134       | \$ 1,358    | \$ 1,024            | \$ 2,516                         | \$ 8       | \$ 376                |

December 31, 2013

| <i>(Dollars in Thousands)</i> | Real Estate Loans |              |             |                 | Total                | Commercial | Consumer<br>and Other |
|-------------------------------|-------------------|--------------|-------------|-----------------|----------------------|------------|-----------------------|
|                               | Total             | Construction | Residential | Non-Residential | Real Estate<br>Loans |            |                       |
| Beginning balance             | \$4,167           | \$1,441      | \$ 951      | \$ 1,129        | \$3,521              | \$ 616     | \$ 30                 |
| Provisions                    | 610               | (980 )       | 903         | 1,136           | 1,059                | (548 )     | 99                    |
| Recoveries                    | 455               | 138          | 177         | 35              | 350                  | 89         | 16                    |
| Charge-offs                   | (2,338)           | (296 )       | (988 )      | (918 )          | (2,202)              | (92 )      | (44 )                 |
| Ending balance                | \$2,894           | \$303        | \$ 1,043    | \$ 1,382        | \$2,728              | \$ 65      | \$ 101                |

-11-

The following is a summary of loans evaluated for impairment individually and collectively, by class, for the nine months ended September 30, 2014 and the year ended December 31, 2013.

### September 30, 2014

| (Dollars in Thousands)    | Total     | Real Estate Loans |             |            | Non-Residential | Total Real Estate Loans | Commercial | Consumer and Other |
|---------------------------|-----------|-------------------|-------------|------------|-----------------|-------------------------|------------|--------------------|
|                           |           | Construction      | Residential | Commercial |                 |                         |            |                    |
| Allowance                 |           |                   |             |            |                 |                         |            |                    |
| Evaluated for impairment  |           |                   |             |            |                 |                         |            |                    |
| Individually              | \$404     | \$20              | \$ 284      | \$ 99      | \$403           | \$ -                    | \$ 1       |                    |
| Collectively              | 2,496     | 114               | 1,074       | 925        | 2,113           | 8                       | 375        |                    |
| Allowance for loan losses | \$2,900   | \$134             | \$ 1,358    | \$ 1,024   | \$2,516         | \$ 8                    | \$ 376     |                    |
| Total Loans               |           |                   |             |            |                 |                         |            |                    |
| Evaluated for impairment  |           |                   |             |            |                 |                         |            |                    |
| Individually              | \$14,626  | \$3,695           | \$ 3,066    | \$ 7,767   | \$14,528        | \$ 15                   | \$ 83      |                    |
| Collectively              | 237,465   | 23,593            | 65,784      | 94,539     | 183,916         | 31,052                  | 22,497     |                    |
| Loans receivable          | \$252,091 | \$27,288          | \$ 68,850   | \$ 102,306 | \$198,444       | \$ 31,067               | \$ 22,580  |                    |

### December 31, 2013

| (Dollars in Thousands)    | Total     | Real Estate Loans |             |            | Non-Residential | Total Real Estate Loans | Commercial | Consumer and Other |
|---------------------------|-----------|-------------------|-------------|------------|-----------------|-------------------------|------------|--------------------|
|                           |           | Construction      | Residential | Commercial |                 |                         |            |                    |
| Allowance                 |           |                   |             |            |                 |                         |            |                    |
| Evaluated for impairment  |           |                   |             |            |                 |                         |            |                    |
| Individually              | \$405     | \$2               | \$ 185      | \$ 163     | \$350           | \$ 53                   | \$ 2       |                    |
| Collectively              | 2,489     | 301               | 858         | 1,219      | 2,378           | 12                      | 99         |                    |
| Allowance for loan losses | \$2,894   | \$303             | \$ 1,043    | \$ 1,382   | \$2,728         | \$ 65                   | \$ 101     |                    |
| Total Loans               |           |                   |             |            |                 |                         |            |                    |
| Evaluated for impairment  |           |                   |             |            |                 |                         |            |                    |
| Individually              | \$18,160  | \$2,495           | \$ 3,091    | \$ 10,998  | \$16,584        | \$ 1,480                | \$ 96      |                    |
| Collectively              | 220,342   | 21,680            | 62,610      | 93,381     | 177,671         | 31,007                  | 11,664     |                    |
| Loans receivable          | \$238,502 | \$24,175          | \$ 65,701   | \$ 104,379 | \$194,255       | \$ 32,487               | \$ 11,760  |                    |

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



delay occurs and all amounts due including accrued interest at the contractual interest rate for the period of delay, are expected to be collected.

-12-

The following summarizes the Company's impaired loans as of September 30, 2014.

| (Dollars in Thousands)              | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment |
|-------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|
| With no related allowance recorded: |                        |                                |                      |                                   |
| Real estate                         |                        |                                |                      |                                   |
| Construction                        | \$ 1,999               | \$ 1,999                       | \$ -                 | \$ 951                            |
| Residential                         | 1,996                  | 2,143                          | -                    | 2,219                             |
| Nonresidential                      | 6,316                  | 6,467                          | -                    | 6,256                             |
| Total real estate loans             | 10,311                 | 10,609                         | -                    | 9,426                             |
| Commercial                          | 15                     | 22                             | -                    | 33                                |
| Consumer and other                  | 67                     | 68                             | -                    | 78                                |
|                                     | 10,393                 | 10,699                         | -                    | 9,537                             |
| With an allowance recorded:         |                        |                                |                      |                                   |
| Real estate                         |                        |                                |                      |                                   |
| Construction                        | 1,696                  | 1,696                          | 20                   | 1,323                             |
| Residential                         | 1,070                  | 1,080                          | 284                  | 985                               |
| Nonresidential                      | 1,451                  | 1,451                          | 99                   | 2,071                             |
| Total real estate loans             | 4,217                  | 4,227                          | 403                  | 4,379                             |
| Commercial                          | -                      | -                              | -                    | 1,065                             |
| Consumer and other                  | 16                     | 22                             | 1                    | 12                                |
|                                     | 4,233                  | 4,249                          | 404                  | 5,456                             |
| Total                               |                        |                                |                      |                                   |
| Real estate                         |                        |                                |                      |                                   |
| Construction                        | 3,695                  | 3,695                          | 20                   | 2,274                             |
| Residential                         | 3,066                  | 3,223                          | 284                  | 3,204                             |
| Nonresidential                      | 7,767                  | 7,918                          | 99                   | 8,327                             |
| Total real estate loans             | 14,528                 | 14,836                         | 403                  | 13,805                            |
| Commercial                          | 15                     | 22                             | -                    | 1,098                             |
| Consumer and other                  | 83                     | 90                             | 1                    | 90                                |
| Total                               | \$ 14,626              | \$ 14,948                      | \$ 404               | \$ 14,993                         |

The following summarizes the Company's impaired loans as of December 31, 2013.

| (Dollars in Thousands)              | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment |
|-------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|
| With no related allowance recorded: |                        |                                |                      |                                   |
| Real estate                         |                        |                                |                      |                                   |
| Construction                        | \$ 680                 | \$ 849                         | \$ -                 | \$ 1,599                          |

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|                         |       |       |   |        |
|-------------------------|-------|-------|---|--------|
| Residential             | 2,127 | 2,272 | - | 3,038  |
| Nonresidential          | 6,047 | 6,365 | - | 8,187  |
| Total real estate loans | 8,854 | 9,486 | - | 12,824 |
| Commercial              | 12    | 18    | - | 1,131  |
| Consumer and other      | 83    | 91    | - | 75     |
|                         | 8,949 | 9,595 | - | 14,030 |

With an allowance recorded:

|                         |       |       |     |       |
|-------------------------|-------|-------|-----|-------|
| Real estate             |       |       |     |       |
| Construction            | 1,815 | 1,815 | 2   | 1,777 |
| Residential             | 964   | 999   | 185 | 1,299 |
| Nonresidential          | 4,951 | 5,087 | 163 | 2,803 |
| Total real estate loans | 7,730 | 7,901 | 350 | 5,879 |
| Commercial              | 1,468 | 1,538 | 53  | 606   |
| Consumer and other      | 13    | 14    | 2   | 28    |
|                         | 9,211 | 9,453 | 405 | 6,513 |

| (Dollars in Thousands)  | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment |
|-------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|
| Total                   |                        |                                |                      |                                   |
| Real estate             |                        |                                |                      |                                   |
| Construction            | \$ 2,495               | \$ 2,664                       | \$ 2                 | \$ 3,375                          |
| Residential             | 3,091                  | 3,271                          | 185                  | 4,337                             |
| Nonresidential          | 10,998                 | 11,452                         | 163                  | 10,990                            |
| Total real estate loans | 16,584                 | 17,387                         | 350                  | 18,702                            |
| Commercial              | 1,480                  | 1,556                          | 53                   | 1,737                             |
| Consumer and other      | 96                     | 105                            | 2                    | 104                               |
| Total                   | \$ 18,160              | \$ 19,048                      | \$ 405               | \$ 20,543                         |

Interest income on impaired loans other than nonaccrual loans is recognized on an accrual basis. Interest income on nonaccrual loans is recognized only as collected. For the nine months ended September 30, 2014 and 2013, interest income recognized on nonaccrual loans was \$61,039 and \$478,475, respectively. If the nonaccrual loans had been accruing interest at their original contracted rates, related income would have been \$81,378 and \$654,639 for the nine months ended September 30, 2014 and 2013, respectively.

A summary of current, past due and nonaccrual loans as of September 30, 2014 was as follows:

| <i>(Dollars in Thousands)</i> | Past Due      | Past Due Over 90 days |                  | Total<br>Past Due | Current    | Total<br>Loans |
|-------------------------------|---------------|-----------------------|------------------|-------------------|------------|----------------|
|                               | 30-89<br>Days | and<br>Accruing       | Non-<br>Accruing |                   |            |                |
| Real estate                   |               |                       |                  |                   |            |                |
| Construction                  | \$ -          | \$ -                  | \$ -             | \$ -              | \$ 27,288  | \$ 27,288      |
| Residential                   | -             | -                     | 1,469            | 1,469             | 67,381     | 68,850         |
| Nonresidential                | -             | -                     | 545              | 545               | 101,761    | 102,306        |
| Total real estate loans       | -             | -                     | 2,014            | 2,014             | 196,430    | 198,444        |
| Commercial                    | -             | -                     | 6                | 6                 | 31,061     | 31,067         |
| Consumer and other            | 6             | -                     | 26               | 32                | 22,548     | 22,580         |
| Totals                        | \$ 6          | \$ -                  | \$ 2,046         | \$ 2,052          | \$ 250,039 | \$ 252,091     |

A summary of current, past due and nonaccrual loans as of December 31, 2013 was as follows:

| <i>(Dollars in Thousands)</i> | Past Due      | Past Due Over 90 days |                  | Total<br>Past Due | Current   | Total<br>Loans |
|-------------------------------|---------------|-----------------------|------------------|-------------------|-----------|----------------|
|                               | 30-89<br>Days | and<br>Accruing       | Non-<br>Accruing |                   |           |                |
| Real estate                   |               |                       |                  |                   |           |                |
| Construction                  | \$ 11         | \$ -                  | \$ 481           | \$ 492            | \$ 23,683 | \$ 24,175      |

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|                         |        |        |          |          |            |            |
|-------------------------|--------|--------|----------|----------|------------|------------|
| Residential             | 344    | -      | 1,672    | 2,016    | 63,685     | 65,701     |
| Nonresidential          | 24     | 127    | 5,006    | 5,157    | 99,222     | 104,379    |
| Total real estate loans | 379    | 127    | 7,159    | 7,665    | 186,590    | 194,255    |
| Commercial              | 3      | -      | 1,393    | 1,396    | 31,091     | 32,487     |
| Consumer and other      | 19     | 8      | 74       | 101      | 11,659     | 11,760     |
| Totals                  | \$ 401 | \$ 135 | \$ 8,626 | \$ 9,162 | \$ 229,340 | \$ 238,502 |

Included in the loan portfolio are particular loans that have been modified in order to maximize the collection of loan balances. If, for economic or legal reasons related to the customer's financial difficulties, the Company grants a concession compared to the original terms and conditions on the loan, the modified loan is classified as a troubled debt restructuring ("TDR"). Concessions can relate to the contractual interest rate, maturity date or payment structure of the note. As part of our workout plan for individual loan relationships, we may restructure loan terms to assist borrowers facing financial challenges in the current economic environment.

At September 30, 2014 there were 26 loans classified as a TDR totaling \$9,190,315. Of the 26 loans, 18 loans totaling \$8,682,945 were performing while eight loans totaling \$507,370 were not performing. As of December 31, 2013, there were 30 loans classified as TDRs totaling \$7,157,230. Of the 30 loans, 16 loans totaling \$3,481,589 were performing while 14 loans totaling \$3,675,641 were not performing. All of these restructured loans resulted in either extended maturity or lowered rates and were included in the impaired loan balance.

The following tables provide, by class, the number of loans modified as TDRs during the three months and nine months ended September 30, 2014 and 2013.

### September 30, 2014

| <i>(Dollars in Thousands)</i> | Three Months Ended September 30, 2014 |            |                                | Nine months ended September 30, 2014 |            |                                |
|-------------------------------|---------------------------------------|------------|--------------------------------|--------------------------------------|------------|--------------------------------|
|                               | Number Recorded<br>of<br>Loans        | Investment | Unpaid<br>Principal<br>Balance | Number Recorded<br>of<br>Loans       | Investment | Unpaid<br>Principal<br>Balance |
| Reduced Rate                  |                                       |            |                                |                                      |            |                                |
| Real estate - Residential     | -                                     | \$ -       | \$ -                           | 1                                    | \$ 62      | \$ 62                          |
| Extended maturity             |                                       |            |                                |                                      |            |                                |
| Real estate – Nonresidential  | 1                                     | 2,738      | 2,738                          | 1                                    | 2,738      | 2,738                          |
| Totals                        | 1                                     | \$ 2,738   | \$ 2,738                       | 2                                    | \$ 2,800   | \$ 2,800                       |

### September 30, 2013

| <i>(Dollars in Thousands)</i> | Three Months Ended September 30, 2013 |            |                                | Nine months ended September 30, 2013 |            |                                |
|-------------------------------|---------------------------------------|------------|--------------------------------|--------------------------------------|------------|--------------------------------|
|                               | Number Recorded<br>of<br>Loans        | Investment | Unpaid<br>Principal<br>Balance | Number Recorded<br>of<br>Loans       | Investment | Unpaid<br>Principal<br>Balance |
| Extended maturity             |                                       |            |                                |                                      |            |                                |
| Real estate – Residential     | -                                     | \$ -       | \$ -                           | 2                                    | \$ 76      | \$ 76                          |
| Nonresidential                | -                                     | -          | -                              | 1                                    | 204        | 204                            |
| Commercial                    | -                                     | -          | -                              | 1                                    | 14         | 14                             |
| Consumer and other            | -                                     | -          | -                              | 1                                    | 13         | 13                             |
| Total                         | -                                     | -          | -                              | 5                                    | 307        | 307                            |
| Reduced Rate                  |                                       |            |                                |                                      |            |                                |
| Real estate – Residential     | 2                                     | \$ 281     | \$ 281                         | 4                                    | \$ 738     | \$ 738                         |
| Totals                        | 2                                     | \$ 281     | \$ 281                         | 9                                    | \$ 1,045   | \$ 1,045                       |

The following tables provide the number of loans and leases modified as TDRs during the previous 12 months which subsequently defaulted during the three and nine months ended September 30, 2014 and 2013, as well as the recorded investments and unpaid principal balances as of September 30, 2014 and 2013. Loans in default are those past due

greater than 89 days.

**September 30, 2014**

|                               | Three Months Ended September 30, 2014 |                        |                                | Nine months ended September 30, 2014 |                        |                                |
|-------------------------------|---------------------------------------|------------------------|--------------------------------|--------------------------------------|------------------------|--------------------------------|
|                               | Number<br>of<br>Loans                 | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Number<br>of<br>Loans                | Recorded<br>Investment | Unpaid<br>Principal<br>Balance |
| Extended maturity<br>Consumer | -                                     | \$ -                   | \$ -                           | 1                                    | \$ 11                  | \$ 11                          |

-15-

September 30, 2013

| <i>(Dollars in Thousands)</i> | Three Months Ended September 30, 2013 |                     |                          | Nine months ended September 30, 2013 |                     |                          |
|-------------------------------|---------------------------------------|---------------------|--------------------------|--------------------------------------|---------------------|--------------------------|
|                               | Number of Loans                       | Recorded Investment | Unpaid Principal Balance | Number of Loans                      | Recorded Investment | Unpaid Principal Balance |
| Extended maturity             |                                       |                     |                          |                                      |                     |                          |
| Real estate – Nonresidential  | -                                     | \$ -                | \$ -                     | 1                                    | \$ 104              | \$ 104                   |
| Reduced Rate                  |                                       |                     |                          |                                      |                     |                          |
| Real estate – Residential     | -                                     | -                   | -                        | 1                                    | 171                 | 171                      |
| Nonresidential                | -                                     | -                   | -                        | 1                                    | 119                 | 119                      |
| Total                         | -                                     | -                   | -                        | 2                                    | 290                 | 290                      |
| Totals                        | -                                     | \$ -                | \$ -                     | 3                                    | \$ 394              | \$ 394                   |

All loans modified as TDRs 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.

### 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.

As of September 30, 2014, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

| <i>(Dollars in Thousands)</i> | Real Estate Loans |              |             |                 | Total             | Commercial | Consumer and Other |
|-------------------------------|-------------------|--------------|-------------|-----------------|-------------------|------------|--------------------|
|                               | Total             | Construction | Residential | Non-Residential | Real Estate Loans |            |                    |
| Pass                          | \$206,813         | \$17,011     | \$ 60,272   | \$ 78,737       | \$156,020         | \$ 28,361  | \$ 22,432          |
| Special mention               | 28,355            | 6,781        | 5,764       | 13,004          | 25,549            | 2,690      | 116                |
| Substandard                   | 16,923            | 3,496        | 2,814       | 10,565          | 16,875            | 16         | 32                 |
| Doubtful                      | -                 | -            | -           | -               | -                 | -          | -                  |
| Totals                        | \$252,091         | \$27,288     | \$ 68,850   | \$ 102,306      | \$198,444         | \$ 31,067  | \$ 22,580          |

As of December 31, 2013, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

| <i>(Dollars in Thousands)</i> | Real Estate Loans |              |             |                     | Total<br>Real<br>Estate<br>Loans | Commercial | Consumer<br>and Other |
|-------------------------------|-------------------|--------------|-------------|---------------------|----------------------------------|------------|-----------------------|
|                               | Total             | Construction | Residential | Non-<br>Residential |                                  |            |                       |
| Pass                          | \$193,839         | \$14,406     | \$56,227    | \$81,891            | \$152,524                        | \$29,735   | \$11,580              |
| Special mention               | 27,926            | 9,085        | 5,904       | 11,588              | 26,577                           | 1,271      | 78                    |
| Substandard                   | 16,737            | 684          | 3,570       | 10,900              | 15,154                           | 1,481      | 102                   |
| Doubtful                      | -                 | -            | -           | -                   | -                                | -          | -                     |
| Totals                        | \$238,502         | \$24,175     | \$65,701    | \$104,379           | \$194,255                        | \$32,487   | \$11,760              |

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 at the dates indicated below:

|                              | September 30,<br>2014 | December 31,<br>2013 |
|------------------------------|-----------------------|----------------------|
| Commitments to extend credit | \$33,847,789          | \$34,397,688         |
| Standby letters of credit    | 75,000                | 8,000                |

#### **Note 6 – Other Real Estate Owned**

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Transactions in OREO for the nine months ended September 30, 2014 and year ended December 31, 2013 are summarized below:

|                   | September 30,<br>2014 | December 31,<br>2013 |
|-------------------|-----------------------|----------------------|
| Beginning balance | \$ 8,932,634          | \$ 15,289,991        |
| Additions         | 634,707               | 4,827,496            |
| Sales             | (7,558,129 )          | (6,279,377 )         |
| Write downs       | -                     | (4,905,476 )         |
| Ending balance    | \$ 2,009,212          | \$ 8,932,634         |

The Company recognized a net gain of \$135,094 and a net loss of \$331,626 on the sale of OREO for the nine months ended September 30, 2014 and 2013, respectively.

OREO expense for the nine months ended September 30, 2014 and 2013 was \$490,137 and \$2,738,692, respectively, which includes gains and losses on sales.

**Note 7 – Shareholders’ Equity**

**Common Stock** – The following is a summary of the changes in common shares outstanding for the nine months ended September 30, 2014 and 2013.

|  | Nine Months ended<br>September 30, |           |
|--|------------------------------------|-----------|
|  | 2014                               | 2013      |
| Common shares outstanding at beginning of the period   | 4,568,695                          | 4,094,861 |
| Conversion of Series C preferred stock to common stock | -                                  | 470,829   |
| Issuance of common stock                               | 1,200                              | 550       |
| Issuance of non-vested restricted shares               | 213,100                            | 1,245     |
| Forfeiture of restricted shares                        | (44,625 )                          | (835 )    |
| Common shares outstanding at end of the period         | 4,738,370                          | 4,566,650 |

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

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

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

The Company must request prior approval from the Federal Reserve Bank of Richmond (the “Federal Reserve”) prior to declaring or paying dividends on its common stock or preferred stock, or making scheduled interest payments on its

trust-preferred securities. Such approval was not granted by the Federal Reserve for payment of the Company's dividends and interest payments due and payable in the twelve consecutive quarters ended September 30, 2014. Additionally, such approval was not granted for payments due in the fourth quarter of 2014. Since the Company has not paid the dividend on its Series A and Series B Shares for more than six consecutive quarterly periods, the holders of these shares currently have the right to appoint up to two individuals to the Company's board of directors. To date, the right to appoint directors has not been exercised by the holders.

As of September 30, 2014, dividends in arrears on the Series A and Series B shares totaled \$2,739,675.

#### **Note 8 – Income Taxes**

The income tax benefit of \$3,211,069 for both the three and nine months ended September 30, 2014, consists of currently payable income taxes of \$226,844, less the increase of \$3,437,913 in the Company's net deferred tax assets. The income tax benefit related to the Company's pretax loss for the three and nine months ended September 30, 2013 was offset by the increase of an equal amount in the valuation allowance related to its net deferred tax assets.

#### **Note 9 – Net Income (Loss) Per Common Share**

Net income (loss) available to common shareholders represents net income (loss) adjusted for preferred dividends including dividends declared, accretions of discounts and amortization of premiums on preferred stock issuances and cumulative dividends related to the current dividend period that have not been declared as of period end. All potential dilutive common shares equivalents were deemed to be anti-dilutive for the three and nine months ended September 30, 2013, due to the net loss available to common shareholders.

The following is a summary of the net income (loss) per common share calculations for the three months and nine months ended September 30, 2014 and 2013.

|  | Three Months Ended<br>September 30, |               | Nine months ended<br>September 30, |               |
|--|-------------------------------------|---------------|------------------------------------|---------------|
|  | 2014                                | 2013          | 2014                               | 2013          |
| Net income (loss) available to common shareholders   |                                     |               |                                    |               |
| Net income (loss)  | \$3,445,186                         | \$(2,469,901) | \$4,163,875                        | \$(2,651,556) |
| Preferred stock dividends  | 362,610                             | 254,449       | 857,595                            | 752,944       |
| Deemed dividends on preferred stock resulting from net accretion of discount and amortization of premium | -                                   | 44,876        | 31,218                             | 133,164       |
| Net income (loss) available to common shareholders   | \$3,082,576                         | \$(2,769,226) | \$3,275,062                        | \$(3,537,664) |
| Basic net income (loss) per common share:  |                                     |               |                                    |               |
| Net income (loss) available to common shareholders   | \$3,082,576                         | \$(2,769,226) | \$3,275,062                        | \$(3,537,664) |
| Average common shares outstanding - basic  | 4,571,726                           | 4,413,119     | 4,570,257                          | 4,202,251     |
| Basic net income (loss) per share  | \$0.67                              | \$(0.63)      | \$0.72                             | \$(0.84)      |
| Diluted net income (loss) per common share:  |                                     |               |                                    |               |
| Net income (loss) available to common shareholders   | \$3,082,576                         | \$(2,769,226) | \$3,275,062                        | \$(3,537,664) |
| Average common shares outstanding – basic  | 4,571,726                           | 4,413,119     | 4,570,257                          | 4,202,251     |
| Dilutive potential common shares   | 93,564                              | -             | 78,278                             | -             |
| Average common shares outstanding - diluted  | 4,665,290                           | 4,413,119     | 4,648,535                          | 4,202,251     |
| Diluted income (loss) per share  | \$0.66                              | \$(0.63)      | \$0.70                             | \$(0.84)      |

#### **Note 10 - Equity Incentive Plan**

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

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

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

During the nine months ended September 30, 2014 and 2013, the Company issued 213,100 and 1,245 shares, respectively, of restricted stock pursuant to the Plan. The shares issued in 2014 vest in a single installment on the seventh anniversary of the date of grant and thus will be fully vested in 2021, subject to meeting the performance criteria of the Plan. All unearned restricted shares outstanding at December 31, 2013 were either forfeited or cancelled during 2014. The weighted-average fair value of restricted stock issued during the nine months ended September 30, 2014 and 2013 was \$2.11 and \$1.76 per share, respectively. Compensation cost associated with the issuance was for 2014 and 2013 was \$449,455 and \$2,191, respectively. During the first nine months of 2014 and 2013, 44,625 and 835 shares, respectively, were either forfeited or cancelled having a weighted average price of \$3.35 and \$3.50, respectively. Deferred compensation expense of \$41,232 and \$82,657, relating to restricted stock, was amortized to income during the nine months ended September 30, 2014 and 2013, respectively. Previously amortized compensation expense of \$135,158, associated with the cancellation of the unearned restricted stock outstanding at of December 31, 2013, was credited to income during the third quarter of 2014.

The Plan also allows for the issuance of Stock Appreciation Rights ("SARs"). The SARs entitle the participant to receive the excess of (1) the market value of a specified or determinable number of shares of the stock at the exercise date over the fair value at grant date or (2) a specified or determinable price which may not in any event be less than the fair market value of the stock at the time of the award. Upon exercise, the Company can elect to settle the awards using either Company stock or cash. The shares start vesting after five years and vest at 20% per year until fully vested. Compensation cost for SARs is amortized to compensation expense over the vesting period. No SARs were issued during the first nine months of 2014 and 2013.

#### **Note 11 – 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.

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

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

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

**Loans** - The Company does not record loans at fair value on a recurring basis, however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan are considered impaired. Once a loan is identified as individually impaired, management measures impairment. The fair value of impaired loans is estimated using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value, and discounted cash flows. Those impaired loans not requiring a specific allowance represent loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. At September 30, 2014 and December 31, 2013, 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** - The fair value of loans held for sale is estimated based upon binding contracts and quotes from third party investors resulting in a Level 2 classification.

**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.

The tables below present the balances of assets and liabilities measured at fair value on a recurring basis by level within the hierarchy at September 30, 2014 and December 31, 2013.

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|                                  | Total        | Level 1 | Level 2      | Level 3 |
|----------------------------------|--------------|---------|--------------|---------|
| September 30, 2014               |              |         |              |         |
| Available-for-sale securities:   |              |         |              |         |
| Mortgage-backed securities       | \$10,676,775 | \$ -    | \$10,676,775 | \$ -    |
| Corporate bonds                  | 2,830,770    | -       | 2,830,770    | -       |
| Equity security                  | 30,000       | -       | 30,000       | -       |
|                                  | 13,537,545   | -       | 13,537,545   | -       |
| Mortgage loans held for sale (1) | 2,568,011    | -       | 2,568,011    | -       |
|                                  | \$16,105,556 | \$ -    | \$16,105,556 | \$ -    |
| December 31, 2013                |              |         |              |         |
| Available-for-sale securities:   |              |         |              |         |
| Mortgage-backed securities       | \$9,318,633  | \$ -    | \$9,318,633  | \$ -    |
| Corporate bonds                  | 2,796,210    | -       | 2,796,210    | -       |
| Equity security                  | 30,000       | -       | 30,000       | -       |
|                                  | 12,144,843   | -       | 12,144,843   | -       |
| Mortgage loans held for sale (1) | 2,248,252    | -       | 2,248,252    | -       |
|                                  | \$14,393,095 | \$ -    | \$14,393,095 | \$ -    |

(1) Carried at the lower of cost or market.

There were no liabilities measured at fair value on a recurring basis at September 30, 2014 and December 31, 2013.

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

Certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The following table presents the assets and liabilities measured at fair value on a nonrecurring basis at September 30, 2014 and December 31, 2013, aggregated by level in the fair value hierarchy within which those measurements fall.

|  | Total        | Level 1 | Level 2 | Level 3      |
|--|--------------|---------|---------|--------------|
| September 30, 2014                             |              |         |         |              |
| Collateral-dependent impaired loans receivable | \$9,130,348  | \$ -    | \$ -    | \$9,130,348  |
| Other real estate owned                        | 2,009,212    | -       | -       | 2,009,212    |
| Total assets at fair value                     | \$11,139,560 | \$ -    | \$ -    | \$11,139,560 |
| December 31, 2013                              |              |         |         |              |
| Collateral-dependent impaired loans receivable | \$13,359,438 | \$ -    | \$ -    | \$13,359,438 |
| Other real estate owned                        | 8,932,634    | -       | -       | 8,932,634    |
| Total assets at fair value                     | \$22,292,072 | \$ -    | \$ -    | \$22,292,072 |

For level 3 assets measured at fair value on a non-recurring basis as of September 30, 2014 and December 31, 2013, the significant unobservable inputs in the fair value measurements were as follows:

|  | Valuation Technique | Significant Unobservable Inputs                  | General Range |
|--|---------------------|--|---------------|
| Collateral-dependant impaired loans receivable | Appraised Value     | Collateral discounts                             | 0-10 %        |
| Other real estate owned                        | Appraised Value     | Collateral discounts and estimated costs to sell | 0-10 %        |

There were no liabilities measured at fair value on a nonrecurring basis at September 30, 2014 and December 31, 2013.

**Disclosures about Fair Value of Financial Instruments**

The following describes the valuation methodologies used by the Company for estimating fair value of financial instruments not recorded at fair value in the balance sheet on a recurring or nonrecurring basis:

***Cash and Due from Banks and Interest-bearing Deposits with Other Banks*** - The carrying amount is a reasonable estimate of fair value.

***Time Deposits in other Banks*** - The carrying amount is a reasonable estimate of fair value.

***Securities Held-to-Maturity*** - The fair values of securities held-to-maturity are based on quoted market prices or dealer quotes. If quoted market prices are not available, fair values are based on quoted market prices of comparable securities.

***Equity Securities*** - The carrying amount of nonmarketable equity securities is a reasonable estimate of fair value since no ready market exists for these securities.

***Loans Receivable*** – For certain categories of loans, such as variable rate loans which are repriced frequently and have no significant change in credit risk, fair values are based on the carrying amounts. The fair value of other types of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities.

***Deposits*** - The fair value of demand deposits, savings, and money market accounts is the amount payable on demand at the reporting date. The fair values of certificates of deposit are estimated using a discounted cash flow calculation that applies current interest rates to a schedule of aggregated expected maturities.

***Securities Sold Under Agreements to Repurchase*** - The carrying amount is a reasonable estimate of fair value because these instruments typically have terms of one day.

**Advances From Federal Home Loan Bank** - The fair values of fixed rate borrowings are estimated using a discounted cash flow calculation that applies the Company's current borrowing rate from the Federal Home Loan Bank. The carrying amounts of variable rate borrowings are reasonable estimates of fair value because they can be repriced frequently.

**Junior Subordinated Debentures** - The carrying value of the junior subordinated debentures approximates their fair value since they were issued at a floating rate.

**Accrued Interest Receivable and Payable** - The carrying value of these instruments is a reasonable estimate of fair value.

**Off-Balance Sheet Financial Instruments** - Fair values of off-balance sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Company's financial instruments as of September 30, 2014 and December 31, 2013. This table excludes financial instruments for which the carrying amount approximates fair value. For short-term financial assets such as cash and cash equivalents, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization. For financial liabilities such as noninterest-bearing demand, interest-bearing demand, and savings deposits, the carrying amount is a reasonable estimate of fair value due to these products having no stated maturity.

|                             | Carrying<br>Amount | Fair<br>Value | Fair Value Measurements  |   |
|-----------------------------|--------------------|---------------|--|---|
|                             |                    |               | Quoted<br>Prices in<br>Active Markets<br>for Identical<br>Assets or<br>Liabilities<br>(Level<br>1) | Significant<br>Unobservable<br>Inputs<br>(Level 2)<br>(Level 3) |
| September 30, 2014          |                    |               |  |   |
| Financial Assets:           |                    |               |  |   |
| Securities held-to-maturity | \$32,626,235       | \$33,247,693  | \$-  | \$33,247,693 \$-  |
| Loans receivable            | 252,090,858        | 254,208,000   | -  | - 254,208,000   |

## Financial Liabilities:

|                                      |              |              |     |              |     |
|--------------------------------------|--------------|--------------|-----|--------------|-----|
| Certificates of deposit              | \$75,591,587 | \$75,777,000 | \$- | \$75,777,000 | \$- |
| Advances from Federal Home Loan Bank | 17,000,000   | 17,004,000   | -   | 17,004,000   | -   |

December 31, 2013

## Financial Assets:

|                             |              |              |     |              |             |
|-----------------------------|--------------|--------------|-----|--------------|-------------|
| Securities held-to-maturity | \$36,951,934 | \$36,951,934 | \$- | \$36,951,934 | \$-         |
| Loans receivable            | 238,502,131  | 240,472,000  | -   | -            | 240,472,000 |

## Financial Liabilities:

|                                      |              |              |     |              |     |
|--------------------------------------|--------------|--------------|-----|--------------|-----|
| Certificates of deposit              | \$84,545,046 | \$85,081,000 | \$- | \$85,081,000 | \$- |
| Advances from Federal Home Loan Bank | 23,000,000   | 23,010,000   | -   | 23,010,000   | -   |

Note 12 - 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. Unrecognized 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 the date the financial statements were issued and no subsequent events occurred that require accrual or disclosure.

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

The following discussion reviews our results of operations and assesses our financial condition as of and for the periods indicated. You should read the following discussion and analysis in conjunction with the discussion of forward-looking statements and unaudited condensed consolidated financial statements as of and for the three and nine months ended September 30, 2014 and 2013 included elsewhere in this report and the audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2013.

### **Cautionary Note Regarding Forward-Looking Statements**

The statements contained in this report on Form 10-Q that are not historical facts are forward-looking statements subject to the safe harbor created by the Private Securities Litigation Reform Act of 1995. We caution readers of this report that such forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to be materially different from those expressed or implied by such forward-looking statements.

Although we believe that our expectations of future performance are based on reasonable assumptions within the bounds of our knowledge of our business and operations, there can be no assurance that actual results will not differ materially from our expectations.

These forward-looking statements involve risks and uncertainties and may not be realized due to a variety of factors, including, but not limited to the following:

- deterioration in the financial condition of borrowers resulting in significant increases in loan losses and provisions for those losses;
- changes in loan underwriting, credit review or loss reserve policies associated with economic conditions, examination conclusions, or regulatory developments;
- the failure of assumptions underlying the establishment of reserves for possible loan losses;
- changes in political and economic conditions, including the political and economic effects of the current economic downturn and other major developments, including the ongoing war on terrorism, continued tensions in the Middle



East, and the ongoing economic challenges facing the European Union;

changes in financial market conditions, either internationally, nationally or locally in areas in which the Company conducts its operations, including, without limitation, reduced rates of business formation and growth, commercial and residential real estate development, and real estate prices;

the Company's ability to comply with any requirements imposed on it or the Bank by their respective regulators, and the potential negative consequences that may result;

the impacts of renewed regulatory scrutiny on consumer protection and compliance led by the Consumer Finance Protection Bureau;

fluctuations in markets for equity, fixed-income, commercial paper and other securities, which could affect availability, market liquidity levels, and pricing;

governmental monetary and fiscal policies, including the undetermined effects of the Federal Reserve's "Quantitative Easing" program, as well as other legislative and regulatory changes;

changes in capital standards and asset risk-weighting included in promulgated rules to implement the so-called "Basel III" accords;

- increased cybersecurity risk, including potential business disruptions or financial losses;

the risks of changes in interest rates or an unprecedented period of record-low interest rates on the level and composition of deposits, loan demand and the values of loan collateral, securities and interest sensitive assets and liabilities; and

the effects of competition from other commercial banks, thrifts, mortgage banking firms, consumer finance companies, credit unions, securities brokerage firms, insurance companies, money market and other mutual funds and other financial institutions operating in our market area and elsewhere, including institutions operating regionally, nationally and internationally, together with such competitors offering banking products and services by mail, telephone and the Internet.

Forward-looking statements speak only as of the date on which they are made. We undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made to reflect the occurrence of unanticipated events.

## **Overview**

The following discussion describes our results of operation for the three and nine months ended September 30, 2014 as compared to the quarter and nine months ended September 30, 2013 and also analyzes our financial condition as of September 30, 2014 as compared to December 31, 2013.

Like most community bank holding companies, we derive the majority of our income from interest received on our loans and investments. Our primary source of funds for making these loans and investments is our deposits, on which we pay interest. Consequently, one of the key measures of our success is our amount of net interest income, or the difference between the income on our interest-earning assets, such as loans and investments, and the expense on our interest-bearing liabilities, such as deposits and borrowings. Another key measure is the spread between the yield we earn on these interest-earning assets and the rate we pay on our interest-bearing liabilities, which is called our net interest spread.

Due to risks inherent in all loans, we maintain an allowance for loan losses to absorb probable losses on existing loans that may become uncollectible. We maintain this allowance by charging a provision for loan losses against our operating earnings for each period. We have included a detailed discussion of this process, as well as several tables describing our allowance for loan losses.

In addition to earning interest on our loans and investments, we earn income through fees and other charges to our customers. We have also included a discussion of the various components of this non-interest income, as well as our non-interest expense.

The following discussion and analysis also identifies significant factors that have affected our financial position and operating results during the periods included in the accompanying financial statements. We encourage you to read this discussion and analysis in conjunction with our financial statements and the other statistical information included in our filings with the Securities and Exchange Commission (the "SEC").

## **Critical Accounting Policies**

We have adopted various accounting policies, which govern the application of accounting principles generally accepted in the United States of America in the preparation of our financial statements. Our significant accounting policies are described in the notes to the consolidated financial statements at December 31, 2013 as filed in our Annual Report on Form 10-K. Certain accounting policies involve significant judgments and assumptions we have made, which have a material impact on the carrying value of certain assets and liabilities. We consider these accounting policies to be critical accounting policies. The judgments and assumptions we use are based on the historical experience and other factors, which we believe to be reasonable under the circumstances. Because of the nature of our judgments and assumptions, actual results could differ from these judgments and estimates which could have a major impact on our carrying values of assets and liabilities and our results of operations.

We believe the allowance for loan losses is a critical accounting policy that requires the most significant judgments and estimates used in preparation of our consolidated financial statements. Refer to the portion of this discussion that addresses our allowance for loan losses for a description of our processes and methodology for determining our allowance for loan losses.

#### Regulatory Matters

Following an examination of the Bank by the FDIC during the first quarter of 2010, the Bank's Board of Directors agreed to enter into a Memorandum of Understanding (the "Bank MOU") with the FDIC and the South Carolina Board of Financial Institutions (the "SC Board"), which became effective August 19, 2010. Among other things, the Bank MOU provides for the Bank to (i) review and formulate objectives relative to liquidity and growth, including a reduction in reliance on volatile liabilities, (ii) formulate plans for the reduction and improvement in adversely classified assets, (iii) maintain a Tier 1 leverage capital ratio of 8% and continue to be "well capitalized" for regulatory purposes, (iv) continue to maintain an adequate allowance for loan and lease losses, (v) not pay any dividend to the Company without the approval of the regulators, (vi) review officer performance and consider additional staffing needs, and (vii) provide progress reports and submit various other information to the regulators.

In addition, on the basis of the same examination by the FDIC and the SC Board, the Federal Reserve requested that the Company enter into a separate Memorandum of Understanding, which the Company entered into in December 2010 (the "Company MOU"). While this agreement provides for many of the same measures suggested by the Bank MOU, the Company MOU requires that the Company seek pre-approval from the Federal Reserve prior to the declaration or payment of dividends or other interest payments relating to its securities. As a result, until the Company is no longer subject to the Company MOU, it will be required to seek regulatory approval prior to paying scheduled dividends on its preferred stock and on its trust preferred securities, including the Series A and Series B Preferred Shares. This provision will also apply to the Company's common stock, although to date, the Company has not elected to pay dividends on its shares of common stock.

The Federal Reserve approved the scheduled payment of dividends on the Company's preferred stock and interest payments on the Company's trust preferred securities for the first three quarters of 2011; however, the Federal Reserve did not approve the Company's request to pay dividends and interest payments relating to its outstanding classes of preferred stock and trust preferred securities due and payable in the fourth quarter of 2011, and such consent has not been granted thereafter, largely out of deference to the Federal Reserve's policy statement on dividends.

A policy statement published by the Board of Governors of the Federal Reserve System indicates that, as a general matter, it believes the board of directors of a bank holding company should eliminate, defer, or significantly reduce the company's dividends if:

the company's net income available to shareholders for the preceding four quarters is not sufficient to fully fund the dividends;

the prospective rate of earnings retention is not consistent with the company's capital needs and overall current and prospective financial condition; or

the company will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios.

The policy statement notes that a failure to do so could result in a supervisory finding that the organization is operating in an unsafe and unsound manner. We believe that the criteria noted above will be heavily weighted by the Federal Reserve in evaluating any future request by the Company to pay dividends on its Series A Shares and the Series B Shares and interest on its outstanding trust preferred securities. Accordingly, we do not anticipate submitting further approval requests until such time as each of the stated criteria has been met or there are other compelling reasons to believe such a request, if submitted, would be approved.

In response to these regulatory matters, the Bank and the Company have taken various actions designed to improve our lending procedures, nonperforming assets, liquidity and capital position and other conditions related to our

operations, which are more fully described in turn as part of this discussion. We believe that the successful completion of these initiatives, and the continued improvement of the local economy of the communities we serve, will result in full compliance with our regulatory obligations with the FDIC, the SC Board and the Federal Reserve and position us well for stability and growth over the long term, although we can make no assurances that our regulatory authorities will deem us to be in compliance with the regulatory directives discussed above.

### **Effect of Economic Trends**

Economic conditions, competition and federal monetary and fiscal policies also affect financial institutions. Lending activities are also influenced by regional and local economic factors, such as housing supply and demand, competition among lenders, customer preferences and levels of personal income and savings in our primary market area.

### **Results of Operations**

Our operating results for the three and nine months ended September 30, 2014 improved significantly versus the same periods of the prior year. Specifically, net income available to common shareholders was \$3,082,576, or a basic and diluted income per common share of \$0.67 and \$0.66, for the three months ended September 30, 2014, respectively, versus a net loss available to common shareholders of \$2,769,226, or a basic and diluted loss per common share of \$0.63, for the three months ended September 30, 2013. Comparing the third quarter of 2014 with the third quarter of 2013, we experienced an increase of \$5,851,802 in net income available to common shareholders. This improvement in operating results for the three months ended September 30, 2014 is attributed primarily to the reversal of \$3,437,913 of the valuation allowance related to our deferred tax assets, an increase of \$541,870 in our net interest income, a reduction of \$1,619,241 in our noninterest expenses and a reduction of \$557,912 in our provision for losses. A detailed discussion of each of these items and others affecting our operating results for the period follows.

For the nine months ended September 30, 2014, net income available to common shareholders was \$3,275,062, or a basic and diluted income per common share of \$0.72 and \$0.70, respectively, versus net loss available to common shareholders of \$3,537,664, or a basic and diluted loss per common share of \$0.84, for the nine months ended September 30, 2013. Comparing the first nine months of 2014 with the first nine months of 2013, we experienced an increase of \$6,812,726 in our net income available to common shareholders. This increase is attributed primarily to the reversal of \$3,437,913 of the valuation allowance related to our deferred tax assets, an increase of \$1,064,754 in our net interest income and a reduction of \$2,135,266 in our noninterest expenses. A detailed discussion of each of these items and others affecting our operating results for the period follows.

## Income Statement Review

### **Net Interest Income**

The largest component of our net income is net interest income, which is the difference between the income earned on assets and interest paid on deposits and on the borrowings used to support such assets. Net interest income is determined by the yields earned on our interest-earning assets and the rates paid on interest-bearing liabilities, the relative amounts of interest-earning assets and interest-bearing liabilities, and the degree of mismatch and the maturity and repricing characteristics of interest-earning assets and interest-bearing liabilities. The total interest-earning assets yield rate less the total interest-bearing liabilities rate represents our net interest rate spread.

Net interest income increased \$541,870, or 18.01%, to \$3,550,435 for the quarter ended September 30, 2014, from \$3,008,565 for the comparable period of 2013. Our net interest income for the nine months ended September 30, 2014 and 2013 was \$10,142,202 and \$9,077,448, respectively. This represents an increase of \$1,064,754, or 11.73%. The increase in both periods is attributable to our interest-bearing liabilities having declined at a higher rate than our earning assets. For the three and nine months ended September 30, 2014, compared to the comparable 2013 periods, the average volume of our interest-bearing liabilities declined 3.28% and 12.14%, respectively, while the average volume of our earning assets declined 1.75% and 8.23%, respectively. Additionally, for the 2014 periods compared to the 2013 periods, we reduced the average rate paid on our interest-bearing liabilities by 44 and 47 basis points, respectively, while we were able to increase the average rate earned on our earning assets by 22 and 37 basis points, respectively.

For the third quarter of 2014, average-earning assets totaled \$318,846,640 with an annualized average yield of 4.72% compared to \$313,365,157 and 4.50%, respectively, for the third quarter of 2013. Average interest-bearing liabilities totaled \$257,098,394 with an annualized average cost of 0.38% for third quarter of 2014 compared to \$265,812,505 and 0.82%, respectively, for the third quarter of 2013.

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Average earning assets for the nine months ended September 30, 2014 and 2013 were \$308,237,804 and \$335,896,069, respectively, with an annualized average yield of 4.79% and 4.42% respectively. Average interest-bearing liabilities totaled \$252,628,632 and \$287,544,924 with an annualized average cost of 0.48% and 0.95% for the nine months ended September 30, 2014 and 2013, respectively.

Our net interest margin and net interest spread were 4.42% and 4.34%, respectively, for the third quarter of 2014 compared to 3.81% and 3.68%, respectively, for the third quarter of 2013. For the nine months ended September 30, 2014, our net interest margin and net interest spread were 4.40% and 4.31%, respectively, compared to 3.61% and 3.47%, respectively, for the comparable period of 2013.

Because loans often provide a higher yield than other types of earning assets, one of our goals is to maintain our loan portfolio as the largest component of total earning assets. Loans comprised 77.70% and 79.33% of average earning assets for the three and nine months ended September 30, 2014, respectively, compared to 75.66% and 74.37%, respectively, for the comparable periods of 2013. Loan interest income for the three and nine months ended September 30, 2014 was \$3,461,473 and \$10,058,113, respectively, compared to \$3,246,099 and \$10,090,301, respectively, for the comparable periods of 2013. The annualized average yield on loans was 5.54% and 5.50%, respectively, for the three and nine months ended September 30, 2014 compared to 5.43% and 5.40%, respectively, for the comparable 2013 periods. For the three months ended September 30, 2014, compared to the comparable 2013 period, the average balances of our loans increased \$10,622,492, or 4.48%. For the nine months ended September 30, 2014, the average balances of our loans decreased \$5,279,116, or 2.11%. Our loan interest income for 2014 was favorably impacted by the significant reduction of our non-performing loans. For the third quarters of 2014 and 2013, the average volume of our nonaccruing loans was \$3,843,747 and \$10,537,357, respectively, a decrease of \$6,693,610, or 63.52%. For the nine months ended September 30, 2014 and 2013, the average volume of our nonaccruing loans was \$6,000,614 and \$16,208,325, respectively, a decrease of \$10,207,711, or 62.98%. Additional information may be found in the "Rate/Volume Analysis" presented below.

Available-for-sale and held-to-maturity investment securities averaged \$46,629,415, or 14.62% of average earning assets, for the third quarter of 2014 compared to \$51,708,168 or 16.50% of average earning assets for the third quarter of 2013. These securities averaged \$47,091,365 and were 15.28% of average earning assets for the nine months ended September 30, 2014, compared to \$54,372,752 and 16.19% for the nine months ended September 30, 2013. Interest earned on these securities totaled \$306,535 and \$931,938 for the three and nine months ended September 30, 2014, respectively, compared to \$289,905 and \$952,145, respectively, for the same periods in 2013. The annualized average yield on these securities was 2.61% and 2.22% for the third quarters of 2014 and 2013, respectively. The annualized average yield was 2.65% and 2.34% for the nine months ended September 30, 2014 and 2013, respectively.

Our average interest-bearing deposits were \$223,038,244 and \$239,491,852 for the third quarters of 2014 and 2013, respectively. This represents a decrease of \$16,453,608, or 6.87%. Our average interest-bearing deposits were \$218,953,973 and \$261,251,687 for the nine months ended September 30, 2014 and 2013, respectively. This represents a decrease of \$42,297,714, or 16.19%. Total interest paid on deposits for the three and nine months ended September 30, 2014 was \$179,817 and \$660,611, respectively, compared to \$425,729 and \$1,676,205 for the same periods of 2013. The annualized average cost of deposits was 0.32% and 0.70% for the three months ended September 30, 2014 and 2013, respectively. The annualized average cost of deposits was 0.40% and 0.86% for the nine months ended September 30, 2014 and 2013, respectively. As our loan demand declined, we concurrently lowered our rates paid for deposits, especially for time deposits, which is the primary reason that the amounts of our average time deposits were 22.83% and 32.99% lower during the three and nine months ended September 30, 2014, respectively, than during the comparable 2013 periods.

The average balance of other interest-bearing liabilities was \$34,060,150 and \$26,320,653 for the three months ended September 30, 2014 and 2013, respectively, an increase of \$7,739,497, or 29.40%. The average balance of other interest-bearing liabilities was \$33,674,659 and \$26,293,237 for the nine months ended September 30, 2014 and 2013, respectively, an increase of \$7,381,422, or 28.07%. The increase for both periods is primarily attributable to the increase of \$6,000,044 and \$6,275,241 in our average volume of borrowing from the Federal Home Loan Bank during the 2014 periods, respectively, which replaced our higher cost time deposits. For the three and nine months ended September 30, 2014, the annualized average cost of borrowing from the Federal Home Land Bank was 0.45% and 0.44%, respectively, while the average rate paid on time deposits was 0.76% and 0.94%, respectively.

The following table sets forth, for the period indicated, certain information related to our average balance sheet and our average yields on assets and average costs of liabilities. Such yields are derived by dividing income or expense by the average balance of the corresponding assets or liabilities. Average balances have been derived from the daily balances throughout the periods indicated.

### Three Months Ended September 30,

Average Balances, Income and Expenses, and Rates



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| (Dollars in thousands)                      | 2014            |                |            | 2013            |                |            | 2012            |                |            |
|---|-----------------|----------------|------------|-----------------|----------------|------------|-----------------|----------------|------------|
|   | Average Balance | Income/Expense | Yield/Rate | Average Balance | Income/Expense | Yield/Rate | Average Balance | Income/Expense | Yield/Rate |
| <b>Assets</b>                               |                 |                |            |                 |                |            |                 |                |            |
| <b>Earning assets:</b>                      |                 |                |            |                 |                |            |                 |                |            |
| Loans (1)                                   | \$247,728       | \$3,461        | 5.54 %     | \$237,106       | \$3,246        | 5.43 %     | \$283,909       | \$4,197        | 5.88 %     |
| Securities, taxable                         | 43,488          | 278            | 2.54       | 49,870          | 273            | 2.17       | 66,312          | 446            | 2.68       |
| Securities, nontaxable                      | 3,141           | 29             | 3.66       | 1,838           | 17             | 3.67       | 13,356          | 128            | 3.82       |
| Other earning assets                        | 24,489          | 27             | 0.44       | 24,551          | 20             | 0.32       | 33,033          | 23             | 0.28       |
| Total earning assets                        | 318,846         | 3,795          | 4.72       | 313,365         | 3,556          | 4.50       | 396,610         | 4,794          | 4.81       |
| Non-earning assets:                         | 44,824          |                |            | 56,272          |                |            | 56,829          |                |            |
| Total assets                                | \$363,670       |                |            | \$369,637       |                |            | \$453,439       |                |            |
| <b>Liabilities and Shareholders' Equity</b> |                 |                |            |                 |                |            |                 |                |            |
| <b>Interest-bearing deposits:</b>           |                 |                |            |                 |                |            |                 |                |            |
| Transaction accounts                        | \$60,279        | \$7            | 0.05 %     | \$45,633        | \$13           | 0.11 %     | \$41,409        | \$15           | 0.15 %     |
| market accounts                             | 85,523          | 25             | 0.12       | 93,776          | 36             | 0.15       | 111,986         | 73             | 0.26       |
| Time deposits                               | 77,236          | 148            | 0.76       | 100,083         | 376            | 1.49       | 168,666         | 823            | 1.94       |
| Total interest-bearing deposits             | 223,038         | 180            | 0.32       | 239,492         | 425            | 0.70       | 322,061         | 911            | 1.13       |

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| (Dollars in thousands)                   | Average Balances, Income and Expenses, and Rates |                |            |                 |                |            |                 |                |            |
|--|--|----------------|------------|-----------------|----------------|------------|-----------------|----------------|------------|
|  | 2014   |                |            | 2013            |                |            | 2012            |                |            |
|  | Average Balance                                  | Income/Expense | Yield/Rate | Average Balance | Income/Expense | Yield/Rate | Average Balance | Income/Expense | Yield/Rate |
| Other interest-bearing liabilities:      |  |                |            |                 |                |            |                 |                |            |
| Federal Home Loan Bank bank borrowing    | \$17,000   | \$19           | 0.44 %     | \$11,000        | \$64           | 2.31 %     | \$13,000        | \$68           | 2.07 %     |
| Junior subordinated debentures           | 10,310   | 45             | 1.73       | 10,310          | 57             | 2.19       | 10,310          | 61             | 2.36       |
| Other                                    | 6,750  | 1              | 0.06       | 5,011           | 1              | 0.08       | 4,691           | 1              | 0.10       |
| Total other interest-bearing liabilities | 34,060   | 65             | 0.76       | 26,321          | 122            | 1.84       | 28,001          | 130            | 1.85       |
| Total interest-bearing liabilities       | 257,098  | 245            | 0.38       | 265,813         | 547            | 0.82       | 350,062         | 1,041          | 1.18       |
| Noninterest-bearing deposits             | 69,753   |                |            | 61,920          |                |            | 57,833          |                |            |
| Other liabilities                        | 3,769  |                |            | 2,550           |                |            | 3,240           |                |            |
| Shareholders' equity                     | 33,050   |                |            | 39,354          |                |            | 42,304          |                |            |
| Total liabilities and equity             | \$363,670  |                |            | \$369,637       |                |            | \$453,439       |                |            |
| Net interest income/interest spread      |  | \$3,550        | 4.34 %     |                 | \$3,009        | 3.68 %     |                 | \$3,753        | 3.63 %     |
| Net yield on earning assets              |  |                | 4.42 %     |                 |                | 3.81 %     |                 |                | 3.76 %     |

(1) Includes mortgage loans held for sale and nonaccruing loans

**Nine Months Ended September 30,**

| (Dollars in thousands) | Average Balances, Income and Expenses, and Rates |                |            |                 |                |            |                 |                |            |
|------------------------|--|----------------|------------|-----------------|----------------|------------|-----------------|----------------|------------|
|                        | 2014   |                |            | 2013            |                |            | 2012            |                |            |
|                        | Average Balance                                  | Income/Expense | Yield/Rate | Average Balance | Income/Expense | Yield/Rate | Average Balance | Income/Expense | Yield/Rate |
| Assets                 |  |                |            |                 |                |            |                 |                |            |
| Earning assets:        |  |                |            |                 |                |            |                 |                |            |
| Loans (1)              | \$244,527  | \$10,058       | 5.50 %     | \$249,806       | \$10,090       | 5.40 %     | \$292,645       | \$12,700       | 5.80 %     |
| Securities, taxable    | 43,946   | 846            | 2.57       | 53,753          | 935            | 2.33       | 66,603          | 1,373          | 2.75       |
| Securities, nontaxable | 3,145  | 86             | 3.65       | 619             | 17             | 3.67       | 17,358          | 506            | 3.90       |
| Other earning assets   | 16,620   | 57             | 0.46       | 31,718          | 73             | 0.31       | 36,033          | 81             | 0.30       |
| Total earning assets   | 308,238  | 11,047         | 4.79       | 335,896         | 11,115         | 4.42       | 412,639         | 14,660         | 4.75       |
| Non earning assets:    | 46,986   |                |            | 55,763          |                |            | 58,709          |                |            |
| Total assets           | \$355,224  |                |            | \$391,659       |                |            | \$471,348       |                |            |

|  |           |          |        |           |         |        |           |          |        |
|--|-----------|----------|--------|-----------|---------|--------|-----------|----------|--------|
| Liabilities and Shareholders' Equity     |           |          |        |           |         |        |           |          |        |
| Interest-bearing deposits:               |           |          |        |           |         |        |           |          |        |
| Transaction accounts                     | \$53,004  | \$24     | 0.06 % | \$44,249  | \$38    | 0.11 % | \$41,966  | \$65     | 0.21 % |
| Savings and money market accounts        | 85,649    | 74       | 0.12   | 97,160    | 135     | 0.19   | 116,145   | 282      | 0.32   |
| Time deposits                            | 80,301    | 563      | 0.94   | 119,843   | 1,503   | 1.68   | 185,104   | 2,833    | 2.04   |
| Total interest-bearing deposits          | 218,954   | 661      | 0.40   | 261,252   | 1,676   | 0.86   | 343,215   | 3,180    | 1.24   |
| Other interest-bearing liabilities:      |           |          |        |           |         |        |           |          |        |
| Federal Home Loan Bank                   |           |          |        |           |         |        |           |          |        |
| Bank borrowing                           | 17,275    | 57       | 0.44   | 11,000    | 188     | 2.29   | 13,000    | 200      | 2.06   |
| Junior subordinated debentures           | 10,310    | 182      | 2.36   | 10,310    | 170     | 1.65   | 10,310    | 185      | 1.79   |
| Other                                    | 6,090     | 5        | 0.11   | 4,983     | 4       | 0.11   | 3,204     | 2        | 0.10   |
| Total other interest-bearing liabilities | 33,675    | 244      | 0.97   | 26,293    | 362     | 1.84   | 26,514    | 387      | 1.95   |
| Total interest-bearing liabilities       | 252,629   | 905      | 0.48   | 287,545   | 2,038   | 0.95   | 369,729   | 3,567    | 1.29   |
| Noninterest-bearing deposits             | 66,628    |          |        | 61,433    |         |        | 56,774    |          |        |
| Other liabilities                        | 3,371     |          |        | 2,318     |         |        | 2,974     |          |        |
| Shareholders' equity                     | 32,596    |          |        | 40,363    |         |        | 41,871    |          |        |
| Total liabilities and equity             | \$355,224 |          |        | \$391,659 |         |        | \$471,348 |          |        |
| Net interest income/interest spread      |           | \$10,142 | 4.31 % |           | \$9,077 | 3.47 % |           | \$11,093 | 3.46 % |
| Net yield on earning assets              |           |          | 4.40 % |           |         | 3.61 % |           |          | 3.59 % |

(1) Includes mortgage loans held for sale and nonaccruing loans

Net interest income can be analyzed in terms of the impact of changing interest rates and changing volume. The following tables set forth the effect which the varying levels of interest-earning assets and interest-bearing liabilities and the applicable rates have had on changes in net interest income for the periods presented.

Three Months Ended September 30,

| (Dollars in thousands)                    | 2014 Compared to<br>2013         |        |        | 2013 Compared to 2012            |         |          |
|---|----------------------------------|--------|--------|----------------------------------|---------|----------|
|   | Due to increase<br>(decrease) in |        |        | Due to increase<br>(decrease) in |         |          |
|   | Volume                           | Rate   | Total  | Volume                           | Rate    | Total    |
| <b>Interest income:</b>                   |                                  |        |        |                                  |         |          |
| Loan                                      | \$ 157                           | \$ 58  | \$ 215 | \$(650)                          | \$(301) | \$(951 ) |
| Securities, taxable                       | (37 )                            | 42     | 5      | (98 )                            | (75 )   | (173 )   |
| Securities, tax exempt                    | 12                               | -      | 12     | (106)                            | (5 )    | (111 )   |
| Other earning assets                      | -                                | 7      | 7      | (6 )                             | 3       | (3 )     |
| Total interest income                     | 132                              | 107    | 239    | (860)                            | (378)   | (1,238)  |
| <b>Interest expense:</b>                  |                                  |        |        |                                  |         |          |
| <b>Interest-bearing deposits</b>          |                                  |        |        |                                  |         |          |
| Interest-bearing transaction accounts     | 3                                | (9 )   | (6 )   | 1                                | (3 )    | (2 )     |
| Savings and money market accounts         | (3 )                             | (8 )   | (11 )  | (10 )                            | (27 )   | (37 )    |
| Time deposits                             | (73 )                            | (155)  | (228)  | (285)                            | (162)   | (447 )   |
| Total interest-bearing deposits           | (73 )                            | (172)  | (245)  | (294)                            | (192)   | (486 )   |
| <b>Other interest-bearing liabilities</b> |                                  |        |        |                                  |         |          |
| Federal Home Loan Bank borrowings         | 24                               | (69 )  | (45 )  | (11 )                            | 7       | (4 )     |
| Junior subordinated debentures            | -                                | (12 )  | (12 )  | -                                | (4 )    | (4 )     |
| Other                                     | -                                | -      | -      | -                                | -       | -        |
| Total other interest-bearing liabilities  | 24                               | (81 )  | (57 )  | (11 )                            | 3       | (8 )     |
| Total interest expense                    | (49 )                            | (253)  | (302)  | (305)                            | (189)   | (494 )   |
| Net interest income                       | \$ 181                           | \$ 360 | \$ 541 | \$(555)                          | \$(189) | \$(744 ) |

Nine months ended September 30,

| (Dollars in thousands)   | 2014 Compared to 2013         |        |         | 2013 Compared to 2012         |          |            |
|--------------------------|-------------------------------|--------|---------|-------------------------------|----------|------------|
|                          | Due to increase (decrease) in |        |         | Due to increase (decrease) in |          |            |
|                          | Volume                        | Rate   | Total   | Volume                        | Rate     | Total      |
| <b>Interest income:</b>  |                               |        |         |                               |          |            |
| Loans                    | \$(216 )                      | \$ 184 | \$(32 ) | \$(1,774 )                    | \$(836 ) | \$(2,610 ) |
| Securities, taxable      | (180 )                        | 91     | (89 )   | (244 )                        | (194 )   | (438 )     |
| Securities, tax exempt   | -                             | 69     | 69      | (461 )                        | (28 )    | (489 )     |
| Other earning assets     | (43 )                         | 27     | (16 )   | (11 )                         | 3        | (8 )       |
| Total interest income    | (439 )                        | 371    | (68 )   | (2,490)                       | (1,055)  | (3,545)    |
| <b>Interest expense:</b> |                               |        |         |                               |          |            |

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|  |          |          |          |             |           |             |
|--|----------|----------|----------|-------------|-----------|-------------|
| Interest-bearing transaction accounts    | 6        | (20 )    | (14 )    | 4           | (31 )     | (27 )       |
| Savings and money market accounts        | (15 )    | (46 )    | (61 )    | (42 )       | (105 )    | (147 )      |
| Time deposits                            | (403 )   | (537 )   | (940 )   | (887 )      | (443 )    | (1,330 )    |
| Total interest-bearing deposits          | (412 )   | (603 )   | (1,015 ) | (925 )      | (579 )    | (1,504 )    |
| Other interest-bearing liabilities       |          |          |          |             |           |             |
| Federal Home Loan Bank borrowings        | 71       | (202 )   | (131 )   | (33 )       | 21        | (12 )       |
| Junior subordinated debentures           | -        | 12       | 12       | -           | (15 )     | (15 )       |
| Other                                    | 1        | 0        | 1        | 1           | 1         | 2           |
| Total other interest-bearing liabilities | 72       | (190 )   | (118 )   | (32 )       | 7         | (25 )       |
| Total interest expense                   | (340 )   | (793 )   | (1,133 ) | (957 )      | (572 )    | (1,529 )    |
| Net interest income                      | \$ (99 ) | \$ 1,164 | \$ 1,065 | \$ (1,533 ) | \$ (483 ) | \$ (2,016 ) |

-30-

## **Provision and Allowance for Loan Losses**

We have developed policies and procedures for evaluating the overall quality of our credit portfolio and the timely identification of potential problem credits. On a quarterly basis, our Board of Directors reviews and approves the appropriate level for the allowance for loan losses based upon management's recommendations, the results of our internal monitoring and reporting system, and an analysis of economic conditions in our market. The objective of management has been to fund the allowance for loan losses at a level greater than or equal to our internal risk measurement system for loan risk.

Additions to the allowance for loan losses, which are expensed as the provision for loan losses on our statement of operations, are made periodically to maintain the allowance at an appropriate level based on management's analysis of the potential risk in the loan portfolio. Loan losses and recoveries are charged or credited directly to the allowance. The amount of the provision is a function of the level of loans outstanding, the level of nonperforming loans, historical loan loss experience, the amount of loan losses actually charged against the reserve during a given period, and current and anticipated economic conditions.

The allowance represents an amount which management believes will be adequate to absorb inherent losses on existing loans that may become uncollectible. Our judgment as to the adequacy of the allowance for loan losses is based on a number of assumptions about future events, which we believe to be reasonable, but which may or may not prove to be accurate. Our determination of the allowance for loan losses is based on regular evaluations of the collectability of loans, including consideration of factors such as the balance of impaired loans, the quality, mix, and size of our overall loan portfolio, economic conditions that may affect the borrower's ability to repay, the amount and quality of collateral securing the loans, our historical loan loss experience, and a review of specific problem loans. We also consider subjective issues such as changes in our lending policies and procedures, changes in the local and national economy, changes in volume or type of credits, changes in the volume or severity of problem loans, quality of loan review and board of director oversight, concentrations of credit, and peer group comparisons.

More specifically, in determining our allowance for loan losses, we regularly review loans for specific and impaired reserves based on the appropriate impairment assessment methodology. Pooled reserves are determined using historical loss trends measured over a four-quarter average applied to risk rated loans grouped by Federal Financial Institutions Examination Council ("FFIEC") call code and segmented by impairment status. The pooled reserves are calculated by applying the appropriate historical loss ratio to the loan categories. Impaired loans greater than a minimum threshold established by management are excluded from this analysis. The sum of all such amounts determines our pooled reserves. In line with our peer group, we review historical losses over four quarters, which results in a provision estimate responsive to current economic conditions. The historical loss factors utilized in our model have been updated as of the end of the third quarter 2014 to reflect losses realized through the end of second quarter 2014.

As we mention above, we track our portfolio and analyze loans grouped by FFIEC call code categories. The first step in this process is to risk grade each loan in the portfolio based on one common set of parameters. These parameters include items like debt-to-worth ratio, liquidity of the borrower, net worth, experience in a particular field and other factors such as underwriting exceptions. Weight is also given to the relative strength of any guarantors on the loan.

After risk grading each loan, we then segment the portfolio by FFIEC call code groupings, separating out substandard and impaired loans. The remaining loans are grouped into “performing loan pools.” The loss history for each performing loan pool is measured over a specific period of time to create a loss factor. The relevant look back period is determined by management, regulatory guidance, and current market events. The loss factor is then applied to the pool balance and the reserve per pool calculated. Loans deemed to be substandard but not impaired are segregated and a loss factor is applied to this pool as well. Loans are segmented based upon sizes as smaller impaired loans are pooled and a loss factor applied, while larger impaired loans are assessed individually using the appropriate impairment measuring methodology. Finally, five qualitative factors are utilized to assess economic and other trends not currently reflected in the loss history. These factors include concentration of credit across the portfolio, the experience level of management and staff, effects of changes in risk selection and underwriting practice, industry conditions and the current economic and business environment. A quantitative value is assigned to each of the five factors, which is then applied to the performing loan pools. Negative trends in the loan portfolio increase the quantitative values assigned to each of the qualitative factors and, therefore, increase the reserve. For example, as general economic and business conditions decline, this qualitative factor’s quantitative value will increase, which will increase the reserve requirement for this factor. Similarly, positive trends in the loan portfolio, such as improvement in general economic and business conditions, will decrease the quantitative value assigned to this qualitative factor, thereby decreasing the reserve requirement for this factor. These factors are reviewed and updated by our management committee on a regular basis to arrive at a consensus for our qualitative adjustments.

Periodically, we adjust the amount of the allowance based on changing circumstances. We recognize loan losses to the allowance and add subsequent recoveries back to the allowance for loan losses. In addition, on a quarterly basis, we informally compare our allowance for loan losses to various peer institutions; however, we recognize that allowances will vary, as financial institutions are unique in the make-up of their loan portfolios and customers, which necessarily creates different risk profiles and risk weighting of qualitative factors for the institutions. We would only consider further adjustments to our allowance for loan losses based on this peer review if our allowance was significantly different from our peer group. To date, we have not made any such adjustment. There can be no assurance that charge-offs of loans in future periods will not exceed the allowance for loan losses as estimated at any point in time or that provisions for loan losses will not be significant to a particular accounting period, especially considering the overall economic weakness in many of our market areas due to a slow recovery from the recent downturn.

Various regulatory agencies review our allowance for loan losses through their periodic examinations, and they may require additions to the allowance for loan losses based on their judgment and assumptions about the economic condition of our market and the loan portfolio at the time of their examinations. Our losses will undoubtedly vary from our estimates, and it is possible that charge-offs in future periods will exceed the allowance for loan losses as estimated at any point in time.

As of September 30, 2014 and 2013, the allowance for loan losses was \$2,900,341 and \$2,899,368, respectively. As a percentage of total loans, the allowance for loan losses was 1.15% and 1.25% at September 30, 2014 and 2013, respectively. The decrease in the allowance ratio is reflective of the significant reductions in practically all categories of our problem loans. See the discussion regarding the provision expense and “Activity in the Allowance for Loan Losses” below for additional information regarding our asset quality and loan portfolio.

Our provision for loan losses was \$51,896 and \$609,808 for the third quarters of 2014 and 2013, respectively, a decrease of \$557,912. For the nine months ended September 30, 2014 and 2013, our provision for loan losses was \$97,826 and \$609,808, respectively, a decrease of \$511,982. Our analysis of the allowance for loan losses as of September 30, 2014, revealed that our overall loss rates have been stabilizing over the past several allowance calculations and that our credit exposure is phasing out in the Myrtle Beach market and the Charleston market, which were particularly hard-hit by the downturn in real estate markets. Additionally, the minimal provisions we recorded for the three and nine months ended September 30, 2014, are reflective of the reduction in our non-performing loans, declining delinquencies, and the reduction in the percentage of classified loans.

We believe the allowance for loan losses at September 30, 2014, is adequate to meet potential loan losses inherent in the loan portfolio and, as described earlier, to maintain the flexibility to adjust the allowance should our local economy and loan portfolio either improve or decline in the future.

Noninterest Income



For the three months ended September 30, 2014, noninterest income decreased \$15,005, or 1.27% compared to same period of 2013. For the nine months ended September 30, 2014, noninterest income decreased \$107,640, or 3.15%, compared to the same period of 2013. Noninterest income was \$1,165,575 and \$3,306,955 for the three and nine months ended September 30, 2014, respectively, compared to \$1,180,580 and \$3,414,595 for the comparable 2013 periods, respectively.

### **Noninterest Expense**

For the quarter ended September 30, 2014, noninterest expense totaled \$4,429,997, which is \$1,619,241, or 26.77%, lower than our noninterest expense for the quarter ended September 30, 2013. For the nine months ended September 30, 2014 and 2013, noninterest expense totaled \$12,398,525 and \$14,533,791, respectively, a decrease of \$2,135,266, or 14.69%.

The expense for salaries and benefits was \$1,741,970 and \$1,939,545 for the third quarters of 2014 and 2013, respectively, and \$5,395,856 and \$5,845,209 for the nine months ended September 30, 2014 and 2013, respectively. By improving operating efficiencies, we reduced the expense for this category by \$197,575, or 10.19%, and \$449,353, or 7.69%, for the three and nine months ended September 30, 2014, respectively.

Furniture and equipment expense for the third quarters of 2014 and 2013 was \$371,530 and \$435,846, respectively, a decrease of \$64,316. For the first nine months of 2014 and 2013, furniture and equipment expense was \$1,178,101 and \$908,688, respectively, an increase of \$269,413. The increase for the nine months ended September 30, 2014, is related to data processing insurance refunds received during the nine months ended September 30, 2013, for prior year service interruptions and lost income.

Other operating expenses decreased \$1,339,567 and \$1,957,177 for the three and nine months ended September 30, 2014, compared to the same periods of 2013, respectively. For the three months ended September 30, 2014 and 2013, other operating expenses were \$1,943,925 and \$3,283,492, respectively. For the nine months ended September 30, 2014 and 2013, they were \$4,699,215 and \$6,656,392, respectively. The decrease in both periods is primarily attributable to the following;

A significant reduction of our OREO expenses. Expenses related to OREO include maintenance costs, marketing costs, property taxes, and other professional services. Due to the significant reduction in the volume of our OREO since September 30, 2013, expenses relating to these items were \$1,698,769 and \$2,248,555 lower for the three and nine months ended September 30, 2014, respectively. Additionally, the reduction in our OREO expenses is partially attributable to the net gain/loss recognized on the sale of OREO properties that are included in OREO expenses. For the three and nine months ended September 30, 2014, we realized a net gain of \$19,000 and \$135,094, respectively, while for the comparable 2013 periods, we realized a net loss of \$88,024 and \$331,626, respectively.

During the third quarter of 2014 we recognized an impairment loss of \$430,000 on land being held for future facilities expansion. The bank elected not to expand facilities at this location. In August of 2014 we entered into a contract, which expires on December, 31, 2014, to sell this land for approximately \$3,570,000, net of closing costs.<sup>2</sup> The carrying value of the land is approximately \$4,000,000. The contract is pending subject to purchaser's determination of the suitability of the land. Under the contract, the purchaser has the right, in his sole discretion, to determine whether the land is suitable for the purpose intended.

## **Income Taxes**

The income tax benefit of \$3,211,069 for both the three and nine months ended September 30, 2014, consists of currently payable income taxes of \$226,844, less the increase of \$3,437,913 in our net deferred tax assets. The income tax benefit related to our pretax loss for the three and nine months ended September 30, 2013 was offset by the increase of an equal amount in the valuation allowance related to our net deferred tax assets. As of September 30, 2014, we have net deferred tax assets from operations of \$10,670,214 with a valuation allowance of \$7,232,301. We have partially reversed the valuation allowance related to our deferred tax asset. The valuation allowance was established based on our analysis of the continued losses incurred by us and likelihood of recovery of those assets. As we have been demonstrating positive earnings, we have concluded that a portion of those assets are likely to be recovered and, as a result, a portion of the valuation allowance has been reversed, creating earnings in the prior quarters. If we continue to generate positive earnings, additional portions of the valuation allowance will be reversed which would positively impact income in future periods.

## **Balance Sheet Review**

## **General**

At September 30, 2014, we had total assets of \$367.8 million, consisting principally of \$252.1 million in loans, \$47.3 million in investment securities, and \$24.6 million in cash and due from banks. Our liabilities at September 30, 2014, totaled \$331.7 million, which consisted principally of \$292.3 million in deposits, \$17.0 million in FHLB advances, and \$17.9 million in other borrowings. At September 30, 2014, our shareholders' equity was \$36.1 million.

At December 31, 2013, we had total assets of \$355.4 million, consisting principally of \$230.5 million in loans, \$50.7 million in investment securities, and \$18.2 million in cash and due from banks. Our liabilities at December 31, 2013 totaled \$323.3 million, consisting principally of \$282.4 million in deposits, \$23.0 million in FHLB advances, and \$15.2 million in other borrowings. At December 31, 2013, our shareholders' equity was \$32.1 million

### **Investment Securities**

The investment securities portfolio, which is also a component of our total earning assets, consists of securities available-for-sale, securities held-to-maturity and nonmarketable equity securities.

**Securities Available-for-Sale** - At September 30, 2014, our investment in available-for-sale securities was \$13,537,545. This is \$1,392,702, or 11.47%, higher than our investment of \$12,144,843 in available-for-sale securities at December 31, 2013. These securities are carried at their estimated fair value.

**Securities Held-to-Maturity** - At September 30, 2014 and December 31, 2013, securities held-to-maturity were \$32,626,235 and \$36,951,934, respectively, a decrease of \$4,325,699, or 11.71%. These securities are carried at amortized cost, including the net unrealized gain in available-for-sale-securities that were reclassified as held-to-maturity on December 31, 2013. The net unrealized gain is being amortized to other comprehensive income over the life of the underlying securities. The net unrealized gain included in the amortized cost at September 30, 2014 and December 31, 2013, was \$185,859 and \$237,797, respectively. We intend to hold these securities to maturity and have the ability to do so.

The amortized costs and the estimated fair value of our securities available-for-sale and held-to-maturities at September 30, 2014 and December 31, 2013 are shown in the following tables.

#### Available-for-Sale

|                            | September 30, 2014 |              | December 31, 2013 |              |
|----------------------------|--------------------|--------------|-------------------|--------------|
|                            | Amortized          | Estimated    | Amortized         | Estimated    |
|                            | Cost               | Fair Value   | Cost              | Fair Value   |
| Mortgage-backed securities | \$10,711,904       | \$10,676,775 | \$9,277,577       | \$9,318,633  |
| Corporate bonds            | 2,782,832          | 2,830,770    | 2,765,950         | 2,796,210    |
| Equity security            | 30,000             | 30,000       | 30,000            | 30,000       |
| Total                      | \$13,524,736       | \$13,537,545 | \$12,073,527      | \$12,144,843 |

#### Held-to-Maturity

|  | September 30, 2014 |              | December 31, 2013 |              |
|--|--------------------|--------------|-------------------|--------------|
|  | Amortized          | Estimated    | Amortized         | Estimated    |
|  | Cost               | Fair Value   | Cost              | Fair Value   |
| Government sponsored enterprises   | \$6,464,681        | \$6,571,780  | \$7,146,409       | \$7,070,985  |
| Mortgage-backed securities   | 22,822,497         | 23,324,502   | 26,404,573        | 26,731,341   |
| Municipals   | 3,153,198          | 3,351,411    | 3,163,155         | 3,149,608    |
| Total  |                    | \$33,247,693 | 36,714,137        | \$36,951,934 |
| Capitalization of net unrealized gains on securities transferred from available-for-sale | 185,859            |              | 237,797           |              |
| Total  | \$32,626,235       |              |                   | \$36,951,934 |

At September 30, 2014, four securities classified as available-for-sale and three securities classified as held-to-maturity were in a loss position as detailed in the preceding tables. We do not intend to sell these securities in the near future and it is more likely than not that we will not be required to sell these securities before recovery of their amortized cost. We believe 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.

#### Distribution and Yields

Contractual maturities and yields on our securities available-for-sale and held-to-maturity at September 30, 2014 are shown in the following tables. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities are presented separately, maturities of which are based on expected maturities since paydowns are expected to occur before contractual maturity dates.

**Available-for-Sale (1)**

|                        | Due after 5 years<br>but within 10 years |        |
|------------------------|--|--------|
| (Dollars in thousands) | Amount                                   | Yield  |
| Corporate bonds        | \$ 2,831                                 | 0.53 % |

(1) Excludes mortgage-backed securities totaling \$10,676,775 with a yield of 2.72% and an equity security in the amount \$30,000.

**Held-to-Maturity (2)**

|                                    | Due after<br>ten years |        |
|------------------------------------|------------------------|--------|
| (Dollars in thousands)             | Amount                 | Yield  |
| U.S. Government sponsored agencies | \$6,408                | 3.24 % |
| Municipals                         | 3,140                  | 4.20 % |
| Total                              | \$9,548                | 3.54 % |

(2) Excludes mortgage-backed securities totaling \$23,078,098 with a yield of 3.18%.

**Nonmarketable Equity Securities** – Nonmarketable equity securities are recorded at their original cost since no ready market exists for these securities. At September 30, 2014 and December 31, 2013, nonmarketable equity securities consisted of Federal Home Loan Bank and Community Bankers Bank stock, which are recorded at their original cost of \$1,084,400 and \$58,100, respectively and \$1,536,800 and \$58,100, respectively. These securities are held primarily as a pre-requisite for accessing liquidity sources provided by the issuers of these securities.

## Loans

Loans, including loans held for sale, are our largest category of earning assets and typically provide higher yields than our other types of earning assets. Associated with the higher loan yields are the inherent credit and liquidity risks that we attempt to control and anticipate. Loans averaged \$244,526,442 during the nine months ended September 30, 2014 compared to \$249,805,558 during the nine months ended September 30, 2013, a decrease of \$5,279,119 or 2.11%. From September 30, 2013 to September 30, 2014, we charged off loans totaling approximately \$639,000 and foreclosed on loans totaling approximately \$860,000, and the loan balances were transferred to other real estate owned. The remainder of this decrease was the result of the economic downturn in our markets and worldwide deleveraging that caused the volume of new loan customers and average loan balances carried by current customers to decrease. At September 30, 2014, total loans were \$254,658,869 compared to \$240,750,383 at December 31, 2013, an increase of \$13,908,486, or 5.78%. Excluding loans held for sale, loans were \$252,090,858 at September 30, 2014, compared to \$238,502,131 at December 31, 2013, which equated to an increase of \$13,588,727, or 5.70%. This increase is mainly attributable to the rise of \$10,686,717, or 91.14% in our consumer loans. During the latter part of 2013, we implemented several new marketing programs designed to increase consumer borrowings, particularly with respect to automobile loans.

The following table summarizes the composition of our loan portfolio at September 30, 2014 and December 31, 2013.

|                               | September 30,<br>2014 | % of<br>Total | December 31,<br>2013 | % of<br>Total |
|-------------------------------|-----------------------|---------------|----------------------|---------------|
| Mortgage loans on real estate |                       |               |                      |               |
| Construction                  | \$ 27,288,184         | 10.82         | \$ 24,175,347        | 10.14         |
| Residential 1-4 family        | 39,921,811            | 15.84         | 35,873,036           | 15.04         |
| Multifamily                   | 3,696,152             | 1.47          | 4,312,057            | 1.81          |
| Second mortgages              | 4,430,141             | 1.76          | 4,245,778            | 1.78          |
| Equity lines of credit        | 20,801,799            | 8.25          | 21,270,126           | 8.92          |
| Total residential             | 68,849,903            | 27.32         | 65,700,997           | 27.55         |
| Nonresidential                | 102,306,351           | 40.58         | 104,378,485          | 43.76         |
| Total real estate loans       | 198,444,438           | 78.72         | 194,254,829          | 81.45         |
| Commercial and industrial     | 31,067,012            | 12.32         | 32,486,848           | 13.62         |
| Consumer                      | 22,412,036            | 8.89          | 11,725,319           | 4.92          |
| Other, net                    | 167,372               | 0.07          | 35,135               | 0.01          |
| Total loans                   | \$ 252,090,858        | 100.00        | \$ 238,502,131       | 100.00        |

In the context of this discussion, a “real estate mortgage loan” is defined as any loan, other than a loan for construction purposes, secured by real estate, regardless of the purpose of the loan. It is common practice for financial institutions in our market area to obtain a mortgage on the borrower’s real estate when possible, in addition to any other available collateral. This real estate collateral is taken as security to reinforce the likelihood of the ultimate repayment of the loan and tends to increase management’s willingness to make real estate loans and, to that extent, also tends to increase the magnitude of the real estate loan portfolio component.

The largest component of our loan portfolio is real estate mortgage loans. At September 30, 2014, real estate mortgage loans totaled \$198,444,438 and represented 78.72% of the total loan portfolio, compared to \$194,254,829, or 81.45%, at December 31, 2013. This represents an increase of \$4,189,609, or 2.16%, from the December 31, 2013 balance.

Residential mortgage loans totaled \$68,849,903 at September 30, 2014, and represented 27.32% of the total loan portfolio, compared to \$65,700,997 and 27.55%, respectively, at December 31, 2013. This represents an increase of \$3,148,906, or 4.79%, from the December 31, 2013 balance. Residential real estate loans consist of first and second mortgages on single or multi-family residential dwellings.

Nonresidential mortgage loans, which include commercial loans and other loans secured by multi-family properties and farmland, totaled \$102,306,351 at September 30, 2014, compared to \$104,378,485 at December 31, 2013. This represents a decline of \$2,072,134, or 1.99%, from the December 31, 2013 balance. These loans represented 40.58% and 43.76% of the total loans at September 30, 2014 and December 31, 2013, respectively.

Real estate construction loans were \$27,288,184 and \$24,175,347 at September 30, 2014 and December 31, 2013, respectively, and represented 10.82% and 10.14% of the total loan portfolio, respectively. From December 31, 2013 to September 30, 2014, these loans increased \$3,112,837, or 12.88%.

Currently, the demand for real estate loans in our market area is still relatively weak, largely because of a slow recovery from the recent recession that affected many businesses and individuals in our market area. However, over the past several quarters we have experienced an increase in the demand for real estate loans.

Commercial and industrial loans decreased \$1,419,836, or 4.37%, to \$31,067,012 at September 30, 2014, from \$32,486,848 at December 31, 2013. At September 30, 2014 and December 31, 2013, commercial and industrial loans represented 12.32% and 13.62%, respectively, of the total loan portfolio.

Our loan portfolio is also comprised of consumer loans that totaled \$22,412,036 and \$11,725,319 at September 30, 2014 and December 31, 2013, respectively, and represented 8.89% and 4.92%, respectively, of the total loan portfolio. From December 31, 2013 to September 30, 2014, our consumer loans have increased by \$10,686,717 mainly related to the increase in automobile loans with the implementation of several marketing programs designed to increase consumer borrowings.

Our loan portfolio reflects the diversity of our markets. The economies of our markets contain elements of medium and light manufacturing, higher education, regional health care, and distribution facilities. We expect our local economy to remain stable; however, due to the slow economic recovery in some of our markets, we do not expect any material growth in our loan portfolio in the near future. We do not engage in foreign lending.

### **Maturities and Sensitivity of Loans to Changes in Interest Rates**

The information in the following tables is based on the contractual maturities of individual loans, including loans, which may be subject to renewal at their contractual maturity. Renewal of such loans is subject to review and credit approval, as well as modification of terms upon maturity. Actual repayments of loans may differ from the maturities reflected below because borrowers have the right to prepay obligations with or without prepayment penalties.

### **Loan Maturity Schedule and Sensitivity to Changes in Interest Rates**



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The following table summarizes the loan maturity distribution by collateral type and related interest rate characteristics at September 30, 2014.

| (Dollars in thousands)              | One Year or<br>Less | Over<br>One Year<br>Through<br>Five Years | Over Five<br>Years | Total      |
|-------------------------------------|---------------------|---|--------------------|------------|
| Real estate                         | \$ 38,986           | \$ 123,942                                | \$ 35,516          | \$ 198,444 |
| Commercial and industrial           | 15,196              | 15,245                                    | 626                | 31,067     |
| Consumer and other                  | 2,125               | 9,867                                     | 10,588             | 22,580     |
|                                     | \$ 56,307           | \$ 149,054                                | \$ 46,730          | \$ 252,091 |
| Loans maturing after one year with: |                     |   |                    |            |
| Fixed interest rates                |                     |   |                    | \$ 148,036 |
| Floating interest rates             |                     |   |                    | 47,748     |
|                                     |                     |   |                    | \$ 195,784 |

**Allowance for Loan Losses**

The following table summarizes the allocation of the allowance for loan losses at September 30, 2014 and December 31, 2013.

| (Dollars in thousands)    | September 30,<br>2014 | % of<br>Total | December 31,<br>2013 | % of<br>Total |
|---------------------------|-----------------------|---------------|----------------------|---------------|
| Real estate loans         |                       |               |                      |               |
| Construction              | \$ 134                | 4.62          | % \$ 303             | 10.47         |
| Residential               | 1,358                 | 46.83         | 1,043                | 36.04         |
| Nonresidential            | 1,024                 | 35.31         | 1,382                | 47.75         |
| Total real estate loans   | 2,516                 | 86.76         | 2,728                | 94.26         |
| Commercial and industrial | 8                     | 0.28          | 65                   | 2.25          |
| Consumer and other        | 376                   | 12.96         | 101                  | 3.49          |
| Total loans               | \$ 2,900              | 100.00%       | \$ 2,894             | 100.00%       |

**Activity in the Allowance for Loan Losses**

The following table summarizes the activity related to our allowance for loan losses for the nine months ended September 30, 2014 and 2013.

| (Dollars in thousands)                         | Nine months ended<br>September 30, |           |
|--|------------------------------------|-----------|
|  | 2014                               | 2013      |
| Balance, January 1                             | \$2,894                            | \$4,167   |
| Loans charged off:                             |                                    |           |
| Real estate – Construction                     | 6                                  | 249       |
| Real estate – Residential                      | 305                                | 981       |
| Real estate – Nonresidential                   | 224                                | 914       |
| Commercial and industrial                      | 5                                  | 92        |
| Consumer and other                             | 35                                 | 38        |
| Total loan losses                              | 575                                | 2,274     |
| Recoveries of previous loan losses:            |                                    |           |
| Real estate – Construction                     | \$147                              | \$123     |
| Real estate – Residential                      | 25                                 | 174       |
| Real estate – Nonresidential                   | 247                                | 18        |
| Commercial and industrial                      | 57                                 | 69        |
| Consumer and other                             | 7                                  | 12        |
| Total recoveries                               | 483                                | 396       |
| Net charge-offs                                | (92 )                              | (1,878 )  |
| Provision for loan losses                      | 98                                 | 610       |
| Balance, September 30                          | \$2,900                            | \$2,899   |
| Total loans outstanding, end of period         | \$252,091                          | \$231,093 |
| Allowance for loan losses to loans outstanding | 1.15 %                             | 1.25 %    |

**Risk Elements in the Loan Portfolio**

The following table shows the nonperforming assets at September 30, 2014 and 2013.

| (Dollars in thousands)                         | September 30, |      |
|--|---------------|------|
|  | 2014          | 2013 |
| Loans over 90 days past due and still accruing | \$-           | \$-  |

Loans on nonaccrual:

|                              |         |          |
|------------------------------|---------|----------|
| Real estate – Construction   | -       | 554      |
| Real estate – Residential    | 1,469   | 1,696    |
| Real estate – Nonresidential | 545     | 5,168    |
| Commercial and industrial    | 6       | 1,432    |
| Consumer and other           | 26      | 77       |
| Total nonaccrual loans       | 2,046   | 8,927    |
| Total of nonperforming loans | 2,046   | 8,927    |
| Other nonperforming assets   | 2,009   | 13,914   |
| Total nonperforming assets   | \$4,055 | \$22,841 |

Percentage of:

|  |        |   |       |   |
|--|--------|---|-------|---|
| Nonperforming assets to total assets                 | 1.10   | % | 6.31  | % |
| Nonperforming loans to total loans                   | 0.81   | % | 3.86  | % |
| Nonperforming loans to the allowance for loan losses | 141.74 | % | 32.47 | % |

***Loans over 90 days past due and still accruing*** – As of September 30, 2014 and 2013, there were no loans past due 90 days or more.

**Nonaccruing loans** – At September 30, 2014 and 2013, loans totaling \$2,046,452 and \$8,926,687, respectively, were in nonaccrual status. The improvement in nonaccrual loans was due primarily to charge-offs and foreclosures. Generally, loans are placed on nonaccrual status if principal or interest payments become 90 days past due and/or we deem the collectibility of the principal and/or interest to be doubtful. Once a loan is placed in nonaccrual status, all previously accrued and uncollected interest is reversed against interest income. Interest income on nonaccrual loans is recognized on a cash basis when the ultimate collectability is no longer considered doubtful. Loans are returned to accrual status when the principal and interest amounts contractually due are brought current and future payments are reasonably assured. For the nine months ended September 30, 2014 and 2013, interest income recognized on nonaccrual loans was \$61,039 and \$478,475, respectively. If the nonaccrual loans had been accruing interest at their original contracted rates, related income would have been \$81,378 and \$654,639 for the nine months ended September 30, 2014 and 2013, respectively. All nonaccruing loans at September 30, 2014 and 2013 were included in our classification of impaired loans at those dates.

**Restructured loans** - In situations where, for economic or legal reasons related to a borrower's financial difficulties, a concession to the borrower is granted that we would not otherwise consider, the related loan is classified as a TDR. The restructuring of a loan may include the transfer of real estate collateral, either through the pledge of additional properties by the borrower or through a transfer to the Bank in lieu of foreclosures. Restructured loans may also include the borrower transferring to the Bank receivables from third parties, other assets, or an equity interest in the borrower in full or partial satisfaction of the loan, a modification of the loan terms, or a combination of the above.

At September 30, 2014 there were 26 loans classified as a TDR totaling \$9,190,315. Of the 26 loans, 18 loans totaling \$8,682,945 were performing while eight loans totaling \$507,370 were not performing. At September 30, 2013 there were 29 loans classified as TDRs totaling \$7,341,485. Of the 29 loans, 15 loans totaling \$3,501,541 were performing while 14 loans totaling \$3,839,944 were not performing. All restructured loans resulted in either extended maturity or lowered rates and were included in the impaired loan balance.

**Impaired loans** - At September 30, 2014, we had impaired loans totaling \$14,626,341, as compared to \$14,794,928 at September 30, 2013. Impaired loans, as a percentage of total loans, were 5.80% at September 30, 2014 as compared 6.40% at September 30, 2013. Included in the impaired loans at September 30, 2014 and 2013 are performing TDRs loans totaling \$8,682,945 and \$3,501,541, respectively. At September 30, 2014, there were eight borrowers that accounted for approximately 76.10% of the total amount of the impaired loans at that date. These loans were primarily commercial real estate loans located in the following South Carolina areas: 10% in the Coastal area, 33% in the Columbia area and 57% in the Florence area.

During the first nine months of 2014, the average investment in impaired loans was approximately \$14,993,000 as compared to \$21,140,000 during the first nine months of 2013. Impaired loans with a specific allocation of the allowance for loan losses totaled approximately \$4,233,000 and \$5,123,000 at September 30, 2014 and 2013, respectively. The amount of the specific allocation at September 30, 2014 and 2013 was \$404,260 and \$280,295, respectively.

The downturn in the real estate market since 2008 has resulted in an increase in loan delinquencies, defaults and foreclosures. While we believe these trends are stabilizing as the liquidation prices for our OREO has stabilized for vertical construction, indicating some stabilization of demand for that product, in some cases the current economic downturn has resulted in a significant impairment to the value of our collateral and limits our ability to sell the collateral upon foreclosure at its appraised value. There is also risk that downward trends could continue at a higher pace. If real estate values further decline, it is also more likely that we would be required to increase our allowance for loan losses.

On a quarterly basis, we analyze each loan that is classified as impaired during the period to determine the potential for possible loan losses. This analysis is focused upon determining the then current estimated value of the collateral, local market condition, and estimated costs to foreclose, repair and resell the property. The net realizable value of the property is then computed and compared to the loan balance to determine the appropriate amount of specific reserve for each loan.

***Other nonperforming assets*** - Other nonperforming assets consist of OREO that was acquired through foreclosure. OREO is carried at fair market value minus estimated costs to sell. Current appraisals are obtained at time of foreclosure and write-downs, if any, charged to the allowance for loan losses as of the date of foreclosure. On a regular basis, we reevaluate our OREO properties for impairment. Along with gains and losses on disposal, expenses to maintain such assets and subsequent changes in the valuation allowance are included in other noninterest expense.

As of September 30, 2014, we had OREO properties totaling \$2,009,212, geographically located in the following South Carolina areas – 19% in the Coastal area, 17% in the Columbia area and 64% in the Florence area. The combined nature of these properties is 73% commercial and 27% residential and other. We are diligently trying to dispose of our OREO properties; however, the relatively low demand in many of these market segments affects our ability to do so in a timely manner without experiencing additional losses. This is especially true for properties consisting of raw land.

From September 30, 2013 to September 30, 2014, OREO decreased \$11,904,767, or 85.56%. During this period, sales and write downs were \$9,262,516 and \$3,501,464, respectively, while properties acquired through foreclosures totaled \$859,513.

The write downs noted in the previous paragraph were primarily the result of an extensive marketing analysis of our OREO properties that we made during the fourth quarter of 2013, taking into consideration our experience as to the time required to sell OREO properties, the volume of OREO properties held by other banks in our market area, and the deeply discounted prices being offered for the purchase of OREO properties. As a result of this analysis, we increased our write downs by \$3,500,000 for estimated future losses on the sale on our OREO properties.

OREO expense for the nine months ended September 30, 2014 and 2013 was \$490,137 and \$2,738,692, respectively, which includes a net gain of \$135,094 and a net loss of \$331,626 on sales, respectively.

### **Deposits and Other Interest-Bearing Liabilities**

Average interest-bearing liabilities decreased \$34,916,292, or 12.14%, to \$252,628,632 for the nine months ended September 30, 2014, from \$287,544,924 for the nine months ended September 30, 2013. This decrease is primarily attributable to the significant reduction in our average interest-bearing deposits.

**Deposits** - For the nine months ended September 30, 2014 and 2013, average total deposits were \$285,582,203 and \$322,685,164 respectively, which is a decrease of \$37,102,961, or 11.50%. As our loan demand declined, we concurrently lowered our rates paid for deposits, specifically for time deposits, which is the primary reason that the amount of our average time deposits are \$39,541,953, or 32.99%, lower during the nine months ended September 30, 2014 than during the same period in 2013. At September 30, 2014 and December 31, 2013, total deposits were \$292,325,730 and \$282,415,023 respectively, an increase of \$9,910,707, or 3.51%.

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Average interest-bearing deposits decreased \$42,297,714, or 16.19%, to \$218,953,973 for the nine months ended September 30, 2014, from \$261,251,687 for the nine months ended September 30, 2013.

The average balance of non-interest bearing deposits increased \$5,194,753, or 8.46%, to \$66,628,230 for the nine months ended September 30, 2014, from \$61,433,477 for the nine months ended September 30, 2013.

The following table shows the average balance amounts and the average rates paid on deposits held by us for the nine months ended September 30, 2014 and 2013.

|                                     | Nine months ended September 30, |              |                 |              | Average Rate |  |
|-------------------------------------|---------------------------------|--------------|-----------------|--------------|--------------|--|
|                                     | 2014                            | Average Rate | 2013            | Average Rate |              |  |
|                                     | Average Amount                  |              | Average Amount  |              |              |  |
| Noninterest bearing demand deposits | \$66,628,230                    | 0.00         | % \$61,433,477  | 0.00         | %            |  |
| Interest bearing demand deposits    | 53,003,931                      | 0.06         | 44,249,194      | 0.11         |              |  |
| Savings accounts                    | 85,649,014                      | 0.12         | 97,159,512      | 0.19         |              |  |
| Time deposits                       | 80,301,028                      | 0.94         | 119,842,981     | 1.68         |              |  |
| Total                               | \$285,582,203                   | 0.31         | % \$322,685,164 | 0.69         | %            |  |

Core deposits, which exclude time deposits of \$100,000 or more, provide a relatively stable funding source for our loan portfolio and other earning assets. Our core deposits were \$255,188,108 and \$242,480,278 at September 30, 2014 and December 31, 2013, respectively. As of September 30, 2014 and December 31, 2013, our core deposits were 87.30% and 85.86% of total deposits, respectively. Overall, we have placed a high priority on securing low-cost local deposits over other, more costly, funding sources in the current low-rate environment.

Included in time deposits of \$100,000 and over at September 30, 2014 and December 31, 2013 are brokered time deposits of \$22,719,000 and \$23,005,000, respectively. In accordance with our asset/liability management strategy, we do not intend to renew or replace the brokered deposits outstanding at September 30, 2014 when they mature.

Deposits, and particularly core deposits, have been our primary source of funding and have enabled us to meet successfully both our short-term and long-term liquidity needs. We anticipate that such deposits will continue to be our primary source of funding in the future. Our loan-to-deposit ratio was 86.24% and 84.45% on September 30, 2014 and December 31, 2013, respectively.

The maturity distribution of our time deposits of \$100,000 or more at September 30, 2014 is set forth in the following table:

|                                   | September 30,<br>2014 |
|-----------------------------------|-----------------------|
| Three months or less              | \$ 3,517,717          |
| Over three through twelve months  | 26,862,759            |
| Over one year through three years | 6,418,334             |
| Over three years                  | 338,812               |
| Total                             | \$ 37,137,622         |

Approximately 81.81% of our time deposits of \$100,000 or more had scheduled maturities within one year. Large certificate of deposit customers tend to be extremely sensitive to interest rate levels, making these deposits less reliable sources of funding for liquidity planning purposes than core deposits. We expect most certificates of deposit with maturities less than one year to be renewed upon maturity. However, there is the possibility that some certificates may not be renewed. We believe that, should these certificates of deposit not be renewed, the impact would be minimal on our operations and liquidity due to the availability of other funding sources.

**Other Borrowings** – Other borrowings at September 30, 2014 and December 31, 2013, consist of the following:

|  | September 30,<br>2014 | December 31,<br>2013 |
|--|-----------------------|----------------------|
| Securities sold under agreements to repurchase | \$ 7,639,859          | \$ 4,876,118         |
| Advances from Federal Home Loan Bank           | 17,000,000            | 23,000,000           |
| Junior subordinated debentures                 | 10,310,000            | 10,310,000           |



Securities sold under agreements to repurchase mature on a one to seven day basis. These agreements are secured by U.S. government agency securities. Advances from the Federal Home Loan Bank mature at different periods, as discussed in the footnotes to the financial statements, and are secured by our one to four family residential mortgage loans and our investment in the Federal Home Loan Bank stock. The junior subordinated debentures mature on November 23, 2035 and have an interest rate of LIBOR plus 1.83%. As of September 30, 2014, accrued and unpaid interest on these debentures totaled \$719,617.

## Capital Resources

Total shareholders' equity at September 30, 2014 and December 31, 2013 was \$36.1 million and \$32.1 million, respectively. The \$4.0 million increase during the first nine months of 2014 resulted mainly from our net income of \$4.2 million.

The following table shows the return on average assets (net income divided by average total assets), return on average equity (net income divided by average equity), and equity to assets ratio (average equity divided by average total assets) for the nine months ended September 30, 2014 and 2013. We have not paid a cash dividend on our common stock since our inception, and, under the terms of the Company MOU (which are more fully described as part of "Management's Discussion and Analysis of Financial Condition and Results of Operation – Regulatory Matters"), the Company must request prior approval from the Federal Reserve prior to declaring or paying dividends on its common stock or preferred stock, or making scheduled interest payments on its trust-preferred securities. The Federal Reserve approved the scheduled payment of dividends on the Company's preferred stock and interest payments on the Company's trust preferred securities for the first three quarters of 2011; however, the Federal Reserve did not approve the Company's request to pay dividends and interest payments relating to its outstanding classes of preferred stock and trust preferred securities due and payable in the fourth quarter of 2011, and such consent has not been granted thereafter, largely out of deference to the Federal Reserve's policy statement on dividends.

|  | Nine months ended |          |
|--|-------------------|----------|
|  | September 30,     |          |
|  | 2014              | 2013     |
| Return on average assets               | 1.57 %            | (0.91 )% |
| Return on average equity               | 17.08             | (8.78 )  |
| Average equity to average assets ratio | 9.18              | 10.31    |

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a material effect on the Company's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Company's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Currently, the Bank MOU requires that the Bank maintain a Tier 1 leverage ratio of 8%, and our other regulatory capital ratios at such levels so as to be considered well capitalized for regulatory purposes. We continue to be in full compliance with this requirement of the Bank MOU. Additional discussion of the Bank MOU is included above as part of "Management's Discussion and Analysis of Financial Condition and Results of Operation – Regulatory Matters."

Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum ratios of Tier 1 and total capital as a percentage of assets and off-balance-sheet exposures, adjusted for risk weights ranging from 0% to 100%. Tier 1 capital of the Company consists of common shareholders' equity, excluding the unrealized gain or loss on securities available-for-sale, minus certain intangible assets. The Company's Tier 2 capital consists of the allowance for loan losses subject to certain limitations. Total capital for purposes of computing the capital ratios consists of the sum of Tier 1 and Tier 2 capital. The regulatory minimum requirements are 4% for Tier 1 capital and 8% for total risk-based capital; under the provisions of the Bank MOU the Bank will be required to maintain a Tier 1 leverage ratio of 8% and a total risk-based capital ratio of 10%. However, as the Company has less than \$500 million in assets, its activities and regulatory capital structure are de-emphasized pursuant to the Federal Reserve's Small Bank Holding Company Policy Statement, with all significant business activities attributed to the Bank by the Company's regulators.

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

The Company and the Bank were each considered to be "well capitalized" for regulatory purposes at September 30, 2014 and December 31, 2013.

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The following table shows the regulatory capital ratios for the Company and the Bank at September 30, 2014 and December 31, 2013.

|  | September 30, 2014 |         | December 31, 2013 |         |
|--|--------------------|---------|-------------------|---------|
|  | Holding            |         | Holding           |         |
|  | Company            | Bank    | Company           | Bank    |
| Total capital (to risk-weighted assets)              | 16.12 %            | 14.95 % | 15.75 %           | 14.35 % |
| Tier 1 capital (to risk-weighted assets)             | 15.13 %            | 13.96 % | 14.73 %           | 13.34 % |
| Leverage or Tier 1 capital (to total average assets) | 12.27 %            | 11.29 % | 11.78 %           | 10.67 % |

In July 2013, the Federal Reserve, the FDIC, and the Office of the Comptroller of the Currency each approved final rules to implement the Basel III regulatory capital reforms, among other changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The rules will apply to all national and state banks, such as the Bank, and savings associations and most bank holding companies and savings and loan holding companies, which we collectively refer to herein as “covered banking organizations.” Bank holding companies with less than \$500 million in total consolidated assets, such as the Company, are not subject to the final rules, nor are savings and loan holding companies substantially engaged in commercial activities or insurance underwriting. The framework requires covered banking organizations to hold more and higher quality capital, which acts as a financial cushion to absorb losses, taking into account the impact of risk. The approved rules include a new minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5% as well as a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets. The rules also raise the minimum ratio of Tier 1 capital to risk-weighted assets from 4% to 6% and include a minimum leverage ratio of 4% for all banking institutions. In terms of quality of capital, the final rules emphasize common equity Tier 1 capital and implement strict eligibility criteria for regulatory capital instruments. The final rules also change the methodology for calculating risk-weighted assets to enhance risk sensitivity. The requirements in the rules begin to phase in on January 1, 2015 for covered banking organizations such as the Bank. The requirements in the rules will be fully phased in by January 1, 2019. The ultimate impact of the new capital standards on the Bank is currently being reviewed.

### Effect of Inflation and Changing Prices

The effect of relative purchasing power over time due to inflation has not been taken into account in our consolidated financial statements. Rather, our financial statements have been prepared on a historical cost basis in accordance with generally accepted accounting principles.

Unlike most industrial companies, the assets and liabilities of financial institutions such as our bank subsidiary are primarily monetary in nature. Therefore, interest rates have a more significant effect on our performance than do the general rate of inflation and of goods and services. In addition, interest rates do not necessarily move in the same direction or in the same magnitude as the prices of goods and services. As discussed previously in "Management's Discussion and Analysis - Rate/Volume Analysis," we seek to manage the relationships between interest sensitive-assets and liabilities in order to protect against wide interest rate fluctuations, including those resulting from inflation.

### Off-Balance Sheet Risk

Through our operations, we have made contractual commitments to extend credit in the ordinary course of our business activities. These commitments are legally binding agreements to lend money to our customers at predetermined interest rates for a specified period of time. At September 30, 2014 we had issued commitments to extend credit of \$33.8 million and standby letters of credit of \$75 thousand through various types of commercial lending arrangements. Approximately \$29.5 million of these commitments to extend credit had variable rates.

The following table sets forth the length of time until maturity for unused commitments to extend credit and standby letters of credit at September 30, 2014:

| <i>(Dollars in Thousands)</i>       | After One |          | After    | Within   | Greater   | Total    |
|-------------------------------------|-----------|----------|----------|----------|-----------|----------|
|                                     | Within    | Through  | Three    |          |           |          |
|                                     | One       | Three    | Twelve   | One      | One Year  |          |
|                                     | Month     | Months   | Months   | Year     |           |          |
| Unused commitments to extend credit | \$3,400   | \$ 1,690 | \$11,292 | \$16,382 | \$ 17,466 | \$33,848 |
| Standby letters of credit           | -         | -        | 75       | 75       | -         | 75       |
| Totals                              | \$3,400   | \$ 1,690 | \$11,367 | \$16,457 | \$ 17,466 | \$33,923 |

### Market Risk

Market risk is the risk of loss from adverse changes in market prices and rates and principally arises from interest rate risk inherent in our lending, investing, deposit gathering, and borrowing activities. Other types of market risks, such as foreign currency exchange rate risk and commodity price risk, do not generally arise in the normal course of our business. Our finance committee monitors and considers methods of managing exposure to interest rate risk. We have both an internal finance committee consisting of senior management and directors that meet at various times during each quarter and a management finance committee that meets weekly as needed. The finance committees are responsible for maintaining the level of interest rate sensitivity of our interest sensitive assets and liabilities within board-approved limits.

We actively monitor and manage our interest rate risk exposure principally by measuring our interest sensitivity "gap," which is the positive or negative dollar difference between assets and liabilities that are subject to interest rate repricing within a given period of time. Interest rate sensitivity can be managed by repricing assets or liabilities, selling securities available for sale, replacing an asset or liability at maturity, or adjusting the interest rate during the life of an asset or liability. Managing the amount of assets and liabilities repricing in this same time interval helps to hedge the risk and minimize the impact on net interest income of rising or falling interest rates. We generally would benefit from increasing market rates of interest when we have an asset-sensitive gap position and generally would benefit from decreasing market rates of interest when we are liability-sensitive.

We were liability-sensitive during the year ended December 31, 2013 and during the nine months ended September 30, 2014. As of September 30, 2014, we expect to be liability-sensitive for the next three months because a majority of our deposits reprice over a 12-month period. Approximately 31% of our loans were variable rate loans at September 30, 2014. The ratio of cumulative gap to total earning assets after 12 months was a negative 33.21% because \$107.0 million more liabilities will reprice in a 12-month period than assets. However, our gap analysis is not a precise indicator of our interest sensitivity position. The analysis presents only a static view of the timing of maturities and repricing opportunities, without taking into consideration that changes in interest rates do not affect all assets and liabilities equally. For example, rates paid on a substantial portion of core deposits may change contractually within a relatively short time frame, but those rates are viewed by us as significantly less interest-sensitive than market-based rates such as those paid on noncore deposits. Net interest income may be affected by other significant factors in a given interest rate environment, including changes in the volume and mix of interest-earning assets and interest-bearing liabilities.

### **Liquidity and Interest Rate Sensitivity**

Liquidity represents the ability of a company to convert assets into cash or cash equivalents without significant loss and the ability to raise additional funds by increasing liabilities. Liquidity management involves monitoring our sources and use of funds in order to meet our day-to-day cash flow requirements while maximizing profits. Liquidity management is made more complicated because different balance sheet components are subject to varying degrees of management control. For example, the timing of maturities of securities in our investment portfolio is fairly predictable and is subject to a high degree of control at the time investment decisions are made. However, net deposit inflows and outflows are far less predictable and are not subject to the same degree of control.

At September 30, 2014, our liquid assets, consisting of cash and cash equivalents amounted to \$24.6 million, or 6.68% of total assets. Our investment securities, excluding nonmarketable securities, at September 30, 2014, amounted to \$46.2 million, or 12.55% of total assets. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, \$18.4 million of these securities were pledged as collateral to secure public deposits and borrowings as of September 30, 2014. At December 31, 2013, our liquid assets, consisting of cash and cash equivalents, amounted to \$18.2 million, or 5.13% of total assets. Our investment securities, excluding nonmarketable securities, at December 31, 2013 amounted to \$49.1 million, or 13.81% of total assets. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, \$17.2 million of these securities were pledged as collateral to secure public deposits and borrowings as of December 31, 2013.

Our ability to maintain and expand our deposit base and borrowing capabilities serves as our primary source of liquidity. For the near future, it is our intention to reduce the use of wholesale funding to fund loan demand, instead relying on lower-cost funding sources, particularly core deposits. We plan to meet our future cash needs through the liquidation of temporary investments, the generation of deposits, and from additional borrowings. In addition, we will receive cash upon the maturity and sale of loans and the maturity of investment securities. At September 30, 2014, we had a \$5.6 million unused line of credit with the Federal Reserve and had sufficient unpledged securities that would

have allowed us to borrow an additional \$28.8 million from the Federal Reserve. Also, as member of the Federal Home Loan Bank of Atlanta, (the “FHLB”), we can make applications for borrowings that can be made for leverage purposes. The FHLB requires that securities, qualifying mortgage loans, and stock of the FHLB owned by the Bank be pledged to secure any advances from them. We have an available line to borrow funds from the FHLB up to 30% of the Bank’s total assets, which provide additional available funds of \$108.9 million at September 30, 2014. At that date the Bank had drawn \$17.0 million on this line. Finally, we had available at September 30, 2014 two unsecured lines of credit, which were unused, to purchase up to \$17.5 million of federal funds from unrelated correspondent institutions. We believe that the sources described above will be sufficient to meet our future liquidity needs.

The Company is largely dependent upon dividends from the Bank as a source of cash. The Bank MOU restricts the ability of the Bank to declare and pay dividends to the Company. The Company MOU requires the Company to obtain approval of the Federal Reserve prior to declaring dividends. The Federal Reserve did not approve the Company’s request to pay dividends and interest payments relating to its outstanding classes of preferred stock and trust preferred securities due and payable in the fourth quarter of 2011, and such consent has not been granted thereafter, largely out of deference to the Federal Reserve’s policy statement on dividends. See “Management’s Discussion and Analysis of Financial Condition and Results of Operation—Regulatory Matters” for additional information relating to the Company MOU.

Asset/liability management is the process by which we monitor and control the mix and maturities of our assets and liabilities. The essential purposes of asset/liability management are to ensure adequate liquidity and to maintain an appropriate balance between interest sensitive assets and liabilities in order to minimize potentially adverse impacts on earnings from changes in market interest rates. We have both an internal finance committee consisting of senior management that meets at various times during each quarter and a management finance committee that meets weekly as needed. The finance committees are responsible for maintaining the level of interest rate sensitivity of our interest-sensitive assets and liabilities within board-approved limits.

## Interest Sensitivity Analysis

The following table sets forth information regarding our rate sensitivity as of September 30, 2014, for each of the time intervals indicated. The information in the table may not be indicative of our rate sensitivity position at other points in time. In addition, the maturity distribution indicated in the table may differ from the contractual maturities of the earning assets and interest-bearing liabilities presented due to consideration of prepayment speeds under various interest rate change scenarios in the application of the interest rate sensitivity methods described above.

The following table sets forth our interest rate sensitivity as of September 30, 2014.

| <i>(Dollars in Thousands)</i>            | Within<br>One<br>Month | After One<br>Through<br>Three<br>Months | After<br>Three<br>Through<br>Twelve<br>Months | Within<br>One<br>Year | Greater<br>Than One<br>Year or<br>Non-<br>Sensitive | Total    |
|--|------------------------|---|---|-----------------------|---|----------|
| <b>Interest-Earning Assets</b>           |                        |   |   |                       |   |          |
| Interest-bearing deposits in other banks | \$20,207               | \$-                                     | \$-   | \$20,207              | \$-   | \$20,207 |
| Time deposits in other banks             | -                      | -                                       | 101   | 101                   | -   | 101      |
| Securities, taxable                      | -                      | -                                       | -   | -                     | 43,024  | 43,024   |
| Securities, nontaxable                   | -                      | -                                       | -   | -                     | 3,140   | 3,140    |
| Nonmarketable securities                 | 1,142                  | -                                       | -   | 1,142                 | -   | 1,142    |
| Loans (1)                                | 28,449                 | 19,715                                  | 58,459  | 106,623               | 148,036   | 254,659  |
| Total earning assets                     | 49,798                 | 19,715                                  | 58,560  | 128,073               | 194,200   | 322,273  |
| <b>Interest-Bearing Liabilities</b>      |                        |   |   |                       |   |          |
| <b>Interest-bearing deposits:</b>        |                        |   |   |                       |   |          |
| Demand deposits                          | \$61,571               | \$-                                     | \$-   | \$61,571              | \$-   | \$61,571 |
| Savings deposits                         | 85,834                 | -                                       | -   | 85,834                | -   | 85,834   |
| Time deposits                            | 5,351                  | 6,932                                   | 50,782  | 63,065                | 12,527  | 75,592   |
| Total interest-bearing deposits          | 152,756                | 6,932                                   | 50,782  | 210,470               | 12,527  | 222,997  |
| Repurchase agreements                    | 7,640                  | -                                       | -   | 7,640                 | -   | 7,640    |
| Federal Home Loan Bank Advances          | 11,000                 | 6,000                                   | -   | 17,000                | -   | 17,000   |
| Junior subordinated debentures           | -                      | -                                       | -   | -                     | 10,310  | 10,310   |
| Total interest-bearing liabilities       | 171,396                | 12,932                                  | 50,782  | 235,110               | 22,837  | 257,947  |
| Period gap                               | \$(121,598)            | \$6,783                                 | \$7,778                                       | \$(107,037)           | \$171,363   |          |
| Cumulative gap                           | \$(121,598)            | \$(114,815)                             | \$(107,037)                                   | \$(107,037)           | \$64,326  |          |
|  | (37.73 )%              | (35.63 )%                               | (33.21 )%                                     | (33.21 )%             | 19.96 %   |          |



Ratio of cumulative gap to total  
earning assets

(1) Including mortgage loans held for sale.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

See "Market Risk" and "Liquidity and Interest Rate Sensitivity" in Item 2, Management's Discussion and Analysis of Financial Condition and Results of Operations, for quantitative and qualitative disclosures about market risk, which information is incorporated herein by reference.

### **Item 4. Controls and Procedures**

As of the end of the period covered by this Quarterly Report on Form 10-Q, our chief executive officer and chief financial officer have evaluated the effectiveness of our "disclosure controls and procedures" ("Disclosure Controls"). Disclosure Controls, as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), are procedures that are designed with the objective of ensuring that information required to be disclosed in our reports filed under the Exchange Act, such as this quarterly Report on Form 10-Q, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure Controls are also designed with the objective of ensuring that such information is accumulated and communicated to our management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

Our management, including the CEO and CFO, does not expect that our Disclosure Controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based upon their controls evaluation, our CEO and CFO have concluded that our Disclosure Controls are effective at a reasonable assurance level.

There have been no changes in our internal controls over financial reporting during our third fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **Part II - Other Information**

### **Item 1. Legal Proceedings**

Other than as previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2013, there are no material, pending legal proceedings to which the Company or its subsidiary is a party or of which any of their property is the subject, and there were no material developments with respect to previously reported legal proceedings during the period covered by this report.

### **Item 1A. Risk Factors**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2013, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

(a) Not applicable.

(b) Not applicable.

**Item 6. Exhibits**

| Exhibit Number | Exhibit   |
|----------------|---|
| 31.1           | Certification pursuant to Rule 13a-15 under the Securities Exchange Act of 1934, as amended.  |
| 31.2           | Certification pursuant to Rule 13a-15 under the Securities Exchange Act of 1934, as amended.  |
| 32.1           | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |
| 32.2           | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |
| 101            | Interactive Data Files providing financial information from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2014 in XBRL. Pursuant to Regulation 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities Exchange Act of 1934, as amended, and are otherwise not subject to liability. |

**SIGNATURES**

In accordance with the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**FIRST RELIANCE BANCSHARES, INC.**

Date: November 14, 2014 By: /s/ F.R. SAUNDERS, JR.  
F. R. Saunders, Jr.  
President & Chief Executive Officer  
(Principal Executive Officer)

Date: November 14, 2014 By: /s/ JEFFREY A. PAOLUCCI  
Jeffrey A. Paolucci  
Senior Vice President and Chief Financial Officer  
(Principal Financial Officer)