

FIRST RELIANCE BANCSHARES INC  
Form 10-Q  
November 13, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C.**

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2012

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)

(843) 656-5000

(Registrant's Telephone Number, Including Area Code)

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

**4,096,774 shares of common stock, par value \$0.01 per share, as of October 31, 2012**

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

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

|   | September<br>30,<br>2012<br>(Unaudited) | December 31,<br>2011<br>(Audited) |
|---|---|-----------------------------------|
| <b>Assets</b>                                 |   |                                   |
| Cash and cash equivalents:                    |   |                                   |
| Cash and due from banks                       | \$1,166,698                             | \$2,134,864                       |
| Interest-bearing deposits with other banks    | 39,536,507                              | 41,885,966                        |
| Total cash and cash equivalents               | 40,703,205                              | 44,020,830                        |
| Time deposits in other banks                  | 100,953                                 | 100,373                           |
| Securities available-for-sale                 | 64,504,304                              | 84,534,318                        |
| Nonmarketable equity securities               | 1,387,400                               | 2,431,800                         |
| Total investment securities                   | 65,891,704                              | 86,966,118                        |
| Mortgage loans held for sale                  | 3,977,700                               | 2,863,297                         |
| Loans receivable                              | 275,156,230                             | 303,398,403                       |
| Less allowance for loan losses                | (4,341,422 )                            | (7,743,470 )                      |
| Loans, net                                    | 270,814,808                             | 295,654,933                       |
| Premises, furniture and equipment, net        | 24,825,928                              | 25,205,064                        |
| Accrued interest receivable                   | 1,376,945                               | 1,938,807                         |
| Other real estate owned                       | 15,358,935                              | 22,135,921                        |
| Cash surrender value life insurance           | 12,510,079                              | 12,228,829                        |
| Other assets                                  | 3,029,928                               | 3,852,250                         |
| Total assets                                  | \$438,590,185                           | \$494,966,422                     |
| <b>Liabilities and Shareholders' Equity</b>   |   |                                   |
| <b>Liabilities</b>                            |   |                                   |
| <b>Deposits</b>                               |   |                                   |
| Noninterest-bearing transaction accounts      | \$56,365,386                            | \$52,299,017                      |
| Interest-bearing transaction accounts         | 42,331,861                              | 42,092,193                        |
| Savings                                       | 108,439,833                             | 122,528,570                       |
| Time deposits \$100,000 and over              | 93,891,131                              | 122,474,202                       |
| Other time deposits                           | 63,316,139                              | 88,422,515                        |
| Total deposits                                | 364,344,350                             | 427,816,497                       |
| Securities sold under agreement to repurchase | 4,711,362                               | -                                 |
| Advances from Federal Home Loan Bank          | 13,000,000                              | 13,000,000                        |

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|   |               |               |
|---|---------------|---------------|
| Junior subordinated debentures  | 10,310,000    | 10,310,000    |
| Accrued interest payable  | 409,899       | 317,678       |
| Other liabilities   | 3,627,383     | 2,404,257     |
| Total liabilities   | 396,402,994   | 453,848,432   |
| Shareholders' Equity  |               |               |
| Preferred stock   |               |               |
| Series A cumulative perpetual preferred stock - 15,349 shares issued and outstanding  | 15,071,307    | 14,925,265    |
| Series B cumulative perpetual preferred stock - 767 shares issued and outstanding   | 790,560       | 802,951       |
| Series C cumulative mandatory convertible preferred stock - 2,293 shares issued and outstanding   | 2,293,000     | 2,293,000     |
| Common stock, \$0.01 par value; 20,000,000 shares authorized, 4,096,774 and 4,084,400 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively | 40,968        | 40,844        |
| Capital surplus   | 28,001,244    | 27,992,485    |
| Treasury stock, at cost, 19,289 and 13,245 shares at September 30, 2012 and December 31, 2011, respectively   | (182,215 )    | (173,650 )    |
| Nonvested restricted stock  | (175,977 )    | (320,196 )    |
| Retained deficit  | (5,303,352 )  | (6,304,429 )  |
| Accumulated other comprehensive income  | 1,651,656     | 1,861,720     |
| Total shareholders' equity  | 42,187,191    | 41,117,990    |
| Total liabilities and shareholders' equity  | \$438,590,185 | \$494,966,422 |

See notes to condensed consolidated financial statements

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

|   | Three Months Ended |             | Nine Months Ended |              |
|---|--------------------|-------------|-------------------|--------------|
|   | September 30,      |             | September 30,     |              |
|   | 2012               | 2011        | 2012              | 2011         |
| Interest income:                                    |                    |             |                   |              |
| Loans, including fees                               | \$4,196,618        | \$5,037,612 | \$12,699,918      | \$15,127,300 |
| Investment securities:                              |                    |             |                   |              |
| Taxable   | 445,994            | 531,989     | 1,373,027         | 1,204,229    |
| Nontaxable  | 128,216            | 276,460     | 506,305           | 1,294,037    |
| Other interest income                               | 22,844             | 20,086      | 80,838            | 74,694       |
| Total   | 4,793,672          | 5,866,147   | 14,660,088        | 17,700,260   |
| Interest expense:                                   |                    |             |                   |              |
| Time deposits                                       | 823,399            | 1,204,764   | 2,833,290         | 4,034,291    |
| Other deposits                                      | 87,814             | 261,227     | 346,952           | 828,675      |
| Other interest expense                              | 129,890            | 125,780     | 386,917           | 188,544      |
| Total   | 1,041,103          | 1,591,771   | 3,567,159         | 5,051,510    |
| Net interest income                                 | 3,752,569          | 4,274,376   | 11,092,929        | 12,648,750   |
| Provision for loan losses                           | 350,955            | 3,036,820   | 950,955           | 3,559,944    |
| Net interest income after provision for loan losses | 3,401,614          | 1,237,556   | 10,141,974        | 9,088,806    |
| Noninterest income:                                 |                    |             |                   |              |
| Service charges on deposit accounts                 | 451,027            | 480,078     | 1,301,545         | 1,372,868    |
| Gain on sales of mortgage loans                     | 303,228            | 362,972     | 855,966           | 664,620      |
| Income from bank owned life insurance               | 91,573             | 101,307     | 281,250           | 301,945      |
| Other charges, commissions and fees                 | 250,335            | 207,348     | 719,344           | 606,591      |
| Gain (loss) on sale of securities                   | 1,298,627          | (64,274 )   | 1,806,414         | 516,582      |
| Other non-interest income                           | 57,544             | 20,875      | 493,904           | 242,257      |
| Total   | 2,452,334          | 1,108,306   | 5,458,423         | 3,704,863    |
| Noninterest expenses:                               |                    |             |                   |              |
| Salaries and employee benefits                      | 1,975,606          | 2,318,510   | 5,771,871         | 6,878,369    |
| Occupancy expense                                   | 375,971            | 383,421     | 1,108,232         | 1,119,734    |
| Furniture and equipment expense                     | 330,979            | 203,634     | 1,083,915         | 831,256      |
| Other operating expenses                            | 2,494,982          | 2,652,500   | 6,501,651         | 7,059,717    |
| Total   | 5,177,538          | 5,558,065   | 14,465,669        | 15,889,076   |
| Net income (loss) before income taxes               | 676,410            | (3,212,203) | 1,134,728         | (3,095,407 ) |

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|  |           |               |           |                |
|--|-----------|---------------|-----------|----------------|
| Income tax expense   | -         | 5,554,099     | -         | 5,134,705      |
| Net income (loss)  | 676,410   | (8,766,302)   | 1,134,728 | (8,230,112 )   |
| Preferred stock dividends  | 249,248   | 249,248       | 747,743   | 747,743        |
| Deemed dividends on preferred stock resulting from net accretion of discount and amortization of premium | 44,876    | 44,875        | 133,652   | 133,163        |
| Net income (loss) available to common shareholders   | \$382,286 | \$(9,060,425) | \$253,333 | \$(9,111,018 ) |
| Average common shares outstanding, basic   | 4,096,774 | 4,094,459     | 4,093,148 | 4,103,189      |
| Average common shares outstanding, diluted   | 4,281,099 | 4,094,459     | 4,290,298 | 4,103,189      |
| Basic earnings (loss) per share  | \$0.09    | \$(2.21 )     | \$0.06    | \$(2.22 )      |
| Diluted earnings (loss) per share  | \$0.09    | \$(2.21 )     | \$0.06    | \$(2.22 )      |

See notes to condensed consolidated financial statements



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

|   | Three Months Ended<br>September 30, |               | Nine Months Ended<br>September 30, |               |
|---|-------------------------------------|---------------|------------------------------------|---------------|
|   | 2012                                | 2011          | 2012                               | 2011          |
| Net income (loss) from operations   | \$676,410                           | \$(8,766,302) | \$1,134,728                        | \$(8,230,112) |
| Other Comprehensive income, net of tax:   |                                     |               |                                    |               |
| Unrealized holding gains on available-for-sale securities arising during period     | 489,779                             | 1,381,239     | 982,169                            | 3,116,118     |
| Reclassification adjustment for (gains) loss realized in net income from operations | (857,094)                           | 42,421        | (1,192,233)                        | (340,944 )    |
| Other comprehensive income (loss)   | (367,315)                           | 1,423,660     | (210,064 )                         | 2,775,174     |
| Comprehensive income (loss)   | \$309,095                           | \$(7,342,642) | \$924,664                          | \$(5,454,938) |

See notes to condensed consolidated financial statements

**FIRST RELIANCE BANCSHARES, INC.****Condensed Consolidated Statements of Shareholders' Equity****For the Nine Months Ended September 30, 2012 and 2011****(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 31,<br>2010  | \$17,843,176       | \$41,159        | \$28,140,094       | \$(168,864)       | \$(679,264)                      | \$4,002,469                       | \$(586,926 )  | \$48,591,844 |
| Net loss  |                    |                 |                    |                   |                                  | (8,230,112)                       |   | (8,230,112 ) |
| Other<br>comprehensive<br>gain, net of tax<br>expense of<br>\$1,379,279 |                    |                 |                    |                   |                                  |                                   | 2,775,174   | 2,775,174    |
| Preferred Stock<br>Dividend   |                    |                 |                    |                   |                                  | (747,743 )                        |   | (747,743 )   |
| Accretion of<br>Series A<br>Preferred stock<br>discount                 | 145,508            |                 |                    |                   |                                  | (145,508 )                        |   | -            |
| Amortization<br>of Series B<br>Preferred stock<br>premium               | (12,345 )          |                 |                    |                   |                                  | 12,345                            |   | -            |
| Issuance<br>Common Stock  |                    | 3               | 999                |                   |                                  |                                   |   | 1,002        |
| Net Change in<br>Restricted<br>Stock                                    |                    | (218 )          | (118,172 )         |                   | 273,160                          |                                   |   | 154,770      |

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|   |               |           |               |             |             |               |              |               |
|---|---------------|-----------|---------------|-------------|-------------|---------------|--------------|---------------|
| Purchase of treasury stock                                |               |           |               | (4,560 )    |             |               |              | (4,560 )      |
| Balance, September 30, 2011                               | \$ 17,976,339 | \$ 40,944 | \$ 28,022,921 | \$(173,424) | \$(406,104) | \$(5,108,549) | \$ 2,188,248 | \$ 42,540,375 |
| Balance, December 31, 2011                                | \$ 18,021,216 | \$ 40,844 | \$ 27,992,485 | \$(173,650) | \$(320,196) | \$(6,304,429) | \$ 1,861,720 | \$ 41,117,990 |
| Net income  |               |           |               |             |             | 1,134,728     |              | 1,134,728     |
| Other comprehensive loss, net of tax benefit of \$108,215 |               |           |               |             |             |               | (210,064 )   | (210,064 )    |
| Accretion of Series A Preferred stock discount            | 146,041       |           |               |             |             | (146,041 )    |              | -             |
| Amortization of Series B Preferred stock premium          | (12,390 )     |           |               |             |             | 12,390        |              | -             |
| Issuance Common Stock                                     |               | 8         | 933           |             |             |               |              | 1,001         |
| Net Change in Restricted Stock                            |               | 116       | 7,766         |             | 144,219     |               |              | 152,101       |
| Purchase of treasury stock                                |               |           |               | (8,565 )    |             |               |              | (8,565 )      |
| Balance, September 30, 2012                               | \$ 18,154,867 | \$ 40,968 | \$ 28,001,244 | \$(182,215) | \$(175,977) | \$(5,303,352) | \$ 1,651,656 | \$ 42,187,191 |

See notes to condensed consolidated financial statements

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

|  | Nine Months Ended<br>September 30, |                |
|--|------------------------------------|----------------|
|  | 2012                               | 2011           |
| Cash flows from operating activities:  |                                    |                |
| Net Income (loss)  | \$1,134,728                        | \$(8,230,112 ) |
| Adjustments to reconcile net income (loss) to net cash Provided by operating activities: |                                    |                |
| Provision for loan losses  | 950,955                            | 3,559,944      |
| Depreciation and amortization expense  | 702,635                            | 734,396        |
| Gain on sale of available-for-sale securities  | (1,806,414 )                       | (516,582 )     |
| Loss on sale of other real estate owned  | 109,516                            | 100,755        |
| Write down of other real estate owned  | 882,189                            | 937,255        |
| Discount accretion and premium amortization on available-for-sale securities             | 169,887                            | 141,184        |
| Disbursements for loans held-for-sale  | (36,145,420)                       | (23,242,719)   |
| Proceeds from loans held-for-sale  | 35,031,017                         | 23,354,531     |
| Net decrease in valuation allowance for loans held-for-sale                              | -                                  | (16,259 )      |
| Decrease in interest receivable  | 561,862                            | 478,756        |
| Increase in cash surrender value of life insurance                                       | (281,250 )                         | (301,945 )     |
| Increase (decrease) in interest payable  | 92,221                             | (306,107 )     |
| Increase in valuation allowance for deferred tax assets                                  | -                                  | 6,554,221      |
| Net increase in net deferred tax assets  | -                                  | (1,435,902 )   |
| Amortization of deferred compensation on restricted stock                                | 152,101                            | 154,770        |
| Increase in other liabilities  | 1,223,126                          | 1,163,389      |
| Decrease in other assets   | 840,699                            | 1,413,604      |
| Net cash provided by operating activities  | 3,617,852                          | 4,543,179      |
| Cash flows from investing activities:  |                                    |                |
| Increase in time deposits  | (580 )                             | (373 )         |
| Net decrease in loans receivable   | 23,792,006                         | 15,893,073     |
| Purchases of securities available-for-sale   | (13,220,603)                       | (44,587,976)   |
| Proceeds on sales of securities available-for-sale                                       | 25,677,784                         | 40,807,255     |
| Maturities of securities available-for-sale  | 8,891,082                          | 4,501,679      |
| Net decrease of nonmarketable equity securities  | 1,044,400                          | 1,332,700      |
| Proceeds from sales of other real estate owned   | 5,882,445                          | 4,852,971      |
| Improvements to other real estate owned  | -                                  | (6,987 )       |
| Purchases of premises and equipment  | (233,662 )                         | (94,109 )      |
| Net cash provided by investing activities  | 51,832,872                         | 22,698,233     |
| Cash flows from financing activities:  |                                    |                |
| Net increase (decrease) in demand deposits, interest-bearing and savings accounts        | (9,782,700 )                       | 27,155,210     |
| Net decrease in certificates of deposit and other time deposits                          | (53,689,447)                       | (48,040,842)   |

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|   |              |              |
|---|--------------|--------------|
| Net increase (decrease) in securities sold under agreements to repurchase | 4,711,362    | (476,522 )   |
| Increase in advances from the Federal Home Loan Bank                      | -            | 7,000,000    |
| Issuance of common stock to employees                                     | 1,001        | 1,002        |
| Preferred stock dividends paid  | -            | (747,743 )   |
| Purchase of treasury stock  | (8,565 )     | (4,560 )     |
| Net cash used by financing activities                                     | (58,768,349) | (15,113,455) |
| Net increase (decrease) in cash and cash equivalents                      | (3,317,625 ) | 12,127,957   |
| Cash and cash equivalents, beginning of period                            | 44,020,830   | 25,670,293   |
| Cash and cash equivalents, end of period                                  | \$40,703,205 | \$37,798,250 |
| Cash paid during the period for:  |              |              |
| Interest  | \$3,474,938  | \$5,357,617  |
| Income taxes  | -            | -            |
| Supplemental noncash investing and financing activities:                  |              |              |
| Foreclosures on loans   | \$5,317,584  | \$10,653,883 |
| Other real estate owned sales financed                                    | 5,220,420    | -            |
| Net change in valuation allowance – available-for-sale                    | (210,064 )   | 2,775,174    |

See notes to condensed consolidated financial statements

## Notes to Condensed Consolidated Financial Statements (Unaudited)

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

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, 2012 and for the interim periods ended September 30, 2012 and 2011 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, 2011 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, 2011.

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

The following is a summary of recent authoritative pronouncements:

In April 2011, the criteria used to determine effective control of transferred assets in the Transfers and Servicing topic of the Accounting Standards Codification ("ASC") was amended by Accounting Standards Update ("ASU") 2011-03. The requirement for the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms and the collateral maintenance implementation guidance related to that criterion were removed from the assessment of effective control. The other criteria to assess effective control were not changed. The amendments were effective for the Company on January 1, 2012 and had no effect on the financial statements.

ASU 2011-04 was issued in May 2011 to amend the Fair Value Measurement topic of the ASC by clarifying the application of existing fair value measurement and disclosure requirements and by changing particular principles or requirements for measuring fair value or for disclosing information about fair value measurements. The amendments were effective for the Company beginning January 1, 2012 and had no effect on the financial statements.

The Comprehensive Income topic of the ASC was amended in June 2011. The amendment eliminates the option to present other comprehensive income as a part of the statement of changes in stockholders' equity and requires consecutive presentation of the statement of net income and other comprehensive income. The amendments were applicable to the Company on January 1, 2012 and have been applied retrospectively. In December 2011, the topic

was further amended to defer the effective date of presenting reclassification adjustments from other comprehensive income to net income on the face of the financial statements. Companies should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect prior to the amendments while the Financial Accounting Standards Board (“FASB”) redeliberates future requirements.

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

Note 3 - Reclassifications

Certain captions and amounts in the financial statements in the Company’s Form 10-Q for the quarter ended September 30, 2011 were reclassified to conform to the September 30, 2012 presentation.

Note 4 - Investment Securities

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

|                            | Amortized<br>Cost | Gross Unrealized<br>Gains | Losses   | Estimated<br>Fair Value |
|----------------------------|-------------------|---------------------------|----------|-------------------------|
| September 30, 2012         |                   |                           |          |                         |
| U.S. Government agencies   | \$7,650,166       | \$404,930                 | \$-      | \$8,055,096             |
| Mortgage-backed securities | 54,311,203        | 2,127,505                 | -        | 56,438,708              |
| Other                      | 100,000           | -                         | 89,500   | 10,500                  |
| Total                      | \$62,061,369      | \$2,532,435               | \$89,500 | \$64,504,304            |

|                            | Amortized<br>Cost | Gross Unrealized<br>Gains | Unrealized<br>Losses | Estimated<br>Fair Value |
|----------------------------|-------------------|---------------------------|----------------------|-------------------------|
| December 31, 2011          |                   |                           |                      |                         |
| U.S. Government agencies   | \$2,839,706       | \$185,239                 | \$-                  | \$3,024,945             |
| Mortgage-backed securities | 59,748,500        | 1,816,651                 | 4,749                | 61,560,402              |
| Municipals                 | 19,084,899        | 853,072                   | -                    | 19,937,971              |
| Other                      | 100,000           | -                         | 89,000               | 11,000                  |
| Total                      | \$81,773,105      | \$2,854,962               | \$93,749             | \$84,534,318            |

The following is a summary of maturities of securities available-for-sale as of September 30, 2012. 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.

|                            | Securities<br>Available-For-Sale                               |                         |
|----------------------------|--|-------------------------|
|                            | Amortized<br>Cost  | Estimated<br>Fair Value |
|                            | U.S. Government agencies - due after five but within ten years | \$7,650,166             |
| Mortgage-backed securities | 54,311,203   | 56,438,708              |
| Other                      | 100,000  | 10,500                  |
| Total                      | \$62,061,369   | \$64,504,304            |

The following table shows gross unrealized losses and fair value, aggregated by investment category, and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2012 and December 31, 2011.

|                                     | September 30, 2012 |                      | December 31, 2011 |                      |
|-------------------------------------|--------------------|----------------------|-------------------|----------------------|
|                                     | Fair<br>Value      | Unrealized<br>Losses | Fair<br>Value     | Unrealized<br>Losses |
| Less Than 12 Months                 |                    |                      |                   |                      |
| U.S. Government agencies            | \$-                | \$-                  | \$5,085,963       | \$4,749              |
| 12 Months or More                   |                    |                      |                   |                      |
| Other                               | 10,500             | 89,500               | 11,000            | 89,000               |
| Total securities available-for-sale | \$10,500           | \$89,500             | \$5,096,963       | \$93,749             |

At September 30, 2012, securities classified as available-for-sale were recorded at fair market value. The entire amount of the unrealized losses is the result of a single security in a continuous loss position for twelve months or more. The Company does not intend to sell this security in the near future and it is more likely than not that the Company will not be required to sell this security before recovery of its amortized cost. The Company believes, based on industry analyst reports and credit ratings, that the deterioration in value is not considered other-than-temporary.



During the first nine months of 2012 and 2011, proceeds from the sale of available-for-sale securities were \$25,677,784 and \$40,807,255, respectively. Net gains on available-for-sale securities totaled \$1,806,414 and \$516,582 for the first nine months of 2012 and 2011, respectively.

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

Major classifications of loans receivable are summarized as follows:

|                           | September<br>30,<br>2012 | December 31,<br>2011 |
|---------------------------|--------------------------|----------------------|
| Real estate loans:        |                          |                      |
| Construction              | \$ 34,389,985            | \$ 43,320,482        |
| Residential:              |                          |                      |
| Residential 1-4 family    | 39,256,376               | 42,837,510           |
| Multifamily               | 5,648,155                | 8,630,232            |
| Second mortgages          | 4,226,594                | 4,503,752            |
| Equity lines of credit    | 22,542,667               | 24,998,277           |
| Total residential         | 71,673,792               | 80,969,771           |
| Nonresidential            | 129,288,612              | 133,603,482          |
| Total real estate loans   | 235,352,389              | 257,893,735          |
| Commercial and industrial | 30,209,877               | 36,465,095           |
| Consumer                  | 9,426,357                | 8,649,649            |
| Other                     | 167,607                  | 389,924              |
| Total loans               | \$ 275,156,230           | \$ 303,398,403       |

The Company has pledged certain loans as collateral to secure its borrowings from the Federal Home Loan Bank. The total of loans pledged was \$39,006,986 and \$35,976,783 at September 30, 2012 and December 31, 2011, respectively.

A summary of the allowance for loan losses for the nine months ended September 30, 2012 and year ended December 31, 2011 is as follows:

|  | September<br>30,<br>2012 | December<br>31,<br>2011 |
|--|--------------------------|-------------------------|
| Beginning balance                          | \$ 7,743,470             | \$ 6,271,045            |
| Provision charged to operations            | 950,955                  | 5,403,416               |
| Recoveries on loans previously charged-off | 781,114                  | 639,211                 |
| Loans charged-off                          | (5,134,117)              | (4,570,202)             |
| Ending balance                             | \$ 4,341,422             | \$ 7,743,470            |

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The following is an analysis of the allowance for loan losses by class of loans for the nine months ended September 30, 2012 and the year ended December 31, 2011.

**September 30, 2012**

| <i>(Dollars in Thousands)</i> | Real Estate Loans |              |             |             | Non-Residential | Total Real Estate Loans | Commercial | Consumer and Other |
|-------------------------------|-------------------|--------------|-------------|-------------|-----------------|-------------------------|------------|--------------------|
|                               | Total             | Construction | Residential | Residential |                 |                         |            |                    |
| Beginning balance             | \$7,743           | \$3,291      | \$ 2,757    | \$ 1,081    | \$7,129         | \$ 575                  | \$ 39      |                    |
| Provisions                    | 951               | 381          | (829 )      | 411         | (37 )           | 992                     | (4 )       |                    |
| Recoveries                    | 781               | 296          | 127         | 54          | 477             | 296                     | 8          |                    |
| Charge-offs                   | (5,134)           | (2,220)      | (897 )      | (899 )      | (4,016)         | (1,107 )                | (11 )      |                    |
| Ending balance                | \$4,341           | \$1,748      | \$ 1,158    | \$ 647      | \$3,553         | \$ 756                  | \$ 32      |                    |

**December 31, 2011**

| <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             | \$6,271           | \$2,548      | \$ 1,730    | \$ 947              | \$5,225                          | \$ 998     | \$ 48                 |
| Provisions                    | 5,403             | 2,212        | 2,580       | 602                 | 5,394                            | (9 )       | 18                    |
| Recoveries                    | 639               | 356          | 88          | 70                  | 514                              | 113        | 12                    |
| Charge-offs                   | (4,570)           | (1,825)      | (1,641 )    | (538 )              | (4,004)                          | (527 )     | (39 )                 |
| Ending balance                | \$7,743           | \$3,291      | \$ 2,757    | \$ 1,081            | \$7,129                          | \$ 575     | \$ 39                 |

The following is a summary of loans evaluated for impairment individually and collectively, by class, for the nine months ended September 30, 2012 and the year ended December 31, 2011.

**September 30, 2012**

| <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 |                                  |            |                       |
| Allowance<br>Evaluated for impairment   |                   |              |             |                     |                                  |            |                       |
| Individually                            | \$658             | \$30         | \$ 389      | \$ 189              | \$608                            | \$ 45      | \$ 5                  |
| Collectively                            | 3,683             | 1,718        | 769         | 458                 | 2,945                            | 711        | 27                    |
| Allowance for loan losses               | \$4,341           | \$1,748      | \$ 1,158    | \$ 647              | \$3,553                          | \$ 756     | \$ 32                 |
| Total Loans<br>Evaluated for impairment |                   |              |             |                     |                                  |            |                       |
| Individually                            | \$30,710          | \$6,119      | \$ 6,357    | \$ 15,813           | \$28,289                         | \$ 2,292   | \$ 129                |
| Collectively                            | 244,446           | 28,271       | 65,317      | 113,476             | 207,064                          | 27,918     | 9,464                 |
| Loans receivable                        | \$275,156         | \$34,390     | \$ 71,674   | \$ 129,289          | \$235,353                        | \$ 30,210  | \$ 9,593              |

**December 31, 2011**

| <i>(Dollars in Thousands)</i> | Real Estate Loans |              |             |                     | Total<br>Real<br>Estate | Consumer |
|-------------------------------|-------------------|--------------|-------------|---------------------|-------------------------|----------|
|                               | Total             | Construction | Residential | Non-<br>Residential |                         |          |

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|                           | Total     | Construction | Residential | Residential | Loans     | Commercial | and Other |
|---------------------------|-----------|--------------|-------------|-------------|-----------|------------|-----------|
| Allowance                 |           |              |             |             |           |            |           |
| Evaluated for impairment  |           |              |             |             |           |            |           |
| Individually              | \$2,665   | \$1,782      | \$ 344      | \$ 471      | \$2,597   | \$ 55      | \$ 13     |
| Collectively              | 5,078     | 1,509        | 2,413       | 610         | 4,532     | 520        | 26        |
| Allowance for loan losses | \$7,743   | \$3,291      | \$ 2,757    | \$ 1,081    | \$7,129   | \$ 575     | \$ 39     |
| Total Loans               |           |              |             |             |           |            |           |
| Evaluated for impairment  |           |              |             |             |           |            |           |
| Individually              | \$26,503  | \$8,618      | \$ 4,644    | \$ 11,895   | \$25,157  | \$ 1,299   | \$ 47     |
| Collectively              | 276,895   | 34,702       | 76,326      | 121,708     | 232,736   | 35,166     | 8,993     |
| Loans receivable          | \$303,398 | \$43,320     | \$ 80,970   | \$ 133,603  | \$257,893 | \$ 36,465  | \$ 9,040  |

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.

The following summarizes the Company's impaired loans as of September 30, 2012.

| <i>(Dollars in Thousands)</i>       | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment |
|-------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|
| With no related allowance recorded: |                        |                                |                      |                                   |
| Real estate                         |                        |                                |                      |                                   |
| Construction                        | \$ 2,441               | \$ 2,636                       | \$ -                 | \$ 3,905                          |
| Residential                         | 3,669                  | 3,814                          | -                    | 4,216                             |
| Nonresidential                      | 13,172                 | 13,629                         | -                    | 9,848                             |
| Total real estate loans             | 19,282                 | 20,079                         | -                    | 17,969                            |
| Commercial                          | 541                    | 609                            | -                    | 1,179                             |
| Consumer and other                  | 102                    | 102                            | -                    | 32                                |
|                                     | 19,925                 | 20,790                         | -                    | 19,180                            |
| With an allowance recorded:         |                        |                                |                      |                                   |
| Real estate                         |                        |                                |                      |                                   |
| Construction                        | \$ 3,678               | \$ 4,253                       | \$ 30                | \$ 3,125                          |
| Residential                         | 2,688                  | 2,885                          | 389                  | 1,389                             |
| Nonresidential                      | 2,641                  | 2,950                          | 189                  | 2,941                             |
| Total real estate loans             | 9,007                  | 10,088                         | 608                  | 7,455                             |
| Commercial                          | 1,751                  | 1,816                          | 45                   | 749                               |
| Consumer and other                  | 27                     | 27                             | 5                    | 24                                |
|                                     | 10,785                 | 11,931                         | 658                  | 8,228                             |
| Total                               |                        |                                |                      |                                   |
| Real estate                         |                        |                                |                      |                                   |
| Construction                        | \$ 6,119               | \$ 6,889                       | \$ 30                | \$ 7,030                          |
| Residential                         | 6,357                  | 6,699                          | 389                  | 5,605                             |
| Nonresidential                      | 15,813                 | 16,579                         | 189                  | 12,789                            |
| Total real estate loans             | 28,289                 | 30,167                         | 608                  | 25,424                            |
| Commercial                          | 2,292                  | 2,425                          | 45                   | 1,928                             |
| Consumer and other                  | 129                    | 129                            | 5                    | 56                                |
| Total                               | \$ 30,710              | \$ 32,721                      | \$ 658               | \$ 27,408                         |

The following summarizes the Company's impaired loans as of December 31, 2011.

| <i>(Dollars in Thousands)</i>       | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment |
|-------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|
| With no related allowance recorded: |                        |                                |                      |                                   |
| Real estate                         |                        |                                |                      |                                   |
| Construction                        | \$ 3,308               | \$ 3,372                       | \$ -                 | \$ 6,914                          |

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|                         |        |        |   |        |
|-------------------------|--------|--------|---|--------|
| Residential             | 3,266  | 3,266  | - | 3,170  |
| Nonresidential          | 10,276 | 10,642 | - | 6,892  |
| Total real estate loans | 16,580 | 17,280 | - | 16,976 |
| Commercial              | 1,072  | 1,202  | - | 919    |
| Consumer and other      | 24     | 24     | - | 23     |
|                         | 17,946 | 18,506 | - | 17,918 |

With an allowance recorded:

|                         |          |          |          |          |
|-------------------------|----------|----------|----------|----------|
| Real estate             |          |          |          |          |
| Construction            | \$ 5,310 | \$ 6,370 | \$ 1,782 | \$ 6,039 |
| Residential             | 1,378    | 1,659    | 344      | 705      |
| Nonresidential          | 1,619    | 1,715    | 471      | 744      |
| Total real estate loans | 8,307    | 9,744    | 2,597    | 7,488    |
| Commercial              | 227      | 227      | 55       | 178      |
| Consumer and other      | 23       | 23       | 13       | 5        |
|                         | 8,557    | 9,994    | 2,665    | 7,671    |

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| <i>(Dollars in Thousands)</i> | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment |
|-------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|
| Total                         |                        |                                |                      |                                   |
| Real estate                   |                        |                                |                      |                                   |
| Construction                  | \$ 8,618               | \$ 9,742                       | \$ 1,782             | \$ 12,953                         |
| Residential                   | 4,644                  | 4,925                          | 344                  | 3,875                             |
| Nonresidential                | 11,895                 | 12,357                         | 471                  | 7,636                             |
| Total real estate loans       | 25,157                 | 27,024                         | 2,597                | 24,464                            |
| Commercial                    | 1,299                  | 1,429                          | 55                   | 1,097                             |
| Consumer and other            | 47                     | 47                             | 13                   | 28                                |
| Total                         | \$ 26,503              | \$ 28,500                      | \$ 2,665             | \$ 25,589                         |

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, 2012, interest income recognized on nonaccrual loans was \$605,750. If the nonaccrual loans had been accruing interest at their original contracted rates, related income would have been \$927,891 for the nine months ended September 30, 2012.

A summary of current, past due and nonaccrual loans as of September 30, 2012 was as follows:

| <i>(Dollars in Thousands)</i> | Past Due<br>30-89<br>Days | Past Due Over 90 days<br>and<br>Accruing | Non-<br>Accruing | Total<br>Past Due | Total<br>Current | Total<br>Loans |
|-------------------------------|---------------------------|--|------------------|-------------------|------------------|----------------|
| Real estate                   |                           |  |                  |                   |                  |                |
| Construction                  | \$ -                      | \$ -                                     | \$ 3,858         | \$ 3,858          | \$ 30,532        | \$ 34,390      |
| Residential                   | 487                       | -  | 3,922            | 4,409             | 67,265           | 71,674         |
| Nonresidential                | 509                       | -  | 13,642           | 14,151            | 115,138          | 129,289        |
| Total real estate loans       | 996                       | -  | 21,422           | 22,418            | 212,935          | 235,353        |
| Commercial                    | 201                       | -  | 619              | 820               | 29,390           | 30,210         |
| Consumer and other            | 34                        | 1  | 34               | 69                | 9,524            | 9,593          |
| Totals                        | \$ 1,231                  | \$ 1                                     | \$ 22,075        | \$ 23,307         | \$ 251,849       | \$ 275,156     |

A summary of current, past due and nonaccrual loans as of December 31, 2011 was as follows:

| <i>(Dollars in Thousands)</i> | Past Due<br>30-89<br>Days | Past Due Over 90 days<br>Non-<br>Accruing | Non-<br>Accruing | Total<br>Past Due | Total<br>Current | Total<br>Loans |
|-------------------------------|---------------------------|---|------------------|-------------------|------------------|----------------|
| Real estate                   |                           |   |                  |                   |                  |                |
| Construction                  | \$ 420                    | \$ -                                      | \$ 8,194         | \$ 8,614          | \$ 34,706        | \$ 43,320      |
| Residential                   | 816                       | -   | 3,852            | 4,668             | 76,302           | 80,970         |



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|                         |          |        |           |           |            |            |
|-------------------------|----------|--------|-----------|-----------|------------|------------|
| Nonresidential          | 5,640    | 328    | 9,437     | 15,405    | 118,198    | 133,603    |
| Total real estate loans | 6,876    | 328    | 21,483    | 28,687    | 229,206    | 257,893    |
| Commercial              | 542      | -      | 1,300     | 1,842     | 34,623     | 36,465     |
| Consumer and other      | 38       | -      | 2         | 40        | 9,000      | 9,040      |
| Totals                  | \$ 7,456 | \$ 328 | \$ 22,785 | \$ 30,569 | \$ 272,829 | \$ 303,398 |

At September 30, 2012 and December 31, 2011 loans past due 90 days and still accruing interest totaled \$943 and \$327,899, respectively.

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").

At September 30, 2012 there were 49 loans classified as TDRs totaling \$15,348,576. Of the 49 loans, 18 loans totaling \$8,312,929 were performing while 31 loans totaling \$7,035,647 were not performing. As of December 31, 2011 there were 37 loans classified as TDRs totaling \$7,258,698. Of the 37 loans, 15 loans totaling \$3,163,205 were performing while 22 loans totaling \$4,095,493 were not performing. All restructured loans resulted in either extended maturity or lowered rates and were included in the impaired loan balance.

The following table provides, by class, the number of loans modified in TDRs during the three and nine months ended September 30, 2012.

|                          | <i>(Dollars in Thousands)</i> Three Months Ended September 30, 2012 |                     |                          | Nine Months Ended September 30, 2012 |                     |                          |
|--------------------------|---|---------------------|--------------------------|--------------------------------------|---------------------|--------------------------|
|                          | Number of Loans   | Recorded Investment | Unpaid Principal Balance | Number of Loans                      | Recorded Investment | Unpaid Principal Balance |
| <b>Extended maturity</b> |   |                     |                          |                                      |                     |                          |
| Real estate –            |   |                     |                          |                                      |                     |                          |
| Construction             | 1   | \$ 495              | \$ 514                   | 4                                    | \$ 3,800            | \$ 3,819                 |
| Residential              | 5   | 1,546               | 1,731                    | 6                                    | 2,560               | 2,745                    |
| Nonresidential           | 3   | 1,759               | 1,816                    | 4                                    | 1,777               | 1,834                    |
| Commercial               | -   | -                   | -                        | 1                                    | 110                 | 110                      |
| Consumer and other       | 2   | 69                  | 74                       | 4                                    | 307                 | 312                      |
| <b>Total</b>             | <b>11</b>   | <b>3,869</b>        | <b>4,135</b>             | <b>19</b>                            | <b>8,554</b>        | <b>8,820</b>             |
| <b>Reduced Rate</b>      |   |                     |                          |                                      |                     |                          |
| Real estate –            |   |                     |                          |                                      |                     |                          |
| Residential              | -   | -                   | -                        | 1                                    | 30                  | 30                       |
| Nonresidential           | 1   | 30                  | 30                       | 2                                    | 446                 | 566                      |
| Commercial               | -   | -                   | -                        | 2                                    | 1,588               | 1,588                    |
| <b>Total</b>             | <b>1</b>  | <b>30</b>           | <b>30</b>                | <b>5</b>                             | <b>2,064</b>        | <b>2,184</b>             |
| <b>Totals</b>            | <b>12</b>   | <b>\$ 3,899</b>     | <b>\$ 4,165</b>          | <b>24</b>                            | <b>\$ 10,618</b>    | <b>\$ 11,004</b>         |

The following table provides the number of loans and leases modified in troubled debt restructurings during the previous 12 months which subsequently defaulted during the three and nine months ended September 30, 2012, as well as the recorded investments and unpaid principal balances as of September 30, 2012. Loans in default are those past due greater than 89 days.

|                          | <i>(Dollars in Thousands)</i> Three Months Ended September 30, 2012 |                     |                          | Nine Months Ended September 30, 2012 |                     |                          |
|--------------------------|---|---------------------|--------------------------|--------------------------------------|---------------------|--------------------------|
|                          | Number of Loans   | Recorded Investment | Unpaid Principal Balance | Number of Loans                      | Recorded Investment | Unpaid Principal Balance |
| <b>Extended Maturity</b> |   |                     |                          |                                      |                     |                          |
| Real estate –            |   |                     |                          |                                      |                     |                          |
| Construction             | 1   | \$ 496              | \$ 514                   | 4                                    | \$ 1,969            | \$ 1,987                 |
| Residential              | 5   | 841                 | 842                      | 7                                    | 1,873               | 1,874                    |
| Nonresidential           | -   | -                   | -                        | 1                                    | 110                 | 110                      |
| Commercial               | -   | -                   | -                        | 1                                    | 222                 | 222                      |
| Consumer and other       | -   | -                   | -                        | 1                                    | 23                  | 23                       |
| <b>Total</b>             | <b>6</b>  | <b>1,337</b>        | <b>1,356</b>             | <b>14</b>                            | <b>4,197</b>        | <b>4,216</b>             |

|                    |   |          |          |    |          |          |
|--------------------|---|----------|----------|----|----------|----------|
| Reduced Rate       |   |          |          |    |          |          |
| Real estate –      |   |          |          |    |          |          |
| Residential        | - | -        | -        | 2  | 471      | 591      |
| Nonresidential     | - | -        | -        | 1  | 16       | 16       |
| Commercial         | - | -        | -        | 1  | 237      | 237      |
| Consumer and other | - | -        | -        | 1  | 4        | 4        |
| Total              | - | -        | -        | 5  | 728      | 848      |
| Totals             | 6 | \$ 1,337 | \$ 1,356 | 19 | \$ 4,925 | \$ 5,064 |

All loans modified in 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, such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. 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, 2012, 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 Real Estate Loans | Commercial | Consumer and Other |
|-------------------------------|-------------------|--------------|-------------|-----------------|-------------------------|------------|--------------------|
|                               | Total             | Construction | Residential | Non-Residential |                         |            |                    |
| Pass                          | \$215,898         | \$22,265     | \$58,370    | \$99,035        | \$179,670               | \$26,835   | \$9,393            |
| Special mention               | 25,940            | 7,949        | 5,662       | 11,829          | 25,440                  | 418        | 82                 |
| Substandard                   | 33,318            | 4,176        | 7,642       | 18,425          | 30,243                  | 2,957      | 118                |
| Doubtful                      | -                 | -            | -           | -               | -                       | -          | -                  |
| Totals                        | \$275,156         | \$34,390     | \$71,674    | \$129,289       | \$235,353               | \$30,210   | 9,593              |

As of December 31, 2011, 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 |              | Non-Residential | Total Real Estate Loans | Consumer |
|-------------------------------|-------------------|--------------|-----------------|-------------------------|----------|
|                               | Total             | Construction |                 |                         |          |

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|                 | Total     | Construction | Residential | Residential | Loans     | Commercial | and Other |
|-----------------|-----------|--------------|-------------|-------------|-----------|------------|-----------|
| Pass            | \$237,537 | \$26,767     | \$ 66,961   | \$ 103,120  | \$196,848 | \$ 31,811  | \$ 8,878  |
| Special mention | 32,444    | 6,719        | 6,623       | 17,655      | 30,997    | 1,356      | 91        |
| Substandard     | 33,417    | 9,834        | 7,386       | 12,828      | 30,048    | 3,298      | 71        |
| Doubtful        | -         | -            | -           | -           | -         | -          | -         |
| Totals          | \$303,398 | \$43,320     | \$ 80,970   | \$ 133,603  | \$257,893 | \$ 36,465  | \$ 9,040  |

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 as of September 30, 2012 and December 31, 2011 whose contract amounts represent credit risk:

|                              | September 30,<br>2012 | December 31,<br>2011 |
|------------------------------|-----------------------|----------------------|
| Commitments to extend credit | \$ 28,850,329         | \$ 34,523,727        |
| Standby letters of credit    | 33,637                | 1,595,656            |

**Note 6 – Other Real Estate Owned**

Transactions in other real estate owned for the nine months ended September 30, 2012 and year ended December 31, 2011 are summarized below:

|                                 | September 30,<br>2012 | December 31,<br>2011 |
|---------------------------------|-----------------------|----------------------|
| Beginning balance               | \$ 22,135,921         | \$ 14,669,051        |
| Additions                       | 5,317,584             | 14,049,177           |
| Improvements made to properties | -                     | 6,987                |
| Sales                           | (11,102,865 )         | (5,427,221 )         |
| Net loss on sales               | (109,516 )            | (57,818 )            |
| Write downs                     | (882,189 )            | (1,104,255 )         |
| Ending balance                  | \$ 15,358,935         | \$ 22,135,921        |

For the nine months ended September 30, 2012 and 2011, sales of other real estate owned totaled \$11,102,865 and \$5,427,221, respectively, of which the Company received cash proceeds of \$5,882,445 and \$5,427,221 and financed the balance of \$5,220,420 and \$0, respectively. The Company recognized a net loss of \$109,516 and \$100,755 on these sales for the nine months ended September 30, 2012 and 2011, respectively.

Other real estate owned expense for the nine months ended September 30, 2012 and 2011 was \$1,766,182 and \$2,042,122, 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, 2012 and 2011.

|  | Nine Months Ended<br>September 30, |           |
|--|------------------------------------|-----------|
|  | 2012                               | 2011      |
| Common shares outstanding at beginning of the period | 4,084,400                          | 4,115,903 |
| Issuance of common stock                             | 770                                | 334       |
| Issuance of non-vested restricted shares             | 13,627                             | 20,000    |
| Forfeiture of restricted shares                      | (2,023 )                           | (41,778 ) |

Common shares outstanding at end of the period                      4,096,774    4,094,459

### **Note 8 – Income Taxes**

The income tax expense related to the Company's pretax income for the first three quarters of 2012 was offset by a reversal of an equal amount of the Company's valuation allowance related to its deferred tax assets. Therefore, no income tax provision was recorded for the nine and three months ended September 30, 2012.

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

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

The following is a summary of the net income (loss) per common share calculations for the three months and nine months ended September 30, 2012 and 2011.

|  | Three Months Ended<br>September 30, |               | Nine Months Ended<br>September 30, |               |
|--|-------------------------------------|---------------|------------------------------------|---------------|
|  | 2012                                | 2011          | 2012                               | 2011          |
| Net income (loss) available to common shareholders   |                                     |               |                                    |               |
| Net income (loss)  | \$676,410                           | \$(8,766,302) | \$1,134,728                        | \$(8,230,112) |
| Preferred stock dividends  | 249,248                             | 249,248       | 747,743                            | 747,743       |
| Deemed dividends on preferred stock resulting from net accretion of discount and amortization of premium | 44,876                              | 44,875        | 133,652                            | 133,163       |
| Net income (loss) available to common shareholders   | \$382,286                           | \$(9,060,425) | \$253,333                          | \$(9,111,018) |

|  | Three Months Ended<br>September 30, |               | Nine Months Ended<br>September 30, |               |
|--|-------------------------------------|---------------|------------------------------------|---------------|
|  | 2012                                | 2011          | 2012                               | 2011          |
| Basic net income (loss) per common share:          |                                     |               |                                    |               |
| Net income (loss) available to common shareholders | \$ 382,286                          | \$(9,060,425) | \$253,333                          | \$(9,111,018) |
| Average common shares outstanding - basic          | 4,096,774                           | 4,094,459     | 4,093,148                          | 4,103,189     |
| Basic net income (loss) per share                  | \$0.09                              | \$(2.21 )     | \$0.06                             | \$(2.22 )     |
| Diluted net income (loss) per common share:        |                                     |               |                                    |               |
| Net income (loss) available to common shareholders | \$ 382,286                          | \$(9,060,425) | \$253,333                          | \$(9,111,018) |
| Average common shares outstanding - basic          | 4,096,774                           | 4,094,459     | 4,093,148                          | 4,103,189     |
| Dilutive potential common shares                   | 184,325                             | -             | 197,150                            | -             |
| Average common shares outstanding - diluted        | 4,281,099                           | 4,094,459     | 4,290,298                          | 4,103,189     |
| Diluted income (loss) per share                    | \$0.09                              | \$(2.21 )     | \$0.06                             | \$(2.22 )     |

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

On January 19, 2006, the Company adopted the 2006 Equity Incentive 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, as 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 this 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. 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 or vested. 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, 2012 and 2011 the Company issued 13,627 and 20,000 shares, respectively, of restricted stock pursuant to the 2006 Equity Incentive Plan. The shares issued in 2012 and 2011 cliff vest in three years and are fully vested in 2015 and 2014, respectively, subject to meeting the performance criteria of the Plan. The weighted-average fair value of restricted stock issued during the nine months ended September 30, 2012 and 2011 was \$1.05 and \$2.20 per share, respectively. Compensation cost associated with the issuance for 2012 and 2011 was \$14,308 and \$44,000, respectively, to be amortized over three years. During the first nine months of 2012 and 2011, 2,023 and 41,778 shares were forfeited having a weighted average price of \$3.18 and \$3.39, respectively. Deferred compensation expense of \$152,101 and \$154,770, relating to restricted stock, was amortized to income during the nine months ended September 30, 2012 and 2011, respectively.

The 2006 Equity Incentive Plan 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.

During the first quarter of 2012, the Board of Directors cancelled all 84,334 SARs that were outstanding at December 31, 2011. Holders of these SARs were given a cash settlement totaling \$37,500 in exchange for the cancellation. The cancellation resulted in the removal of all accrued SARs expense and related unrecognized compensation costs. For the nine months ended September 30, 2012, net income of \$337,153 was recognized as a result of the cancellation. The SARs compensation expense for the nine months ended September 30, 2011 was \$38,058.

### **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, 2012 and December 31, 2011, substantially all of the 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 other real estate owned. 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, 2012 and December 31, 2011.

|                                  | Total        | Level 1 | Level 2      | Level 3 |
|----------------------------------|--------------|---------|--------------|---------|
| September 30, 2012               |              |         |              |         |
| Available-for-sale securities:   |              |         |              |         |
| U.S. Government agencies         | \$8,055,096  | \$ -    | \$8,055,096  | \$ -    |
| Mortgage-backed securities       | 56,438,708   | -       | 56,438,708   | -       |
| Other                            | 10,500       | -       | 10,500       | -       |
|                                  | 64,504,304   | -       | 64,504,304   | -       |
| Mortgage loans held for sale (1) | 3,977,700    | -       | 3,977,700    | -       |
|                                  | \$68,482,004 | \$ -    | \$68,482,004 | \$ -    |

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

|                                  |              |      |              |      |
|----------------------------------|--------------|------|--------------|------|
| December 31, 2011                |              |      |              |      |
| Available-for-sale securities:   |              |      |              |      |
| U.S. Government agencies         | \$3,024,945  | \$ - | \$3,024,945  | \$ - |
| Mortgage-backed securities       | 61,560,402   | -    | 61,560,402   | -    |
| Municipals                       | 19,937,971   | -    | 19,937,971   | -    |
| Other                            | 11,000       | -    | 11,000       | -    |
|                                  | 84,534,318   | -    | 84,534,318   | -    |
| Mortgage loans held for sale (1) | 2,863,297    | -    | 2,863,297    | -    |
|                                  | \$87,397,615 | \$ - | \$87,397,615 | \$ - |

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

There were no liabilities measured at fair value on a recurring basis at September 30, 2012 and December 31, 2011.

**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, 2012 and December 31, 2011, aggregated by level in the fair value hierarchy within which those measurements fall.

|                            | Total        | Level 1 | Level 2      | Level 3      |
|----------------------------|--------------|---------|--------------|--------------|
| September 30, 2012         |              |         |              |              |
| Impaired loans receivable  | \$30,052,229 | \$ -    | \$-          | \$30,052,229 |
| Other real estate owned    | 15,358,935   | -       | 15,358,935   | -            |
| Total assets at fair value | \$45,411,164 | \$ -    | \$15,358,935 | \$30,052,229 |

|                            | Total        | Level 1 | Level 2      | Level 3      |
|----------------------------|--------------|---------|--------------|--------------|
| December 31, 2011          |              |         |              |              |
| Impaired loans receivable  | \$23,837,812 | \$ -    | \$-          | \$23,837,812 |
| Other real estate owned    | 22,135,921   | -       | 22,135,921   | -            |
| Total assets at fair value | \$45,973,733 | \$ -    | \$22,135,921 | \$23,837,812 |

There were no liabilities measured at fair value on a nonrecurring basis at September 30, 2012 and December 31, 2011.

Impaired loans which are measured for impairment using the fair value of collateral for collateral dependent loans, had a carrying value of \$30,710,491 at September 30, 2012 with a valuation allowance of \$658,262. Impaired loans had a carrying value of \$26,503,206 at December 31, 2011 with a valuation allowance of \$2,665,394.

Other real estate owned, which is measured at the lower of carrying amount or fair value less costs to sell, had a net carrying value of \$15,358,935 and \$22,135,921 at September 30, 2012 and December 31, 2011, respectively. Write downs of other real estate owned for the nine months ended September 30, 2012 and for the year ended December 31, 2011 were \$882,189 and \$1,104,255, respectively.

#### **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.

***Nonmarketable 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, 2012 and December 31, 2011. 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.





|                                      |               |               | Fair Value Measurements |               |               |
|--------------------------------------|---------------|---------------|-------------------------|---------------|---------------|
|                                      |               |               | Quoted                  |               |               |
|                                      |               |               | Prices                  |               |               |
|                                      |               |               | in                      |               |               |
|                                      |               |               | Active                  |               |               |
|                                      |               |               | Markets                 |               |               |
|                                      |               |               | for                     | Other         | Significant   |
|                                      |               |               | Identical               | Assets        | Unobservable  |
|                                      |               |               | Assets                  | or            | Inputs        |
|                                      | Carrying      | Fair          | Liabilities             | Observable    | (Level 3)     |
|                                      | Amount        | Value         | (Level 1)               | (Level 2)     | (Level 3)     |
| September 30, 2012                   |               |               |                         |               |               |
| Financial Assets:                    |               |               |                         |               |               |
| Loans receivable                     | \$275,156,230 | \$277,688,000 | \$-                     | \$-           | \$277,688,000 |
| Financial Liabilities:               |               |               |                         |               |               |
| Certificates of deposit              | \$157,207,270 | \$159,478,000 | \$-                     | \$159,478,000 | \$-           |
| Advances from Federal Home Loan Bank | 13,000,000    | 13,076,000    | -                       | 13,076,000    | -             |
| December 31, 2011                    |               |               |                         |               |               |
| Financial Assets:                    |               |               |                         |               |               |
| Loans receivable                     | \$303,398,403 | \$305,701,000 | \$-                     | \$-           | \$305,701,000 |
| Financial Liabilities:               |               |               |                         |               |               |
| Certificates of deposit              | \$210,896,717 | \$215,293,000 | \$-                     | \$215,293,000 | \$-           |
| Advances from Federal Home Loan Bank | 13,000,000    | 13,050,000    | -                       | 13,050,000    | -             |

**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 have 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. You should read the following discussion and analysis in conjunction with the accompanying consolidated financial statements. The commentary should be read in conjunction with the discussion of forward-looking statements, the financial statements and the related notes and the other statistical information included in this report.

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

Certain of the statements made under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere throughout this Form 10-Q are forward-looking statements for purposes of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended (the Exchange Act). Forward-looking statements relate to future events or our future financial performance and may involve known or unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of First Reliance to be materially different from future results, performance, or achievements expressed or implied by such forward-looking statements. Forward-looking statements include statements using the words such as "may," "will," "anticipate," "should," "would," "project," "future," "strategy," "believe," "contemplate," "expect," "estimate," "continue," "in" other similar words and expressions of the future.

These forward-looking statements involve risks and uncertainties, and may not be realized due to a variety of factors, including, without limitation: the effects of future economic conditions, governmental monetary and fiscal policies, as well as legislative and regulatory changes, including, but not limited, proposed changes to capital standards and asset risk-weighting (otherwise known as Basel III); the risks of changes in interest rates on the level and composition of deposits, loan demand, and the values of loan collateral, securities, and interest sensitive assets and liabilities; continued economic uncertainty stemming from the adverse economic conditions affecting the European Union; continued political unrest and instability in the Middle East; the historically flat yield curve for investment securities, and its potential effects on our asset mix and asset yields; the costs of evaluating possible strategic and capital alternatives and the risks inherent in integrating acquisitions; 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 First Reliance's market area and elsewhere, including institutions operating regionally, nationally and internationally, together with such competitors offering banking products and services by mail, telephone, computer and the Internet; and, the failure of assumptions underlying the establishment of reserves for possible loan losses. Additional factors that could cause actual results to differ materially are discussed in our filings with the Securities and Exchange Commission, including, without limitation, our Annual Report on Form 10-K and our Quarterly Reports on Form 10-Q.

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. All written or oral forward-looking statements attributable to First Reliance are expressly qualified in their entirety by this Cautionary Note.

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## Overview

The following discussion describes our results of operation for the quarter and nine months ended September 30, 2012 as compared to the quarter and nine months ended September 30, 2011 and also analyzes our financial condition as of September 30, 2012 as compared to December 31, 2011.

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 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, 2011 as filed on 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 Federal Deposit Insurance Corporation (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 South Carolina Commissioner of Banks ("SC State Board"), that 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 Bank's parent holding 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 State Board, the Federal Reserve Bank of Richmond (the "Federal Reserve Bank") 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 Memorandum already in place for the Bank, the Company MOU requires that the Company seek pre-approval from the Federal Reserve Bank 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 trust preferred securities, including the Series A Preferred Stock and Series B Preferred Stock issued to the Treasury as part of our participation in the TARP CPP, as well as the Series C Preferred Stock issued as part of a private offering completed in 2010. This provision will also apply to the Company's common stock, although to date, the Company has not elected to pay dividend on its shares of common stock. The Federal Reserve Bank 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 in the first three quarters of 2012. Also, such approval was not granted for payments due in the fourth quarter of 2012. As a result, no assurance can be given as to the ability of the Company to obtain approval from the Federal Reserve Bank to resume the payment of such dividends and interest in future quarters while the Company MOU remains in effect. Should the Company fail to pay the dividend on its preferred stock held by the U. S. Treasury for six quarterly periods, the holder of the Company's Series A and Series B Preferred Stock will have the right to appoint up to two directors to the Company's board of directors.

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 will result in full compliance with our regulatory obligations with the FDIC, the SC State Board and the Federal Reserve Bank and position us well for stability and growth over the long term.

### **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**

For the third quarter of 2012 our net income available to common shareholders was \$382,286, or a basic and diluted income per common share of \$0.09 compared to a net loss available to common shareholders of \$9,060,425, or a basic

and diluted loss per common share of \$2.21 for the third quarter of 2011. Comparing the third quarter of 2012 with the third quarter of 2011, we experienced an increase of \$9,442,711 in our net income available to common shareholders. For the third quarter of 2012, we did not record an income tax provision, whereas for the third quarter of 2011 we recorded an income tax expense of \$5,554,099. Additionally, our third quarter earnings were favorably impacted by the reduction of \$2,685,865 in our provision for loan losses, which resulted from decreased exposure to certain coastal markets and a decrease in the risk profile of our loan portfolio through a decrease in our volume of construction loans.

For the nine months ended September 30, 2012, we realized net income available to common shareholders of \$253,333, compared to a net loss available to common shareholders of \$9,111,018 for the nine months ended September 30, 2011. This resulted in basic and diluted income per common share of \$0.06 for the nine months ended September 30, 2012, compared to a net loss per common share of \$2.22 for the nine months ended September 30, 2011. Comparing the first nine months of 2012 with the first nine months of 2011, we experienced an increase of \$9,364,351 in our net income available to common shareholders. For the nine months ended September 30, 2012, we did not record an income tax provision, whereas for first nine months of 2011 we recorded an income tax expense of \$5,134,705. Our earnings for the first nine months of 2012 were favorably impacted by the reduction of \$2,608,989 in our provision for loan losses, the increase of \$1,289,832 in our net gain on sale of securities, and the reduction of \$1,106,498 in our expense for salaries and employee benefits. Our net income available to common shareholders was negatively impacted by the reduction of \$1,555,821 in our net interest income.

#### 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 its interest-earning assets and interest-bearing liabilities. Total interest-earning assets yield less total interest-bearing liabilities rate represents our net interest rate spread.

Net interest income decreased \$521,807 or 12.21%, to \$3,752,569 for the quarter ended September 30, 2012, from \$4,274,376 for the comparable period of 2011. Our net interest income for the nine months ended September 30, 2012 and 2011 was \$11,092,929 and \$12,648,750, respectively. This represents a decrease of \$1,555,821 or 12.30%. The decrease in both periods is due primarily to the significant reduction in the average volume of our loans, which are our highest yielding earning assets. The average volume of our loans was \$43,786,751 and \$44,948,664, lower for the three and nine months ended September 30, 2012, respectively, than they were for comparable 2011 periods.

For the third quarter of 2012, average-earning assets totaled \$396,609,932 with an annualized average yield of 4.81% compared to \$451,244,119, and 5.21%, respectively, for the third quarter of 2011. Average interest-bearing liabilities totaled \$350,062,011 with an annualized average cost of 1.18% for the third quarter of 2012 compared to \$412,124,876 and 1.55%, respectively, for the third quarter of 2011.

Average earning assets for the nine months ended September 30, 2012 and 2011 were \$412,638,664 and \$457,783,324, respectively, with an annualized average yield of 4.75% and 5.17% respectively. Average interest-bearing liabilities totaled \$369,728,688 and \$421,294,366 with an annualized average cost of 1.29% and 1.60% for the nine months ended September 30, 2012 and 2011, respectively.

Our net interest margin and net interest spread were 3.76% and 3.63%, respectively, for the third quarter of 2012 compared to 3.80% and 3.66%, respectively, for the third quarter of 2011. For the nine months ended September 30, 2012, our net interest margin and net interest spread were 3.59% and 3.46%, respectively compared to 3.69% and 3.57%, respectively for the comparable period of 2011.

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 71.58% and 70.92% of average earning assets for the three and nine months ending September 30, 2012, respectively compared to 72.62% and 73.75%, respectively for the comparable period of 2011.

Loan interest income for the three and nine months ended September 30, 2012 was \$4,196,618 and \$12,699,918, respectively, compared to \$5,037,612 and \$15,127,300, respectively, for the comparable periods of 2011. The annualized average yield on loans was 5.88% and 5.80%, respectively, for the three and nine months ended September 30, 2012 compared to 6.17% and 5.99%, respectively, for the comparable 2011 periods. For the three and nine months ended September 30, 2012, compared to the three and nine months ended September 30, 2011, the average balances of our loans decreased \$43,786,751, or 13.36% and \$44,948,664, or 13.31%, respectively. Our loan interest income for the three and nine months ended September 30, 2012, was negatively affected by the significant decrease in the average volume of our loans and the continuation of the downturn in our local real estate markets. Additional information may be found in the "Rate/Volume Analysis" presented on the following page.



Available-for-sale investment securities averaged \$79,668,045, or 20.09 % of average earning assets, for the third quarter of 2012 compared to \$95,045,955, or 21.06% of average earning assets, for the third quarter of 2011. Available-for-sale investment securities averaged \$83,961,032 and 20.35% of average earning assets for the nine months ended September 30, 2012 compared to \$87,673,600 and 19.15% for the nine months ended September 30, 2011. Interest earned on available-for-sale securities amounted to \$574,210 and \$1,879,332 for the three and nine months ended September 30, 2012, respectively, compared to \$808,449 and \$2,498,266 respectively, for the same periods in 2011. The annualized average yield on available-for-sale investment securities was 2.87% and 3.41% for the third quarter of 2012 and 2011, respectively. The annualized average yield on available-for-sale investment securities was 2.99% and 3.81% for the nine months ended September 30, 2012 and 2011, respectively. The decrease in yield on our available-for-sale investment securities was caused, in part, by a historically flat yield curve for investment yields that has diminished returns available for this asset type.

Our average interest-bearing deposits were \$322,060,860 and \$381,770,338 for the third quarter of 2012 and 2011, respectively. This represented a decrease of \$59,709,478, or 15.64%. Our average interest-bearing deposits were \$343,214,204 and \$391,364,837 for the nine months ended September 30, 2012 and 2011, respectively. This represented a decrease of \$48,150,633, or 12.30%. Total interest paid on deposits for the three and nine months ended September 30, 2012 was \$911,213 and \$3,180,242, respectively, compared to \$1,465,991 and \$4,862,966 for the same periods of 2011. The annualized average cost of deposits was 1.13% and 1.54% for the three months ended September 30, 2012 and 2011, respectively. The annualized average cost of deposits was 1.24% and 1.66% for the nine months ended September 30, 2012 and 2011, respectively. As our loan demand declined, we concurrently lowered our rates paid for deposits, especially for time deposits, which is the primary reason why the amounts of our average time deposits were 22.29% and 20.66% lower during the three and nine months ended September 30, 2012 than during the comparable 2011 periods.

The average balance of other interest-bearing liabilities was \$28,001,151 and \$30,354,538 for the three months ended September 30, 2012 and 2011, respectively. This represented a decrease of \$2,353,387 and 7.75%. For the nine months ended September 30, 2012 and 2011 the average balance of other interest bearing liabilities was \$26,514,484 and \$29,929,529, respectively. This represented a decrease of \$3,415,045, or 11.41%. The decrease in both periods is mainly attributable to the decrease in our average borrowings from the Federal Home Loan Bank. With the diminished loan demand we experienced during the past year, we utilized fewer borrowings from the Federal Home Loan Bank to meet our funding needs.

### Rate/Volume Analysis

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,

| (Dollars in thousands)                      | Average Balances, Income and Expenses, and Rates |                |            |                 |                |            |                 |                |            |
|---|--|----------------|------------|-----------------|----------------|------------|-----------------|----------------|------------|
|   | 2012   |                |            | 2011            |                |            | 2010            |                |            |
|   | Average Balance                                  | Income/Expense | Yield/Rate | Average Balance | Income/Expense | Yield/Rate | Average Balance | Income/Expense | Yield/Rate |
| <b>Assets</b>                               |  |                |            |                 |                |            |                 |                |            |
| Earning assets:                             |  |                |            |                 |                |            |                 |                |            |
| Loans (1)                                   | \$283,909  | \$4,197        | 5.88 %     | \$327,696       | \$5,038        | 6.17 %     | \$372,071       | \$5,653        | 6.09 %     |
| Securities, taxable                         | 66,312   | 446            | 2.68       | 68,323          | 532            | 3.12       | 60,426          | 549            | 3.64       |
| Securities, nontaxable                      | 13,356   | 128            | 3.82       | 26,722          | 276            | 4.15       | 56,460          | 597            | 4.24       |
| Other earning assets                        | 33,033   | 23             | 0.28       | 28,503          | 20             | 0.28       | 41,970          | 33             | 0.31       |
| Total earning assets                        | 396,610  | 4,794          | 4.81       | 451,244         | 5,866          | 5.21       | 530,927         | 6,832          | 5.16       |
| Non-earning assets:                         | 56,829   |                |            |                 | 65,590         |            | 57,538          |                |            |
| Total assets                                | \$453,439  |                |            |                 | \$516,834      |            | \$588,465       |                |            |
| <b>Liabilities and Shareholders' Equity</b> |  |                |            |                 |                |            |                 |                |            |
| Interest-bearing deposits:                  |  |                |            |                 |                |            |                 |                |            |
| Transaction accounts                        | \$41,409   | \$15           | 0.15 %     | \$40,478        | \$43           | 0.43 %     | \$36,620        | \$51           | 0.56 %     |
| Savings and money market accounts           | 111,986  | 73             | 0.26       | 124,239         | 218            | 0.70       | 111,307         | 302            | 1.09       |
| Time deposits                               | 168,666  | 823            | 1.94       | 217,053         | 1,205          | 2.23       | 304,834         | 2120           | 2.79       |
| Total interest-bearing deposits             | 322,061  | 911            | 1.13       | 381,770         | 1,466          | 1.54       | 452,761         | 2473           | 2.19       |

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|  |           |          |        |           |          |        |           |          |        |
|--|-----------|----------|--------|-----------|----------|--------|-----------|----------|--------|
| Other interest-bearing liabilities:      |           |          |        |           |          |        |           |          |        |
| Federal Home Loan Bank bank borrowing    | 13,000    | 68       | 2.07   | 20,000    | 71       | 1.42   | 26,000    | 238      | 3.67   |
| Junior subordinated debentures           | 10,310    | 61       | 2.36   | 10,310    | 55       | 2.14   | 10,310    | 156      | 6.08   |
| Other                                    | 4,691     | 1        | 0.10   | 45        | -        | 0.00   | 808       | -        | 0.00   |
| Total other interest-bearing liabilities | 28,001    | 130      | 1.85   | 30,355    | 126      | 1.66   | 37,118    | 394      | 4.26   |
| Total interest-bearing liabilities       | 350,062   | 1,041    | 1.18   | 412,125   | 1,592    | 1.55   | 489,879   | 2,867    | 2.35   |
| Noninterest-bearing deposits             | 57,833    |          |        | 52,285    |          |        | 44,184    |          |        |
| Other liabilities                        | 3,240     |          |        | 2,564     |          |        | 3,610     |          |        |
| Shareholders' equity                     | 42,304    |          |        | 49,860    |          |        | 50,792    |          |        |
| Total liabilities and equity             | \$453,439 |          |        | \$516,834 |          |        | \$588,465 |          |        |
| Net interest income/interest spread      |           | \$ 3,753 | 3.63 % |           | \$ 4,274 | 3.66 % |           | \$ 3,965 | 2.81 % |
| Net yield on earning assets              |           |          | 3.76 % |           |          | 3.80 % |           |          | 3.00 % |

(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 |                |                    |                 |                |                    |                 |                |                    |
|---|--|----------------|--------------------|-----------------|----------------|--------------------|-----------------|----------------|--------------------|
|   | 2012   |                |                    | 2011            |                |                    | 2010            |                |                    |
|   | Average Balance                                  | Income/Expense | Yield/ <u>Rate</u> | Average Balance | Income/Expense | Yield/ <u>Rate</u> | Average Balance | Income/Expense | Yield/ <u>Rate</u> |
| <b>Assets</b>                               |  |                |                    |                 |                |                    |                 |                |                    |
| Earning assets:                             |  |                |                    |                 |                |                    |                 |                |                    |
| Loans (1)                                   | \$292,645  | \$12,700       | 5.80 %             | \$337,594       | \$15,127       | 5.99 %             | \$386,276       | \$17,720       | 6.13 %             |
| Securities, taxable                         | 66,603   | 1,373          | 2.75               | 47,890          | 1,204          | 3.36               | 60,827          | 1,742          | 3.83               |
| Securities, nontaxable                      | 17,358   | 506            | 3.90               | 39,783          | 1,294          | 4.35               | 59,261          | 1,904          | 4.30               |
| Other earning assets                        | 36,033   | 81             | 0.30               | 32,516          | 75             | 0.31               | 40,347          | 88             | 0.29               |
| Total earning assets                        | 412,639  | 14,660         | 4.75               | 457,783         | 17,700         | 5.17               | 546,711         | 21,454         | 5.25               |
| Non earning assets:                         | 58,709   |                |                    | 63,476          |                |                    | 56,748          |                |                    |
| Total assets                                | \$471,348  |                |                    | \$521,259       |                |                    | \$603,459       |                |                    |
| <b>Liabilities and Shareholders' Equity</b> |  |                |                    |                 |                |                    |                 |                |                    |
| Interest-bearing deposits:                  |  |                |                    |                 |                |                    |                 |                |                    |
| Transaction accounts                        | \$41,966   | \$65           | 0.21 %             | \$38,425        | \$139          | 0.48 %             | \$38,394        | \$140          | 0.49 %             |
| Savings and money market accounts           | 116,145  | 282            | 0.32               | 119,634         | 690            | 0.77               | 106,489         | 982            | 1.23               |
| Time deposits                               | 185,104  | 2,833          | 2.04               | 233,306         | 4,034          | 2.31               | 325,166         | 6,978          | 2.87               |
| Total interest-bearing deposits             | 343,215  | 3,180          | 1.24               | 391,365         | 4,863          | 1.66               | 470,049         | 8,100          | 2.30               |
| Other interest-bearing liabilities:         |  |                |                    |                 |                |                    |                 |                |                    |
| Federal Home Loan Bank bank borrowing       | 13,000   | 200            | 2.06               | 19,513          | 207            | 1.42               | 26,613          | 712            | 3.57               |
| Junior subordinated debentures              | 10,310   | 185            | 1.79               | 10,310          | (19 )          | (0.25)             | 10,310          | 463            | 6.01               |
| Other                                       | 3,204  | 2              | 0.10               | 107             | -              | 1.00               | 789             | -              | 0.00               |
| Total other interest-bearing liabilities    | 26,514   | 387            | 1.95               | 29,930          | 188            | 0.84               | 37,712          | 1,175          | 4.17               |
| Total interest-bearing liabilities          | 369,729  | 3,567          | 1.29               | 421,295         | 5,051          | 1.60               | 507,761         | 9,275          | 2.44               |
| Noninterest-bearing deposits                | 56,774   |                |                    | 48,949          |                |                    | 43,879          |                |                    |
| Other liabilities                           | 2,974  |                |                    | 2,542           |                |                    | 3,857           |                |                    |
| Shareholders' equity                        | 41,871   |                |                    | 48,473          |                |                    | 47,962          |                |                    |
| Total liabilities and equity                | \$471,348  |                |                    | \$521,259       |                |                    | \$603,459       |                |                    |
|   |  | \$11,093       | 3.46 %             |                 | \$12,649       | 3.57 %             |                 | \$12,179       | 2.81 %             |

Net interest  
income/interest spread

|                                |        |        |        |
|--------------------------------|--------|--------|--------|
| Net yield on earning<br>assets | 3.59 % | 3.69 % | 2.98 % |
|--------------------------------|--------|--------|--------|

(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,

| <i>(Dollars in thousands)</i>         | 2012 Compared to 2011            |         |          | 2011 Compared to 2010            |       |          |
|---------------------------------------|----------------------------------|---------|----------|----------------------------------|-------|----------|
|                                       | Due to increase<br>(decrease) in |         |          | Due to increase<br>(decrease) in |       |          |
|                                       | Volume                           | Rate    | Total    | Volume                           | Rate  | Total    |
| <b>Interest income:</b>               |                                  |         |          |                                  |       |          |
| Loan                                  | \$(622)                          | \$(219) | \$(841 ) | \$(688)                          | \$73  | \$(615 ) |
| Securities, taxable                   | (15 )                            | (71 )   | (86 )    | 67                               | (84 ) | (17 )    |
| Securities, tax exempt                | (128)                            | (20 )   | (148 )   | (309)                            | (12 ) | (321 )   |
| Other earning assets                  | 3                                | -       | 3        | (9 )                             | (4 )  | (13 )    |
| Total interest income                 | (762)                            | (310)   | (1,072)  | (939)                            | (27 ) | (966 )   |
| <b>Interest expense:</b>              |                                  |         |          |                                  |       |          |
| <b>Interest-bearing deposits</b>      |                                  |         |          |                                  |       |          |
| Interest-bearing transaction accounts | 1                                | (29 )   | (28 )    | 5                                | (13 ) | (8 )     |
| Savings and money market accounts     | (20 )                            | (125)   | (145 )   | 33                               | (117) | (84 )    |
| Time deposits                         | (241)                            | (141)   | (382 )   | (539)                            | (376) | (915 )   |
| Total interest-bearing deposits       | (260)                            | (295)   | (555 )   | (501)                            | (506) | (1,007)  |

| <i>(Dollars in thousands)</i>            | 2012 Compared to 2011 |          |           | 2011 Compared to 2010 |        |          |
|--|-----------------------|----------|-----------|-----------------------|--------|----------|
|  | Volume                | Rate     | Total     | Volume                | Rate   | Total    |
| Other interest-bearing liabilities       |                       |          |           |                       |        |          |
| Federal Home Loan Bank borrowings        | (30 )                 | 27       | (3 )      | (46 )                 | (121 ) | (167 )   |
| Junior subordinated debentures           | -                     | 6        | 6         | -                     | (101 ) | (101 )   |
| Other                                    | 1                     | -        | 1         | -                     | -      | -        |
| Total other interest-bearing liabilities | (29 )                 | 33       | 4         | (46 )                 | (222 ) | (268 )   |
| Total interest expense                   | (289 )                | (262 )   | (551 )    | (547 )                | (728 ) | (1,275 ) |
| Net interest income                      | \$ (473 )             | \$ (48 ) | \$ (521 ) | \$ (392 )             | \$ 701 | \$ 309   |

**Nine Months Ended September 30,**

| <i>(Dollars in thousands)</i>            | 2012 Compared to 2011 |           |             | 2011 Compared to 2010 |           |             |
|--|-----------------------|-----------|-------------|-----------------------|-----------|-------------|
|  | Volume                | Rate      | Total       | Volume                | Rate      | Total       |
| Interest income:                         |                       |           |             |                       |           |             |
| Loans                                    | \$ (1,960 )           | \$ (467 ) | \$ (2,427 ) | \$ (2,195 )           | \$ (398 ) | \$ (2,593 ) |
| Securities, taxable                      | 414                   | (245 )    | 169         | (341 )                | (197 )    | (538 )      |
| Securities, tax exempt                   | (663 )                | (125 )    | (788 )      | (632 )                | 22        | (610 )      |
| Other earning assets                     | 8                     | (2 )      | 6           | (19 )                 | 6         | (13 )       |
| Total interest income                    | (2,201 )              | (839 )    | (3,040 )    | (3,187 )              | (567 )    | (3,754 )    |
| Interest expense:                        |                       |           |             |                       |           |             |
| Interest-bearing deposits                |                       |           |             |                       |           |             |
| Interest-bearing transaction accounts    | 12                    | (86 )     | (74 )       | -                     | (1 )      | (1 )        |
| Savings and money market accounts        | (19 )                 | (389 )    | (408 )      | 109                   | (401 )    | (292 )      |
| Time deposits                            | (767 )                | (434 )    | (1,201 )    | (1,741 )              | (1,203 )  | (2,944 )    |
| Total interest-bearing deposits          | (774 )                | (909 )    | (1,683 )    | (1,632 )              | (1,605 )  | (3,237 )    |
| Other interest-bearing liabilities       |                       |           |             |                       |           |             |
| Federal Home Loan Bank borrowings        | (82 )                 | 75        | (7 )        | (155 )                | (350 )    | (505 )      |
| Junior subordinated debentures           | -                     | 204       | 204         | -                     | (482 )    | (482 )      |
| Other                                    | 2                     | 0         | 2           | -                     | -         | -           |
| Total other interest-bearing liabilities | (80 )                 | 279       | 199         | (155 )                | (832 )    | (987 )      |
| Total interest expense                   | (854 )                | (630 )    | (1,484 )    | (1,787 )              | (2,437 )  | (4,224 )    |
| Net interest income                      | \$ (1,347 )           | \$ (209 ) | \$ (1,556 ) | \$ (1,400 )           | \$ 1,870  | \$ 470      |

**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. We calculate a loss factor for each geographic region, then weight the overall loss factor by the geographic weight remaining in the overall portfolio. Over time, we expect these changes to our loan loss allowance methodology to have a material positive impact on our required allowance level as we continue to reduce our exposure to certain markets. We have shortened the period over which we review historical losses from eight quarters to four in response to industry trends and conditions; the shorter loss history window is more in line with our peer group and tracks more closely the unusual market volatility of the past several years, making the provision estimate more responsive to current economic conditions. The historical loss factors utilized in our model have been updated as of the end of the third quarter 2012 to reflect losses realized through the end of second quarter 2012.

As we mentioned 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 for each geographic region. The overall loss factor is then calculated by weighting each geographic region within the overall portfolio. 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 weakness in the economic environment in our market areas.

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, 2012 and 2011, the allowance for loan losses was \$4,341,422 and \$6,422,526, respectively, a decrease of \$2,081,104, or 32.40%, from the 2011 allowance. The decrease was partly due to the charge-off of certain large borrowers against previously established allowances, which did not require the allowance to be replenished. As a percentage of total loans, the allowance for loan losses was 1.58% and 1.98% at September 30, 2012 and 2011, respectively. 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.

The provision for loan losses was \$950,955 and \$3,559,944 for the nine months ended September 30, 2012 and 2011, respectively. This represents a decrease of \$2,608,989, or 73.29%. Our provision for loan losses for the third quarter of 2012 and 2011 was \$350,955 and \$3,036,820. Our analysis of the allowance for loan losses as of September 30, 2012 showed that our overall loss rates have been stabilizing over the past several allowance calculations and that our credit exposure in the Myrtle Beach market and the Charleston market, which were particularly hard-hit by the downturn in the real estate markets and disproportionately contributed to previous loan losses suffered in our loan portfolio, is phasing out.

We believe the allowance for loan losses at September 30, 2012, is adequate to meet potential loan losses inherent in the loan portfolio and, as described earlier, we maintain the flexibility to adjust the allowance to respond to short-term and long-term trends in our local economy that are reflected in our loan portfolio.

### **Noninterest Income**

Noninterest income increased \$1,344,028, or 121.27%, to \$2,452,334 for the third quarter of 2012 from \$1,108,306 for the third quarter of 2011. Noninterest income increased \$1,753,560, or 47.33%, to \$5,458,423 for the first nine months of 2012 from \$3,704,863 for the first nine months of 2011. The increase in our noninterest income for both periods is due primarily to the increase of \$1,362,901 and \$1,289,832 in gain on sale of securities for the three and nine months ended September 30, 2012, respectively. During the third quarter of 2012 we sold our entire portfolio of municipal bonds due to concerns about the continued fiscal uncertainty with respect to the local and state governments that had issued the debt underlying these investments.

### **Noninterest Expense**

For the quarter ended September 30, 2012, noninterest expense totaled \$5,177,538 which is \$380,527, or 6.85%, lower than our noninterest expense for the quarter ended September 30, 2011. For the nine months ended September 30, 2012 and 2011, noninterest expense totaled \$14,465,669 and \$15,889,076, respectively, a decrease of \$1,423,407, or 8.96% for 2012 compared to 2011.

During the latter part of 2011, we performed a rigorous review of our expense categories. Based on this review, we implemented a number of operational changes that resulted in a reduction of a number of our noninterest expenses for the three and nine months ended September 30, 2012 versus the comparable 2011 periods. The largest reduction realized was \$342,904 and \$1,106,498 in our expense for salaries and benefits for the three and nine months ended September 30, 2012, respectively. Included in the expense achieved in the first nine months of 2012 is \$353,003 attributable to the cancellation of all stock appreciation rights that were outstanding at December 31, 2011, during the first quarter of 2012. Additional information regarding the cancellation of the stock appreciation rights is provided in

Note 10 to our financial statements.

Additionally, with the reduction in our deposits base, the cost of our Federal Deposit Insurance premiums were \$104,607 and \$305,386 lower for the three and nine months ended September 30, 2012, respectively, compared to same periods in 2011.

The favorable factors mentioned above were offset by increases in the following noninterest expenses for the three and nine months ended September 30, 2012 compared to the same 2011 periods.

Insurance expense was \$42,719 and \$119,172 higher for the three and nine months ended September 30, 2012, **1.** respectively, compared to the comparable 2011 periods. The increases are due to the expanded policy coverage and higher insurance premiums.

Furniture and equipment expense for the quarters ended September 30, 2012 and 2011 was \$330,979 and \$203,634, respectively, which represents an increase of \$127,345. For the nine months ended September 30, 2012 and 2011, **2.** the expense was \$1,083,915 and \$831,256, respectively, an increase of \$252,659. The increases are due to the recent outsourcing of our data processing and servers to a vendor. While we will have more processing costs in the future, we believe these costs will be offset by lower computer hardware and maintenance costs in the future.

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## **Income Taxes**

The income tax expense related to the Company's pre-tax income for the first three quarters of 2012 was offset by a reversal of an equal amount of the Company's valuation allowance related to its deferred tax assets. Therefore, no income tax provision was recorded for the three and nine months ended September 30, 2012.

## **Balance Sheet Review**

### **General**

At September 30, 2012, we had total assets of \$438.6 million, consisting principally of \$275.2 million in loans, \$65.9 million in investment securities, and \$40.7 million in cash and due from banks. Our liabilities at September 30, 2012, totaled \$396.4 million, which consisted principally of \$364.3 million in deposits, \$13.0 million in FHLB advances, and \$15.0 million in other borrowings. At September 30, 2012, our shareholders' equity was \$42.2 million.

At December 31, 2011, we had total assets of \$495.0 million, consisting principally of \$303.4 million in loans, \$87.0 million in investments, and \$44.0 million in cash and due from banks. Our liabilities at December 31, 2011 totaled \$453.8 million, consisting principally of \$427.8 million in deposits, \$13.0 million in FHLB advances, and \$10.3 million in other borrowings. At December 31, 2011, our shareholders' equity was \$41.1 million.

### **Investment Securities**

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

At September 30, 2012 our investment in available-for-sale securities was \$64,504,304. This is \$20,030,014, or 23.69%, lower than our investment of \$84,534,318 in available-for-sale securities at December 31, 2011. During the third quarter of 2012 we sold our entire portfolio of municipal securities because of our concerns about the deterioration in their market bond ratings. It is our intention to only invest in U. S. Government agencies and mortgage-backed securities in the near future.

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The amortized costs and the fair value of our securities available-for-sale at September 30, 2012 and December 31, 2011 are shown in the following table.

|                                  | September 30, 2012 |                      | December 31, 2011 |                      |
|----------------------------------|--------------------|----------------------|-------------------|----------------------|
|                                  | Amortized Cost     | Estimated Fair Value | Amortized Cost    | Estimated Fair Value |
| Government sponsored enterprises | \$7,650,166        | \$8,055,096          | \$2,839,706       | \$3,024,945          |
| Mortgage-backed securities       | 54,311,203         | 56,438,708           | 59,748,500        | 61,560,402           |
| Municipal securities             | -                  | -                    | 19,084,899        | 19,937,971           |
| Other                            | 100,000            | 10,500               | 100,000           | 11,000               |
| Total                            | \$62,061,369       | \$64,504,304         | \$81,773,105      | \$84,534,318         |

At September 30, 2012, securities classified as available-for-sale are recorded at fair market value. The entire amount of the unrealized losses is the result of a single security in a continuous loss position for twelve months or more. We do not intend to sell this security in the near future and it is more likely than not that we will not be required to sell this security before recovery of its amortized cost. Based on industry analyst reports and credit ratings, we believe that the deterioration in value is not considered other-than-temporary. Please see Note 4 to our financial statements for additional information.

## Securities Available-for-Sale Maturity Distribution and Yields

Contractual maturities and yields on our available-for-sale securities at September 30, 2012 are shown in the following table. 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.

| (Dollars in thousands)              | U.S Government<br>Agencies and<br>Corporations |        |
|-------------------------------------|--|--------|
|                                     | Amount   | Yield  |
| Due after five but within ten years | \$ 8,055                                       | 3.25 % |
| Total securities (1)                | \$ 8,055                                       | 3.25 % |

(1) Excludes mortgage-backed securities totaling \$56,438,708 with a yield of 3.18% and other securities totaling \$10,500.

At September 30, 2012 and December 31, 2011, nonmarketable equity securities totaled \$1,387,400 and \$2,431,800, respectively, consisting of Federal Home Loan Bank stock and Community Bankers Bank stock. These stocks are recorded at their original cost. At September 30, 2012 and December 31, 2011 the Federal Home Loan Bank stock totaled \$1,329,300 and \$2,373,700, respectively. The Community Bankers Bank stock totaled \$58,100 at September 30, 2012 and December 31, 2011.

## Loans

Loans, including loans held for sale, are the largest category of earning assets and typically provide higher yields than the other types of earning assets. Associated with the higher loan yields are the inherent credit and liquidity risks that we attempt to control and counterbalance. Loans averaged \$292,645,495 during the nine months ended September 30, 2012 compared to \$337,594,159 during the nine months ended September 30, 2011, a decrease of \$44,948,664, or 13.31%. At September 30, 2012, total loans were \$279,133,930 compared to \$306,261,700 at December 31, 2011, a decrease of \$27,127,770, or 8.86%. Excluding loans held for sale, loans were \$275,156,230 at September 30, 2012, compared to \$303,398,403 at December 31, 2011, which equated to a decrease of \$28,242,173, or 9.30%. During nine months of 2012 we charged off loans totaling \$5,134,117 and foreclosed on loans totaling \$5,317,584, whereby the loan balances were transferred to other real estate owned. The remainder of this decrease is 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.

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The following table summarizes the composition of our loan portfolio September 30, 2012 and December 31, 2011.

|                               | September 30,<br>2012 | % of<br>Total | December 31,<br>2011 | % of<br>Total |
|-------------------------------|-----------------------|---------------|----------------------|---------------|
| Mortgage loans on real estate |                       |               |                      |               |
| Construction                  | \$ 34,389,985         | 12.50         | % \$ 43,320,482      | 14.28         |
| Residential 1-4 family        | 39,256,376            | 14.26         | 42,837,510           | 14.13         |
| Multifamily                   | 5,648,155             | 2.05          | 8,630,232            | 2.84          |
| Second mortgages              | 4,226,594             | 1.54          | 4,503,752            | 1.48          |
| Equity lines of credit        | 22,542,667            | 8.19          | 24,998,277           | 8.24          |
| Total residential             | 71,673,792            | 26.04         | 80,969,771           | 26.69         |
| Nonresidential                | 129,288,612           | 46.99         | 133,603,482          | 44.03         |
| Total real estate loans       | 235,352,389           | 85.53         | 257,893,735          | 85.00         |
| Commercial and industrial     | 30,209,877            | 10.98         | 36,465,095           | 12.02         |
| Consumer                      | 9,426,357             | 3.43          | 8,649,649            | 2.85          |
| Other, net                    | 167,607               | 0.06          | 389,924              | 0.13          |
| Total loans                   | \$ 275,156,230        | 100.00        | % \$ 303,398,403     | 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 collateral is taken 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, 2012, real estate mortgage loans totaled \$235,352,389 and represented 85.53% of the total loan portfolio, compared to \$257,893,735, or 85.00%, at December 31, 2011.

Real estate construction loans were \$34,389,985 and \$43,320,482 at September 30, 2012 and December 31, 2011, respectively, and represented 12.50% and 14.28% of the total loan portfolio, respectively.

Residential mortgage loans totaled \$71,673,792 at September 30, 2012 and 26.04% of the total loan portfolio, compared to \$80,969,771 and 26.69%, respectively, at December 31, 2011. 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 \$129,288,612 at September 30, 2012 compared to \$133,603,482 at December 31, 2011.

Currently, the demand for all types of real estate mortgage loans in our market area is very weak, largely because of the general economic downturn that affected many businesses and individuals in our market area.

Commercial and industrial loans decreased to \$30,209,877 at September 30, 2012, from \$36,465,095 at December 31, 2011. The decrease is mainly due to the economic downturn in our markets that caused demand for these types of loans to decrease. At September 30, 2012 and December 31, 2011, commercial and industrial loans represented 10.98% and 12.02%, respectively, of the total loan portfolio.

Our loan portfolio is also comprised of consumer and other loans that totaled \$9,593,964 and \$9,039,573 at September 30, 2012 and December 31, 2011, respectively. At September 30, 2012 and December 31, 2011, these loans represented 3.49% and 2.98%, respectively, of the total loan portfolio.

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 over the coming months; however, due to current economic challenges facing our markets, we do not expect any material growth in our loan portfolio in the near future. Additionally, 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

The following table summarizes the loan maturity distribution by collateral type and related interest rate characteristics at September 30, 2012.

| (Dollars in thousands)              | One Year or<br>Less | Over<br>One Year<br>Through<br>Five Years | Over Five<br>Years | Total      |
|-------------------------------------|---------------------|---|--------------------|------------|
| Real Estate                         | \$ 79,653           | \$ 129,351                                | \$ 26,348          | \$ 235,352 |
| Commercial and industrial           | 15,066              | 15,144                                    | -                  | 30,210     |
| Consumer and other                  | 1,715               | 7,006                                     | 873                | 9,594      |
|                                     | \$ 96,434           | \$ 151,501                                | \$ 27,221          | \$ 275,156 |
| Loans maturing after one year with: |                     |   |                    |            |
| Fixed interest rates                |                     |   |                    | \$ 119,061 |
| Floating interest rates             |                     |   |                    | 59,661     |
|                                     |                     |   |                    | \$ 178,722 |

**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, 2012 and 2011.

| (Dollars in thousands)                         | Nine Months Ended |           |
|--|-------------------|-----------|
|  | September 30,     |           |
|  | 2012              | 2011      |
| Balance, January 1                             | \$7,743           | \$6,271   |
| Loans charged off:                             |                   |           |
| Real estate – Construction                     | 2,220             | 1,318     |
| Real estate – Residential                      | 897               | 2,083     |
| Real estate – Nonresidential                   | 899               | -         |
| Commercial and industrial                      | 1,107             | 514       |
| Consumer and other                             | 11                | 32        |
| Total loan losses                              | 5,134             | 3,947     |
| Recoveries of previous loan losses:            |                   |           |
| Real estate – Construction                     | 296               | 281       |
| Real estate – Residential                      | 127               | 156       |
| Real estate – Nonresidential                   | 54                | -         |
| Commercial and industrial                      | 296               | 98        |
| Consumer and other                             | 8                 | 4         |
| Total recoveries                               | 781               | 539       |
| Net charge-offs                                | (4,353 )          | (3,408 )  |
| Provision for loan losses                      | 951               | 3,560     |
| Balance, September 30                          | \$4,341           | \$6,423   |
| Total loans outstanding, end of period         | \$275,156         | \$324,373 |
| Allowance for loan losses to loans outstanding | 1.58 %            | 1.98 %    |

**Risk Elements in the Loan Portfolio**

The following table shows the nonperforming assets at September 30, 2012 and 2011.

| (Dollars in thousands)                         | September 30, |      |
|--|---------------|------|
|  | 2012          | 2011 |
| Loans over 90 days past due and still accruing | \$1           | \$17 |
| Loans on nonaccrual:                           |               |      |

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|   |          |          |       |   |
|---|----------|----------|-------|---|
| Real estate – Construction  | 3,858    | 11,040   |       |   |
| Real estate – Residential   | 3,922    | 3,549    |       |   |
| Real estate – Nonresidential                                      | 13,642   | 7,445    |       |   |
| Commercial and industrial   | 619      | 1,482    |       |   |
| Consumer and other  | 34       | 2        |       |   |
| Total nonaccrual loans  | 22,075   | 23,518   |       |   |
| Total of nonperforming loans                                      | 22,076   | 23,535   |       |   |
| Other nonperforming assets  | 15,359   | 19,439   |       |   |
| Total nonperforming assets  | \$37,435 | \$42,974 |       |   |
| Percentage of nonperforming assets to total assets                | 8.54     | %        | 8.42  | % |
| Percentage of nonperforming loans to total loans                  | 8.02     | %        | 7.26  | % |
| Allowance for loan losses as a percentage of non-performing loans | 19.66    | %        | 27.29 | % |

***Loans over 90 days past due and still accruing*** – As of September 30, 2012 and 2011, we had loans totaling \$943 and \$17,171, respectively, that were past due over 90 days and still accruing interest. All loans are secured and included in our impaired loan classification at September 30, 2012 and 2011.

**Nonaccruing loans** – At September 30, 2012 and 2011, loans totaling \$22,074,789 and \$23,518,313, respectively, were in nonaccrual status. Generally, loans are placed on nonaccrual status if principal or interest payments become 90 days past due and/or we deem the collectability of the principal and/or interest to be doubtful. Generally, once a loan is placed in nonaccrual status, all previously accrued and uncollected interest is reversed against interest income, unless collection of interest accrued to date is expected. 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, 2012 and 2011, interest income recognized on nonaccrual loans was \$605,750 and \$170,335, respectively. If the nonaccrual loans had been accruing interest at their original contracted rates, related income would have been \$927,891 and \$975,110 for the nine months ended September 30, 2012 and 2011, respectively. We note that the increased volume of nonaccrual nonresidential real estate loans was roughly offset by a reduction in the volume of nonaccrual real estate construction loans that were primarily located in coastal markets that were harder hit by the economic downturn. All nonaccruing loans at September 30, 2012 and 2011 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 troubled debt restructuring ("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, 2012 there were 49 loans classified as TDR totaling \$15,348,576. Of the 49 loans, 18 loans totaling \$8,312,929 were performing while 31 loans totaling \$7,035,647 were not performing. At September 30, 2011, there were 9 loans classified as TDR totaling \$1,206,955, including \$856,955 which were performing and \$350,000 which were not performing. From September 30, 2011 to September 30, 2012 TDR loans increased by \$14,141,621 due to the increase in the volume of problem loans that were modified to enhance the borrowers' repayment ability. All restructured loans resulted in either extended maturity or lowered rates and were included in the impaired loan balance.

**Impaired loans** - At September 30, 2012, we had impaired loans totaling \$30,710,491, as compared to \$25,183,965 at September 30, 2011. Included in the impaired loans at September 30, 2012 were 16 borrowers that accounted for approximately 78.68% of the total amount of the impaired loans at that date. These loans were primarily commercial real estate loans located in coastal South Carolina. Impaired loans, as a percentage of total loans, were 11.16% at September 30, 2012 as compared to 7.76% at September 30, 2011.

During the first nine months of 2012, the average investment in impaired loans was approximately \$27,408,000 as compared to \$25,361,000 during the first nine months of 2011. Impaired loans with a specific allocation of the allowance for loan losses totaled approximately \$10,785,000 and \$7,606,000 at September 30, 2012 and 2011,

respectively. The amount of the specific allocation at September 30, 2012 and 2011 was \$658,262 and \$1,613,025, respectively.

The downturn in the real estate market that began in 2008 and continued into 2012 has resulted in an increase in loan delinquencies, defaults and foreclosures; however, we believe these trends are stabilizing as the liquidation prices for our other real estate owned have 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 other real estate owned (“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, 2012, we had OREO properties totaling \$15,358,935, geographically located in the following South Carolina areas - 78% in the Coastal area, 16% in the Columbia area and 16% in the Florence area. The combined nature of these properties is 78% commercial and 22% residential and other. While we are diligently trying to dispose of our OREO properties, the currently depressed real estate market in many of these market segments affects our ability to do so in a timely manner without experiencing additional losses. Additionally, there can be no assurance that these properties can be sold for their carrying values.

From September 30, 2011 to September 30, 2012, due primarily to sales, OREO decreased \$4,080,004, or 20.98%. While OREO properties that consist of raw land continue to be difficult to sell, the majority of our OREO inventory with improvements is income producing, either through sale or interim leasing. This cash flow helps offset direct costs such as taxes and insurance, while offsetting opportunity cost during marketing. During the first three quarters of 2012 and 2011, income earned on OREO was \$116,702 and \$39,988, respectively.

### Deposits and Other Interest-Bearing Liabilities

Average interest-bearing liabilities decreased \$51,565,678, or 12.24%, to \$369,728,688 for the nine months ending September 30, 2012 from \$421,294,366 for the nine months ended September 30, 2011.

**Deposits** - For the nine months ended September 30, 2012 and 2011, average total deposits were \$399,988,574 and \$440,313,854, respectively, which is a decrease of \$40,325,280, or 9.16%. At September 30, 2012 and December 31, 2011, total deposits were \$364,344,350 and \$427,816,497 respectively, a decrease of \$63,472,147, or 14.84%. As our loan demand declined, we concurrently lowered our rates paid for deposits, especially for time deposits, which is the primary reason why the amounts of our total deposits were significantly lower for the period ended September 30, 2012 compared to 2011.

Average interest-bearing deposits decreased \$48,150,633, or 12.30%, to \$343,f,204 for the nine months ended September 30, 2012, from \$391,364,837 for the nine months ended September 30, 2011.

The average balance of non-interest bearing deposits increased \$7,825,353, or 15.99%, to \$56,774,370 for the nine months ended September 30, 2012, from \$48,949,017 for the nine months ended September 30, 2011.

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, 2012 and 2011.

|                                     | Nine Months Ended September 30, |                 |                   |                 |
|-------------------------------------|---------------------------------|-----------------|-------------------|-----------------|
|                                     | 2012                            | 2011            | 2012              | 2011            |
|                                     | Average<br>Amount               | Average<br>Rate | Average<br>Amount | Average<br>Rate |
| Noninterest bearing demand deposits | \$56,774,370                    | 0.00            | % \$48,949,017    | 0.00            |
| Interest bearing demand deposits    | 41,965,768                      | 0.21            | 38,424,879        | 0.48            |
| Savings accounts                    | 116,145,534                     | 0.32            | 119,634,049       | 0.77            |

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|               |                |      |   |                |      |   |
|---------------|----------------|------|---|----------------|------|---|
| Time deposits | 185,102,902    | 2.04 |   | 233,305,909    | 2.31 |   |
| Total         | \$ 399,988,574 | 1.06 | % | \$ 440,313,854 | 1.48 | % |

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 \$270,453,219 and \$305,342,295 at September 30, 2012 and December 31, 2011, respectively. As of September 30, 2012 and December 31, 2011, our core deposits were 74.23% and 71.37% of total deposits, respectively.

Included in time deposits of \$100,000 and over, at September 30, 2012 and December 31, 2011 are brokered time deposits of \$66,860,000 and \$90,860,000, respectively, equating to a decrease of \$24,000,000. In accordance with our asset/liability management strategy, we do not intend to renew or replace the brokered deposits outstanding at September 30, 2012, 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 75.52% and 70.92% on September 30, 2012 and December 31, 2011, respectively.

The maturity distribution of our time deposits of \$100,000 or more at September 30, 2012, is set forth in the following table:

|                                   | September 30,<br>2012 |
|-----------------------------------|-----------------------|
| Three months or less              | \$ 15,639,089         |
| Over three through twelve months  | 43,538,884            |
| Over one year through three years | 34,308,573            |
| Over three years                  | 404,585               |
| Total                             | \$ 93,891,131         |

Approximately 63.03% 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 deposits 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, 2012 and December 31, 2011, consist of the following:

|   | September 30,<br>2012 | December 31,<br>2011 |
|---|-----------------------|----------------------|
| Securities sold under agreement to repurchase | \$ 4,711,362          | \$ -                 |
| Advances from the Federal Home Loan Bank      | 13,000,000            | 13,000,000           |
| 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%.

### Capital Resources

Total shareholders' equity at September 30, 2012 and December 31, 2011 was \$42,187,191 and \$41,117,990, respectively. The \$1,069,201 increase during the first nine months of 2012 resulted mainly from our net income of \$1,134,728 for this period.

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, 2012 and 2011. While we have not paid a cash dividend on our common stock since our inception, the Company has declared and paid dividends on its outstanding shares of preferred stock, and made quarterly interest payments on its trust-preferred securities. Under the terms of the Company MOU, the terms of 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 our common stock or preferred stock, or making scheduled interest payments on our 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 four quarters ended September 30, 2012 and such approval was not granted for payments due in the fourth quarter of 2012.

|                          | Nine Months Ended<br>September 30, |          |
|--------------------------|------------------------------------|----------|
|                          | 2012                               | 2011     |
| Return on average assets | 0.32 %                             | (2.11 )% |
| Return on average equity | 3.62                               | (22.70 ) |



Average equity to average assets ratio    8.88        9.30

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 Memorandum the Bank will be required to maintain a Tier 1 leverage ratio of 8% and a total risk-based capital ratio of 10%.

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, 2012 and December 31, 2011. The following table shows the regulatory capital ratios for the Company and the Bank at September 30, 2012 and December 31, 2011.

|  | September 30, 2012 |         | December 31, 2011 |         |
|--|--------------------|---------|-------------------|---------|
|  | Holding            |         | Holding           |         |
|  | Company            | Bank    | Company           | Bank    |
| Tier 1 capital (to risk-weighted assets)             | 15.22 %            | 14.11 % | 13.54 %           | 12.33 % |
| Total capital (to risk-weighted assets)              | 16.77 %            | 15.37 % | 14.80 %           | 13.59 % |
| Leverage or Tier 1 capital (to total average assets) | 11.21 %            | 10.18 % | 9.85 %            | 8.96 %  |

### 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 an historical cost basis in accordance with generally accepted accounting principles.

Unlike most industrial companies, our assets and liabilities are primarily monetary in nature. Therefore, the effect of changes in interest rates will have a more significant impact on our performance than will the effect of changing prices and inflation in general. In addition, interest rates may generally increase as the rate of inflation increases, although not necessarily in the same magnitude. As discussed previously, we seek to manage the relationships between interest sensitive assets and liabilities in order to protect against wide 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, 2012 we had issued commitments to extend credit of \$28.9 million and standby letters of credit of \$34 thousand through various types of commercial lending arrangements. Approximately \$26.2 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, 2012:

| <i>(Dollars in Thousands)</i>       | After One        |                      | After                 | Within   | Greater       | Total    |
|-------------------------------------|------------------|----------------------|-----------------------|----------|---------------|----------|
|                                     | Within One Month | Through Three Months | Through Twelve Months | One Year | Than One Year |          |
| Unused commitments to extend credit | \$2,237          | \$ 2,376             | \$10,112              | \$14,725 | \$ 14,125     | \$28,850 |
| Standby letters of credit           | -                | -                    | 34                    | 34       | -             | 34       |
| Totals                              | \$2,237          | \$ 2,376             | \$10,146              | \$14,759 | \$ 14,125     | \$28,884 |

### 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 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.

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, 2011 and during the nine months ended September 30, 2012. As of September 30, 2012, we expect to be liability sensitive for the next nine months because a majority of our deposits reprice over a 12-month period. Approximately 35% of our loans were variable rate loans at September 30, 2012. The ratio of cumulative gap to total earning assets after 12 months was a negative 17.70% because \$68.1 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, 2012, our liquid assets, consisting of cash and cash equivalents amounted to \$40.7 million, or 9.28% of total assets. Our investment securities, excluding nonmarketable securities, at September 30, 2012, amounted to \$64.5 million, or 14.70% of total assets. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, \$15.3 million of these securities were pledged as collateral to secure public deposits and borrowings as of September 30, 2012. At December 31, 2011, our liquid assets, consisting of cash and cash equivalents, amounted to \$44.0 million, or 8.90% of total assets. Our investment securities, excluding nonmarketable securities, at December 31, 2011 amounted to \$84.5 million, or 17.08% of total assets. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, \$17.4 million of these securities were pledged as collateral to secure public deposits and borrowings as of December 31, 2011.

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. 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, 2012, we had a \$5.0 million unused line of credit with the Federal Reserve Bank and had sufficient unpledged securities that would have allowed us to borrow up to \$49.2 million from the

Federal Reserve Bank. Also, as a 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 the FHLB. We have an available line to borrow funds from the Federal Home Loan Bank up to 30% of the Bank's total assets, which provide available funds of \$141.3 million at September 30, 2012. At that date the Bank had drawn \$13.0 million on this line. 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 Bank 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 four quarters ended September 30, 2012, nor did Federal Reserve approve the Company's request to make the payments due in the fourth quarter of 2012. 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, 2012, 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.

| <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        | \$39,537               | \$-                                     | \$  | \$39,537              | \$-   | \$39,537 |
| Loans (1)                                       | 53,469                 | 30,301                                  | 76,303  | 160,073               | 119,061   | 279,134  |
| Securities, taxable                             | -                      | -                                       | -   | -                     | 64,504  | 64,504   |
| Nonmarketable securities                        | 1,387                  | -                                       | -   | 1,387                 | -   | 1,387    |
| Time deposits in other banks                    | -                      | -                                       | 101   | 101                   | -   | 101      |
| Total earning assets                            | 94,393                 | 30,301                                  | 76,404  | 201,098               | 183,565   | 384,663  |
| <b>Interest-Bearing Liabilities</b>             |                        |   |   |                       |   |          |
| <b>Interest-bearing deposits:</b>               |                        |   |   |                       |   |          |
| Demand deposits                                 | \$42,332               | \$-                                     | \$-   | \$42,332              | \$-   | \$42,332 |
| Savings deposits                                | 108,440                | -                                       | -   | 108,440               | -   | -108,440 |
| Time deposits                                   | 11,001                 | 17,303                                  | 83,412  | 111,716               | 45,491  | 157,207  |
| Total interest-bearing deposits                 | 161,773                | 17,303                                  | 83,412  | 262,488               | 45,491  | 307,979  |
| Federal Home Loan Bank Advances                 | 2,000                  | -                                       | -   | 2,000                 | 11,000  | 13,000   |
| Junior subordinated debentures                  | -                      | -                                       | -   | -                     | 10,310  | 10,310   |
| Repurchase agreements                           | 4,711                  | -                                       | -   | 4,711                 | -   | 4,711    |
| Total interest-bearing liabilities              | 168,484                | 17,303                                  | 83,412  | 269,199               | 66,801  | 336,000  |
| Period gap                                      | \$(74,091 )            | \$ 12,998                               | \$(7,008 )                                    | \$(68,101 )           | \$ 116,764  |          |
| Cumulative gap                                  | \$(74,091 )            | \$(61,093 )                             | \$(68,101)                                    | \$(68,101 )           | \$48,663  |          |
| Ratio of cumulative gap to total earning assets | (19.26 )%              | (15.88 )%                               | (17.70 )%                                     | (17.70 )%             | 12.65 %   |          |

(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 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 error 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.**

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.

**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, 2011, 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) The following stock repurchases were made during the period covered by this report in connection with administration of the Company's employee stock ownership plan.

| Period                       | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|------------------------------|----------------------------------|------------------------------|--|--|
| July 1, 2012 – July 30, 2012 | 69                               | \$ 2.08                      | -  | -  |

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|  |    |         |   |   |
|--|----|---------|---|---|
| August 1, 2012 - August 31, 2012       | -  | \$ -    | - | - |
| September 1, 2012 – September 30, 2012 | -  | \$ -    | - | - |
|  | 69 | \$ 2.08 | - | - |

**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, 2012 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. |

**SIGNATURE**

Pursuant to 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 12, 2012 By: /s/ F.R. SAUNDERS, JR.  
F. R. Saunders, Jr.  
President and Chief Executive Officer

Date: November 12, 2012 By: /s/ JEFFERY A. PAOLUCCI  
Jeffery A. Paolucci  
Senior Vice President and Chief Financial Officer