

## FORM OF WARRANT TO PURCHASE PREFERRED STOCK

THE SECURITIES REPRESENTED BY THIS INSTRUMENT HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, OR THE SECURITIES LAWS OF ANY STATE AND MAY NOT BE TRANSFERRED, SOLD OR OTHERWISE DISPOSED OF EXCEPT WHILE A REGISTRATION STATEMENT RELATING THERETO IS IN EFFECT UNDER SUCH ACT AND APPLICABLE STATE SECURITIES LAWS OR PURSUANT TO AN EXEMPTION FROM REGISTRATION UNDER SUCH ACT OR SUCH LAWS. THIS INSTRUMENT IS ISSUED SUBJECT TO THE RESTRICTIONS ON TRANSFER AND OTHER PROVISIONS OF A SECURITIES PURCHASE AGREEMENT BETWEEN THE ISSUER OF THESE SECURITIES AND THE INVESTOR REFERRED TO THEREIN, A COPY OF WHICH IS ON FILE WITH THE ISSUER. THE SECURITIES REPRESENTED BY THIS INSTRUMENT MAY NOT BE SOLD OR OTHERWISE TRANSFERRED EXCEPT IN COMPLIANCE WITH SAID AGREEMENT. ANY SALE OR OTHER TRANSFER NOT IN COMPLIANCE WITH SAID AGREEMENT WILL BE VOID.

**WARRANT  
to purchase**

\_\_\_\_\_  
**Shares of Preferred Stock**

of \_\_\_\_\_

Issue Date: \_\_\_\_\_

1. Definitions. Unless the context otherwise requires, when used herein the following terms shall have the meanings indicated.

“*Board of Directors*” means the board of directors of the Company, including any duly authorized committee thereof.

“*business day*” means any day except Saturday, Sunday and any day on which banking institutions in the State of New York generally are authorized or required by law or other governmental actions to close.

“*Charter*” means, with respect to any Person, its certificate or articles of incorporation, articles of association, or similar organizational document.

“*Company*” means the Person whose name, corporate or other organizational form and jurisdiction of organization is set forth in Item 1 of Schedule A hereto.

“*Exchange Act*” means the Securities Exchange Act of 1934, as amended, or any successor statute, and the rules and regulations promulgated thereunder.

“*Exercise Price*” means the amount set forth in Item 2 of Schedule A hereto.

“*Expiration Time*” has the meaning set forth in Section 3.

“*Issue Date*” means the date set forth in Item 3 of Schedule A hereto.

“*Liquidation Amount*” means the amount set forth in Item 4 of Schedule A hereto.

“*Original Warrantholder*” means the United States Department of the Treasury. Any actions specified to be taken by the Original Warrantholder hereunder may only be taken by such Person and not by any other Warrantholder.

“*Person*” has the meaning given to it in Section 3(a)(9) of the Exchange Act and as used in Sections 13(d)(3) and 14(d)(2) of the Exchange Act.

“*Preferred Stock*” means the series of perpetual preferred stock set forth in Item 5 of Schedule A hereto.

“*Purchase Agreement*” means the Securities Purchase Agreement – Standard Terms incorporated into the Letter Agreement, dated as of the date set forth in Item 6 of Schedule A hereto, as amended from time to time, between the Company and the United States Department of the Treasury (the “*Letter Agreement*”), including all annexes and schedules thereto.

“*Regulatory Approvals*” with respect to the Warrantholder, means, to the extent applicable and required to permit the Warrantholder to exercise this Warrant for shares of Preferred Stock and to own such Preferred Stock without the Warrantholder being in violation of applicable law, rule or regulation, the receipt of any necessary approvals and authorizations of, filings and registrations with, notifications to, or expiration or termination of any applicable waiting period under, the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, and the rules and regulations thereunder.

“*SEC*” means the U.S. Securities and Exchange Commission.

“*Securities Act*” means the Securities Act of 1933, as amended, or any successor statute, and the rules and regulations promulgated thereunder.

“*Shares*” has the meaning set forth in Section 2.

“*Warrantholder*” has the meaning set forth in Section 2.

“*Warrant*” means this Warrant, issued pursuant to the Purchase Agreement.

2. Number of Shares; Exercise Price. This certifies that, for value received, the United States Department of the Treasury or its permitted assigns (the “*Warrantholder*”) is entitled, upon the terms and subject to the conditions hereinafter set forth, to acquire from the

Company, in whole or in part, after the receipt of all applicable Regulatory Approvals, if any, up to an aggregate of the number of fully paid and nonassessable shares of Preferred Stock set forth in Item 7 of Schedule A hereto (the “*Shares*”), at a purchase price per share of Preferred Stock equal to the Exercise Price.

3. Exercise of Warrant; Term. Subject to Section 2, to the extent permitted by applicable laws and regulations, the right to purchase the Shares represented by this Warrant is exercisable, in whole or in part by the Warrantholder, at any time or from time to time after the execution and delivery of this Warrant by the Company on the date hereof, but in no event later than 5:00 p.m., New York City time on the tenth anniversary of the Issue Date (the “*Expiration Time*”), by (A) the surrender of this Warrant and Notice of Exercise annexed hereto, duly completed and executed on behalf of the Warrantholder, at the principal executive office of the Company located at the address set forth in Item 8 of Schedule A hereto (or such other office or agency of the Company in the United States as it may designate by notice in writing to the Warrantholder at the address of the Warrantholder appearing on the books of the Company), and (B) payment of the Exercise Price for the Shares thereby purchased, by having the Company withhold, from the shares of Preferred Stock that would otherwise be delivered to the Warrantholder upon such exercise, shares of Preferred Stock issuable upon exercise of the Warrant with an aggregate Liquidation Amount equal in value to the aggregate Exercise Price as to which this Warrant is so exercised.

If the Warrantholder does not exercise this Warrant in its entirety, the Warrantholder will be entitled to receive from the Company within a reasonable time, and in any event not exceeding three business days, a new warrant in substantially identical form for the purchase of that number of Shares equal to the difference between the number of Shares subject to this Warrant and the number of Shares as to which this Warrant is so exercised. Notwithstanding anything in this Warrant to the contrary, the Warrantholder hereby acknowledges and agrees that its exercise of this Warrant for Shares is subject to the condition that the Warrantholder will have first received any applicable Regulatory Approvals.

4. Issuance of Shares; Authorization. Certificates for Shares issued upon exercise of this Warrant will be issued in such name or names as the Warrantholder may designate and will be delivered to such named Person or Persons within a reasonable time, not to exceed three business days after the date on which this Warrant has been duly exercised in accordance with the terms of this Warrant. The Company hereby represents and warrants that any Shares issued upon the exercise of this Warrant in accordance with the provisions of Section 3 will be duly and validly authorized and issued, fully paid and nonassessable and free from all taxes, liens and charges (other than liens or charges created by the Warrantholder, income and franchise taxes incurred in connection with the exercise of the Warrant or taxes in respect of any transfer occurring contemporaneously therewith). The Company agrees that the Shares so issued will be deemed to have been issued to the Warrantholder as of the close of business on the date on which this Warrant and payment of the Exercise Price are delivered to the Company in accordance with the terms of this Warrant, notwithstanding that the stock transfer books of the Company may then be closed or certificates representing such Shares may not be actually delivered on such date. The Company will at all times reserve and keep available, out of its authorized but unissued preferred stock, solely for the purpose of providing for the exercise of this Warrant, the aggregate number of shares of Preferred Stock then issuable upon exercise of this Warrant at any

time. The Company will use reasonable best efforts to ensure that the Shares may be issued without violation of any applicable law or regulation or of any requirement of any securities exchange on which the Shares are listed or traded.

5. No Rights as Stockholders; Transfer Books. This Warrant does not entitle the Warrantholder to any voting rights or other rights as a stockholder of the Company prior to the date of exercise hereof. The Company will at no time close its transfer books against transfer of this Warrant in any manner which interferes with the timely exercise of this Warrant.

6. Charges, Taxes and Expenses. Issuance of certificates for Shares to the Warrantholder upon the exercise of this Warrant shall be made without charge to the Warrantholder for any issue or transfer tax or other incidental expense in respect of the issuance of such certificates, all of which taxes and expenses shall be paid by the Company.

7. Transfer/Assignment.

(A) Subject to compliance with clause (B) of this Section 7, this Warrant and all rights hereunder are transferable, in whole or in part, upon the books of the Company by the registered holder hereof in person or by duly authorized attorney, and a new warrant shall be made and delivered by the Company, of the same tenor and date as this Warrant but registered in the name of one or more transferees, upon surrender of this Warrant, duly endorsed, to the office or agency of the Company described in Section 3. All expenses (other than stock transfer taxes) and other charges payable in connection with the preparation, execution and delivery of the new warrants pursuant to this Section 7 shall be paid by the Company.

(B) The transfer of the Warrant and the Shares issued upon exercise of the Warrant are subject to the restrictions set forth in Section 4.4 of the Purchase Agreement. If and for so long as required by the Purchase Agreement, this Warrant shall contain the legends as set forth in Section 4.2(a) of the Purchase Agreement.

8. Exchange and Registry of Warrant. This Warrant is exchangeable, upon the surrender hereof by the Warrantholder to the Company, for a new warrant or warrants of like tenor and representing the right to purchase the same aggregate number of Shares. The Company shall maintain a registry showing the name and address of the Warrantholder as the registered holder of this Warrant. This Warrant may be surrendered for exchange or exercise in accordance with its terms, at the office of the Company, and the Company shall be entitled to rely in all respects, prior to written notice to the contrary, upon such registry.

9. Loss, Theft, Destruction or Mutilation of Warrant. Upon receipt by the Company of evidence reasonably satisfactory to it of the loss, theft, destruction or mutilation of this Warrant, and in the case of any such loss, theft or destruction, upon receipt of a bond, indemnity or security reasonably satisfactory to the Company, or, in the case of any such mutilation, upon surrender and cancellation of this Warrant, the Company shall make and deliver, in lieu of such lost, stolen, destroyed or mutilated Warrant, a new Warrant of like tenor and representing the right to purchase the same aggregate number of Shares as provided for in such lost, stolen, destroyed or mutilated Warrant.

10. Saturdays, Sundays, Holidays, etc. If the last or appointed day for the taking of any action or the expiration of any right required or granted herein shall not be a business day, then such action may be taken or such right may be exercised on the next succeeding day that is a business day.

11. Rule 144 Information. The Company covenants that it will use its reasonable best efforts to timely file all reports and other documents required to be filed by it under the Securities Act and the Exchange Act and the rules and regulations promulgated by the SEC thereunder (or, if the Company is not required to file such reports, it will, upon the request of any Warrantholder, make publicly available such information as necessary to permit sales pursuant to Rule 144 under the Securities Act), and it will use reasonable best efforts to take such further action as any Warrantholder may reasonably request, in each case to the extent required from time to time to enable such holder to, if permitted by the terms of this Warrant and the Purchase Agreement, sell this Warrant without registration under the Securities Act within the limitation of the exemptions provided by (A) Rule 144 under the Securities Act, as such rule may be amended from time to time, or (B) any successor rule or regulation hereafter adopted by the SEC. Upon the written request of any Warrantholder, the Company will deliver to such Warrantholder a written statement that it has complied with such requirements.

12. Adjustments and Other Rights. For so long as the Original Warrantholder holds this Warrant or any portion thereof, if any event occurs that, in the good faith judgment of the Board of Directors of the Company, would require adjustment of the Exercise Price or number of Shares into which this Warrant is exercisable in order to fairly and adequately protect the purchase rights of the Warrants in accordance with the essential intent and principles of the Purchase Agreement and this Warrant, then the Board of Directors shall make such adjustments in the application of such provisions, in accordance with such essential intent and principles, as shall be reasonably necessary, in the good faith opinion of the Board of Directors, to protect such purchase rights as aforesaid.

Whenever the Exercise Price or the number of Shares into which this Warrant is exercisable shall be adjusted as provided in this Section 12, the Company shall forthwith file at the principal office of the Company a statement showing in reasonable detail the facts requiring such adjustment and the Exercise Price that shall be in effect and the number of Shares into which this Warrant shall be exercisable after such adjustment, and the Company shall also cause a copy of such statement to be sent by mail, first class postage prepaid, to each Warrantholder at the address appearing in the Company's records.

13. No Impairment. The Company will not, by amendment of its Charter or through any reorganization, transfer of assets, consolidation, merger, dissolution, issue or sale of securities or any other voluntary action, avoid or seek to avoid the observance or performance of any of the terms to be observed or performed hereunder by the Company, but will at all times in good faith assist in the carrying out of all the provisions of this Warrant and in taking of all such action as may be necessary or appropriate in order to protect the rights of the Warrantholder.

14. Governing Law. This Warrant will be governed by and construed in accordance with the federal law of the United States if and to the extent such law is applicable, and otherwise in accordance with the laws of the State of New York applicable to contracts made and

to be performed entirely within such State. Each of the Company and the Warrantholder agrees (a) to submit to the exclusive jurisdiction and venue of the United States District Court for the District of Columbia for any civil action, suit or proceeding arising out of or relating to this Warrant or the transactions contemplated hereby, and (b) that notice may be served upon the Company at the address in Section 17 below and upon the Warrantholder at the address for the Warrantholder set forth in the registry maintained by the Company pursuant to Section 8 hereof. To the extent permitted by applicable law, each of the Company and the Warrantholder hereby unconditionally waives trial by jury in any civil legal action or proceeding relating to the Warrant or the transactions contemplated hereby or thereby.

15. Binding Effect. This Warrant shall be binding upon any successors or assigns of the Company.

16. Amendments. This Warrant may be amended and the observance of any term of this Warrant may be waived only with the written consent of the Company and the Warrantholder.

17. Notices. Any notice, request, instruction or other document to be given hereunder by any party to the other will be in writing and will be deemed to have been duly given (a) on the date of delivery if delivered personally, or by facsimile, upon confirmation of receipt, or (b) on the second business day following the date of dispatch if delivered by a recognized next day courier service. All notices hereunder shall be delivered as set forth in Item 9 of Schedule A hereto, or pursuant to such other instructions as may be designated in writing by the party to receive such notice.

18. Entire Agreement. This Warrant, the forms attached hereto and Schedule A hereto (the terms of which are incorporated by reference herein), and the Letter Agreement (including all documents incorporated therein), contain the entire agreement between the parties with respect to the subject matter hereof and supersede all prior and contemporaneous arrangements or undertakings with respect thereto.

*[Remainder of page intentionally left blank]*

[Form of Notice of Exercise]

Date: \_\_\_\_\_

TO: [Company]

RE: Election to Purchase Preferred Stock

The undersigned, pursuant to the provisions set forth in the attached Warrant, hereby agrees to subscribe for and purchase such number of shares of Preferred Stock covered by the Warrant such that after giving effect to an exercise pursuant to Section 3(B) of the Warrant, the undersigned will receive the net number of shares of Preferred Stock set forth below. The undersigned, in accordance with Section 3 of the Warrant, hereby agrees to pay the aggregate Exercise Price for such shares of Preferred Stock in the manner set forth in Section 3(B) of the Warrant.

Number of Shares of Preferred Stock:<sup>1</sup> \_\_\_\_\_

The undersigned agrees that it is exercising the attached Warrant in full and that, upon receipt by the undersigned of the number of shares of Preferred Stock set forth above, such Warrant shall be deemed to be cancelled and surrendered to the Company.

Holder: \_\_\_\_\_

By: \_\_\_\_\_

Name: \_\_\_\_\_

Title: \_\_\_\_\_

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1. Number of shares to be received by the undersigned upon exercise of the attached Warrant pursuant to Section 3(B) thereof.

IN WITNESS WHEREOF, the Company has caused this Warrant to be duly executed by a duly authorized officer.

Dated: \_\_\_\_\_

COMPANY: \_\_\_\_\_

By: \_\_\_\_\_

Name:

Title:

Attest:

By: \_\_\_\_\_

Name:

Title:

[Signature Page to Warrant]



SCHEDULE A

Item 1

Name:

Corporate or other organizational form:

Jurisdiction of organization:

Item 2

Exercise Price:<sup>2</sup>

Item 3

Issue Date:

Item 4

Liquidation Amount:

Item 5

Series of Perpetual Preferred Stock:

Item 6

Date of Letter Agreement between the Company and the United States Department of the Treasury:

Item 7

Number of shares of Preferred Stock:<sup>3</sup>

Item 8

Company's address:

Item 9

Notice information:

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<sup>2</sup> \$0.01 per share or such greater amount as the Charter may require as the par value of the Preferred Stock.

<sup>3</sup> The initial number of shares of Preferred Stock for which this Warrant is exercisable shall include the number of shares required to effect the cashless exercise pursuant to Section 3(B) of this Warrant (e.g., such number of shares of Preferred Stock having an aggregate Liquidation Amount equal in value to the aggregate Exercise Price) such that, following exercise of this Warrant and payment of the Exercise Price in accordance with such Section 3(B), the net number of shares of Preferred Stock delivered to the Warranholder (and rounded to the nearest whole share) would have an aggregate Liquidation Amount equal to 5% of the aggregate amount invested by the United States Department of the Treasury on the investment date.

**ADDITIONAL TERMS AND CONDITIONS**

Company Information:

Name of the Company: **First Reliance Bancshares, Inc.**

Corporate or other organizational form: **C Corporation**

Jurisdiction of Organization: **South Carolina**

Appropriate Federal Banking Agency: **Federal Deposit Insurance Corporation**

Notice Information:

With Copy to:

**Mr. Jeff A. Paolucci**  
**Senior VP and Chief Financial Officer**  
**First Reliance Bancshares, Inc.**  
**2170 W. Palmetto Street**  
**Florence, SC 29501**  
**Tel: (843) 674-3250**  
**Fax: (843) 674-3045**  
**Email: [jpaolucci@firstreliance.com](mailto:jpaolucci@firstreliance.com)**

**Mr. B.T. Atkinson**  
**Bryan Cave LLP**  
**One Wachovia Center, Suite 3700**  
**301 S. College St.**  
**Charlotte, NC 28202**  
**Tel: (704) 749-8954**  
**Fax: (704) 749-8990**  
**Email: [bt.atkinson@bryancave.com](mailto:bt.atkinson@bryancave.com)**

Terms of the Purchase:

Series of Preferred Stock Purchased: **Fixed Rate Cumulative Perpetual Preferred Stock, Series A**

Per Share Liquidation Preference of Preferred Stock: **One Thousand Dollars (\$1,000.00)**

Number of Shares of Preferred Stock Purchased: **15,349**

Dividend Payment Dates on the Preferred Stock: **February 15, May 15, August 15, November 15**

Series of Warrant Preferred Stock: **Fixed Rate Cumulative Perpetual Preferred Stock, Series B**

Number of Warrant Shares: **767.00767**

Number of Net Warrant Shares (after net settlement): **767**

Exercise Price of the Warrant: **\$0.01 per share**

Purchase Price: **\$15,349,000**

Closing:

Location of Closing: **To be mutually agreed upon by the Parties**

Time of Closing: **9:00 a.m., Eastern Time**

Date of Closing: **March 6, 2009**

Wire Information for Closing:

ABA Number: [REDACTED]

Bank: [REDACTED]

Account Name: [REDACTED]

Account Number: [REDACTED]

Beneficiary: [REDACTED]

Contact for Confirmation of Wire Information:

[REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED]

**SCHEDULE B**

**CAPITALIZATION**

Capitalization Date: **February 28, 2009**

**Common Stock**

Par value: **\$0.01**

Total Authorized: **20,000,000**

Outstanding: **3,525,004\***

\* **Includes 10,184 treasury shares.**

Subject to warrants, options, convertible securities, etc.: **269,447**

Reserved for benefit plans and other issuances: **305,586**

Remaining authorized but unissued: **15,899,963\***

\* **The Company had outstanding on the Capitalization Date 45,774 stock appreciation rights with a strike price of \$14.85 per share and 62,481 stock appreciation rights with a strike price of \$15.00 per share. The rights are subject to settlement in shares of Common Stock. Based on the closing price of the Company's Common Stock on the Capitalization Date, the number of shares of Common Stock the Company was obligated to issue pursuant to these rights was 0.**

Shares issued after Capitalization Date (other than pursuant to warrants, options, convertible securities, etc. as set forth above): **None**

**Preferred Stock**

Par value: **None**

Total Authorized: **10,000,000**

Outstanding (by series): **0**

Reserved for issuance: **0**

Remaining authorized but unissued: **10,000,000**

**Holder of 5% or more of any class of capital stock**

**Primary Address**

**Paul C. Saunders**

**2170 W. Palmetto Street  
Florence, SC 29501**

**F.R. Saunders, Jr.**

**2170 W. Palmetto Street  
Florence, SC 29501**

**Service Capital Partners, LP; Service Capital Advisors,  
LLC; and Doris Wiley**

**1700 Pacific Avenue  
Suite 2000  
Dallas, TX 75201**

**SCHEDULE C**

**LITIGATION**

List any exceptions to the representation and warranty in Section 2.2(l) of the Securities Purchase Agreement – Standard Terms.

If none, please so indicate by checking the box:

**SCHEDULE D**

**COMPLIANCE WITH LAWS**

List any exceptions to the representation and warranty in the second sentence of Section 2.2(m) of the Securities Purchase Agreement – Standard Terms.

If none, please so indicate by checking the box:

List any exceptions to the representation and warranty in the last sentence of Section 2.2(m) of the Securities Purchase Agreement – Standard Terms.

If none, please so indicate by checking the box:

**SCHEDULE E**

**REGULATORY AGREEMENTS**

List any exceptions to the representation and warranty in Section 2.2(s) of the Securities Purchase Agreement – Standard Terms.

If none, please so indicate by checking the box:

**SCHEDULE F**

**COMPANY FINANCIAL STATEMENTS**

The December 31, 2008 financial statements are not yet completed and will be provided to the Investor promptly when available. The remaining Company Financial Statements that were Previously Disclosed pursuant to Section 2.2(h) of the Securities Purchase Agreement – Standard Terms are attached hereto.



## FIRST RELIANCE BANCSHARES, INC.

## Consolidated Balance Sheets

	September 30, 2008 (Unaudited)	December 31, 2007 (Audited)
<b>Assets</b>		
Cash and cash equivalents:		
Cash and due from banks	\$ 5,928,325	\$ 7,164,650
Total cash and cash equivalents	<u>5,928,325</u>	<u>7,164,650</u>
Securities available-for-sale	56,982,931	58,580,313
Nonmarketable equity securities	<u>3,922,200</u>	<u>3,930,400</u>
Total investment securities	<u>60,905,131</u>	<u>62,510,713</u>
Loans held for sale	11,226,920	19,600,850
Loans receivable	459,686,752	468,137,690
Less allowance for loan losses	<u>(6,210,753)</u>	<u>(5,270,607)</u>
Loans, net	<u>453,475,999</u>	<u>462,867,083</u>
Premises, furniture and equipment, net	23,770,377	22,233,746
Accrued interest receivable	3,049,352	3,092,767
Other real estate owned	293,700	196,950
Cash surrender value life insurance	10,880,649	10,540,273
Other assets	<u>4,143,229</u>	<u>3,497,180</u>
Total assets	<u>\$ 573,673,682</u>	<u>\$ 591,704,212</u>
<b>Liabilities and Shareholders' Equity</b>		
<b>Liabilities</b>		
<b>Deposits</b>		
Noninterest-bearing transaction accounts	\$ 42,917,049	\$ 43,542,528
Interest-bearing transaction accounts	27,159,758	39,450,393
Savings	121,475,590	85,819,481
Time deposits \$100,000 and over	131,809,645	169,825,252
Other time deposits	<u>124,196,593</u>	<u>110,860,061</u>
Total deposits	<u>447,558,635</u>	<u>449,497,715</u>
Securities sold under agreement to repurchase	7,195,414	7,927,754
Federal funds purchased	2,170,000	13,359,000
Advances from Federal Home Loan Bank	63,500,000	69,000,000
Note payable	3,000,000	3,000,000
Junior subordinated debentures	10,310,000	10,310,000
Accrued interest payable	583,346	767,577
Other liabilities	<u>1,401,244</u>	<u>814,262</u>
Total liabilities	<u>535,718,639</u>	<u>554,676,308</u>
<b>Shareholders' Equity</b>		
Common stock, \$0.01 par value; 20,000,000 shares authorized, 3,523,921 shares issued at September 30, 2008 and 3,504,313 shares issued at December 31, 2007. 3,513,508 shares outstanding at September 30, 2008 and 3,494,646 shares outstanding at December 31, 2007	35,239	34,946
Nonvested restricted stock	(247,637)	(152,762)
Capital surplus	26,114,785	25,875,012
Treasury stock (10,413 and 9,667 shares at cost at September 30, 2008 and December 31, 2007, respectively)	(155,259)	(145,198)
Retained earnings	13,488,095	11,417,275
Accumulated other comprehensive loss	<u>(1,280,180)</u>	<u>(1,369)</u>
Total shareholders' equity	<u>37,955,043</u>	<u>37,027,904</u>
Total liabilities and shareholders' equity	<u>\$ 573,673,682</u>	<u>\$ 591,704,212</u>

See notes to condensed financial statements.

## FIRST RELIANCE BANCSHARES, INC.

Condensed Consolidated Statements of Income  
(Unaudited)

	Nine Months Ended September 30,		Three Months Ended September 30,	
	2008	2007	2008	2007
<b>Interest income:</b>				
Loans, including fees	\$ 25,895,022	\$ 25,745,192	\$ 8,234,706	\$ 9,234,300
Investment securities:				
Taxable	1,025,605	638,647	349,641	192,571
Nontaxable	981,013	552,593	325,521	199,636
Federal funds sold	54,502	384,420	42,662	48,010
Other interest income	212,941	121,958	98,977	34,078
Total	<u>28,169,083</u>	<u>27,442,810</u>	<u>9,051,507</u>	<u>9,708,595</u>
<b>Interest expense:</b>				
Time Deposits over \$100,000	5,524,539	5,062,204	1,491,623	1,909,567
Other deposits	5,128,023	7,218,069	1,722,955	2,613,580
Other interest expense	2,817,167	1,412,171	932,809	488,234
Total	<u>13,469,729</u>	<u>13,692,444</u>	<u>4,147,387</u>	<u>5,011,381</u>
Net interest income	14,699,354	13,750,366	4,904,120	4,697,214
Provision for loan losses	1,757,364	869,397	609,967	408,961
Net interest income after provision for loan losses	<u>12,941,990</u>	<u>12,880,969</u>	<u>4,294,153</u>	<u>4,288,253</u>
<b>Noninterest income:</b>				
Service charges on deposit accounts	1,477,950	1,394,945	548,098	486,508
Gain on sales of mortgage loans	1,445,876	1,635,949	319,519	519,818
Brokerage fees	112,242	124,220	5,685	38,351
Income from Bank Owned Life Insurance	340,376	201,050	110,811	100,310
Other charges, commissions and fees	361,643	262,907	123,548	95,513
Gain on sale of securities	-	5,996	-	-
Gain on sale of other real estate	700	4,187	700	(16,187)
Gain on sale of fixed assets	7,092	16,104	7,092	-
Other non-interest income	147,574	236,113	46,705	40,247
Total	<u>3,893,453</u>	<u>3,881,471</u>	<u>1,162,158</u>	<u>1,264,560</u>
<b>Noninterest expenses:</b>				
Salaries and employee benefits	8,343,153	7,922,140	2,589,777	2,694,710
Occupancy expense	1,149,437	979,034	418,005	323,142
Furniture and equipment expense	645,114	607,784	222,624	188,021
Other operating expenses	3,803,663	4,107,690	1,248,888	1,418,732
Total	<u>13,941,367</u>	<u>13,616,648</u>	<u>4,479,294</u>	<u>4,624,605</u>
Income before income taxes	2,894,076	3,145,792	977,017	928,208
Income tax expense	619,354	946,000	211,839	343,331
Net income	<u>\$ 2,274,722</u>	<u>\$ 2,199,792</u>	<u>\$ 765,178</u>	<u>\$ 584,877</u>
<b>Earnings per share</b>				
Basic earnings per share	\$ 0.65	\$ 0.64	\$ 0.22	\$ 0.17
Diluted earnings per share	\$ 0.64	\$ 0.62	\$ 0.22	\$ 0.17

See notes to condensed financial statements.

## FIRST RELIANCE BANCSHARES, INC.

Condensed Consolidated Statements of Shareholders' Equity and Comprehensive Income  
For the nine months ended September 30, 2008 and 2007  
(Unaudited)

	Common Stock		Capital Surplus	Non-vested Restricted Stock	Treasury Stock	Retained Earnings	Accumulated Other Compre- hensive Income (Loss)	Total
	Shares	Amount						
Balance, December 31, 2006	3,424,878	\$ 34,249	\$ 25,257,814	\$ (66,131)	\$ -	\$ 8,837,755	\$ 9,576	\$ 34,093,263
Net income						2,199,792		2,199,792
Other comprehensive loss, net of tax benefit of \$110,112							(213,747)	(213,747)
Comprehensive income								1,986,045
Purchase of Treasury Stock					(145,198)			(145,198)
Issuance of shares to 404c plan	13,383	134	198,246					198,380
Issuance of Restricted stock	8,987	90	132,393	(81,598)				50,885
Issuance of advisory board shares								
Exercise of stock options	40,145	401	219,591					219,992
Balance, September 30, 2007	3,487,393	\$ 34,874	\$ 25,808,044	\$ (147,729)	\$ (145,198)	\$ 11,057,547	\$ (204,171)	\$ 36,403,367
Balance, December 31, 2007	3,494,646	\$ 34,946	\$ 25,875,012	\$ (152,762)	\$ (145,198)	\$ 11,417,275	\$ (1,369)	\$ 37,927,904
Adjustment to reflect the cumulative effect of change in Accounting for Life Insurance Arrangement						(203,902)		(203,902)
Balance December 31, 2007	3,494,646	34,946	25,875,012	(152,762)	(145,198)	11,213,373	(1,369)	36,824,002
Net income						2,274,722		2,274,722
Other comprehensive loss net of tax benefit of \$658,781							(1,278,811)	(1,278,811)
Comprehensive income								995,911
Purchase of Treasury Stock					(10,061)			(10,061)
Issuance of Restricted stock	22,275	223	201,163	(94,875)				106,511
Issuance of shares to employees	100	1	1009					1,010
Exercise of stock options	6,900	69	37,601					37,670
Balance, September 30, 2008	3,523,921	\$ 35,239	\$ 26,114,785	\$ (247,637)	\$ (155,259)	\$ 13,488,095	\$ (1,280,180)	\$ 37,955,043

See notes to condensed financial statements.

## FIRST RELIANCE BANCSHARES, INC.

Condensed Consolidated Statements of Cash Flows  
(Unaudited)

	Nine Months Ended	
	September 30,	September 30,
	2008	2007
<b>Cash flows from operating activities:</b>		
Net income	\$ 2,274,722	\$ 2,199,792
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Provision for loan losses	1,757,364	869,397
Depreciation and amortization expense	751,388	576,096
Gain on sale of equipment	(7,092)	(16,104)
Gain on sale of other real estate owned	(700)	(4,187)
Gain on sale of securities	-	(5,996)
Write down of other real estate owned	106,750	-
Discount accretion and premium amortization	18,284	44,933
Disbursements for loans held-for-sale	(96,084,748)	(105,965,150)
Proceeds from loans held-for-sale	104,458,678	103,588,674
Deferred income tax benefit	(666,101)	(428,749)
(Increase) Decrease in interest receivable	43,415	(184,236)
Increase (decrease) in interest payable	(184,231)	146,968
Amortization of deferred compensation on restricted stock	106,511	50,885
Increase (decrease) in other liabilities	413,818	(730,105)
(Increase) decrease in other assets	123,604	(953,286)
Net cash provided (used) by operating activities	13,111,663	(811,068)
<b>Cash flows from investing activities:</b>		
Net (increase) decrease in loans receivable	7,224,870	(81,375,712)
Purchases of securities available-for-sale	(3,812,500)	(10,019,236)
Proceeds on sales of securities available-for-sale	-	9,785,569
Maturities of securities available-for-sale	3,454,006	1,698,281
(Purchase) sale of non marketable equity securities	8,200	(1,766,300)
Proceeds on sale of nonmarketable equity securities	-	2,051,000
Sales of other real estate owned	206,050	1,598,690
Proceeds from disposal of premises, furniture, and equipment	-	38,066
Purchases of premises and equipment	(2,096,813)	(7,469,132)
Net cash provided (used) by investing activities	4,983,813	(85,458,774)
<b>Cash flows from financing activities:</b>		
Net increase in demand deposits, interest bearing and savings accounts	22,739,995	24,277,097
Net (decrease) increase in certificates of deposit and other time deposits	(24,679,075)	43,612,383
Increase (decrease) in Federal Funds purchased	(11,189,000)	3,000,000
Net (decrease) increase in securities sold under agreements to repurchase	(732,340)	448,070
Decrease in advances from the Federal Home Loan Bank	(5,500,000)	(4,500,000)
Proceeds from issuance of shares to ESOP	-	198,380
Purchase of treasury stock	(10,061)	(145,198)
Proceeds from the exercise of stock options	38,680	219,992
Net cash provided (used) by financing activities	(19,331,801)	67,110,724
Net decrease in cash and cash equivalents	(1,236,325)	(19,159,118)
Cash and cash equivalents, beginning of period	7,164,650	31,463,075
Cash and cash equivalents, end of period	\$ 5,928,325	\$ 12,303,957
<b>Cash paid during the period for</b>		
Income taxes	\$ 973,499	\$ 1,111,821
Interest	\$ 13,653,960	\$ 13,545,476

See notes to condensed financial statements.

## FIRST RELIANCE BANCSHARES, INC.

## Notes to Condensed Consolidated Financial Statements

**Note 1 - Basis of Presentation**

The accompanying financial statements have been prepared in accordance with the requirements for interim financial statements and, accordingly, they omit disclosures which would substantially duplicate those contained in the Company's most recent Annual Report to shareholders. The financial statements as of September 30, 2008 and 2007 and for the interim periods then ended are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation. The financial information as of December 31, 2007 has been derived from the Company's audited financial statements as of that date. For further information, refer to the financial statements and the notes included in First Reliance Bancshares, Inc.'s 2007 Annual Report on Form 10-K.

**Note 2 - Recently Issued Accounting Pronouncements**

The following is a summary of recent authoritative pronouncements:

In December 2007, the FASB issued SFAS No. 141(R), "Business Combinations," ("SFAS 141(R)") which replaces SFAS 141. SFAS 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for acquisitions by the Company taking place on or after January 1, 2009. Early adoption is prohibited. Accordingly, a calendar year-end company is required to record and disclose business combinations following existing accounting guidance until January 1, 2009. The Company will assess the impact of SFAS 141(R) if and when a future acquisition occurs.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51" ("SFAS 160"). SFAS 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Before this statement, limited guidance existed for reporting noncontrolling interests (minority interest). As a result, diversity in practice exists. In some cases minority interest is reported as a liability and in others it is reported in the mezzanine section between liabilities and equity. Specifically, SFAS 160 requires the recognition of a noncontrolling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement. SFAS 160 clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the noncontrolling equity investment on the deconsolidation date. SFAS 160 also includes expanded disclosure requirements regarding the interests of the parent and its noncontrolling interests. SFAS 160 is effective for the Company on January 1, 2009. Earlier adoption is prohibited. The Company is currently evaluating the impact, if any, the adoption of SFAS 160 will have on its financial position, results of operations and cash flows.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities" ("SFAS 161"). SFAS 161 requires enhanced disclosures about an entity's derivative and hedging activities, and thereby improving the transparency of financial reporting. It is intended to enhance the current disclosure framework in SFAS 133 by requiring that objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation. This disclosure better conveys the purpose of derivative use in terms of the risks that the entity is intending to manage. SFAS 161 is effective for the Company on January 1, 2009. This pronouncement does not impact accounting measurements but will result in additional disclosures if the Company is involved in material derivative and hedging activities at that time.

In February 2008, the FASB issued FASB Staff Position No. 140-3, "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions" ("FSP 140-3"). This FSP provides guidance on accounting for a transfer of a financial asset and the transferor's repurchase financing of the asset. This FSP presumes that an initial transfer of a financial asset and a repurchase financing are considered part of the same arrangement (linked transaction) under SFAS No. 140. However, if certain criteria are met, the initial transfer and repurchase financing are not evaluated as a linked transaction and are evaluated separately under SFAS No. 140. FSP 140-3 will be effective for financial statements issued for fiscal years beginning after November 15, 2008, and interim periods within those fiscal years and earlier application is not permitted. Accordingly, this FSP is effective for the Company on January 1, 2009. The Company is currently evaluating the impact, if any, the adoption of FSP 140-3 will have on its financial position, results of operations and cash flows.

## Notes to Condensed Consolidated Financial Statements

## FIRST RELIANCE BANCSHARES, INC.

Note 2 - Recently Issued Accounting Pronouncements- continued

In April 2008, the FASB issued FASB Staff Position No. 142-3, "Determination of the Useful Life of Intangible Assets" ("FSP 142-3"). This FSP amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, "Goodwill and Other Intangible Assets". The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141(R), "Business Combinations," and other U.S. generally accepted accounting principles. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years and early adoption is prohibited. Accordingly, this FSP is effective for the Company on January 1, 2009. The Company does not believe the adoption of FSP 142-3 will have a material impact on its financial position, results of operations or cash flows.

Effective January 1, 2008, the Company adopted SFAS No. 157, "Fair Value Measurements" ("SFAS 157") which provides a framework for measuring and disclosing fair value under generally accepted accounting principles. SFAS 157 requires disclosures about the fair value of assets and liabilities recognized in the balance sheet in periods subsequent to initial recognition, 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).

SFAS 157 defines fair value as the exchange 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. SFAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1	Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as U.S. Treasury securities.
Level 2	Observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include debt securities with quoted prices that are traded less frequently than exchange-traded instruments, mortgage-backed securities, municipal bonds, corporate debt securities, and derivative contracts whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data. This category generally includes certain derivative contracts and impaired loans.
Level 3	Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. For example, this category generally includes certain private equity investments, retained residual interests in securitizations, residential mortgage servicing rights, and highly-structured or long-term derivative contracts.

## FIRST RELIANCE BANCSHARES, INC.

Assets measured at fair value on a recurring basis are as follows as of September 30, 2008:

	Quoted Market Price in active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for Sale Securities	\$ -	\$ 56,982,931	-
Mortgage Loans Held for Sale	\$ -	\$ 11,226,920	-
Total	\$ -	\$ 68,209,851	-

The Company has no liabilities carried at fair value or measured at fair value on a nonrecurring basis.

The Company is predominantly an asset based lender with real estate serving as collateral on a substantial majority of loans. Loans that are deemed to be impaired are primarily valued on a nonrecurring basis at the fair values of the underlying real estate collateral. Such fair values are obtained using independent appraisals, which the Company considers to be level 2 inputs. The aggregate carrying amount of impaired loans at September 30, 2008 was \$8,391,560.

## FIRST RELIANCE BANCSHARES, INC.

## Notes to Condensed Consolidated Financial Statements

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

FASB Staff Position No. FAS 157-2 delays the implementation of SFAS 157 until the first quarter of 2009 with respect to goodwill, other intangible assets, real estate and other assets acquired through foreclosure and other non-financial assets measured at fair value on a nonrecurring basis.

The Company has no assets or liabilities whose fair values are measured using level 3 inputs.

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 - Equity Incentive Plan**

During the first quarter of 2006, the Company adopted the 2006 Equity Incentive Plan. The 2006 Equity Incentive Plan provides for the granting of dividend equivalent rights, options, performance unit awards, phantom shares, stock appreciation rights, and stock awards of up to 350,000 shares of the Company's common stock to officers, employees, directors, consultants, and other service providers of the Company, or any Affiliate of the Company.

During the nine months ended September 30, 2008 and 2007, the Company granted 0 and 62,481 stock appreciation rights, respectively. A stock appreciation right entitles an individual to receive the excess of the fair market value from the grant date to the exercise date in a settlement of Company stock. The Company has funded the liability through charges to earnings. The accrued liability for the stock appreciation rights at September 30, 2008 was \$157,776.

During the three months ended September 30, 2008 and 2007, the company did not issue any stock appreciation rights.

A summary of the status of the Company's stock appreciation rights as of the nine and three months ended September 30, 2008 and 2007 is presented below:

**For the Nine Months Ended September 30,**

	2008		2007	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at January 1	93,981	\$ 14.95	45,501	\$ 14.87
Granted	-	-	62,481	15.00
Exercised	-	-	-	-
Forfeited	-	-	-	-
Outstanding at September 30	<u>93,981</u>	<u>\$ 14.95</u>	<u>107,982</u>	<u>\$ 14.95</u>

**For the Three Months Ended September 30,**

	2008		2007	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at July 1	93,981	14.95	107,982	\$ 14.95
Granted	-	-	-	-
Exercised	-	-	-	-
Forfeited	-	-	-	-
Outstanding at September 30	<u>93,981</u>	<u>\$ 14.95</u>	<u>107,982</u>	<u>\$ 14.95</u>



## FIRST RELIANCE BANCSHARES, INC.

## Notes to Condensed Consolidated Financial Statements

Note 3 - Equity Incentive Plan - continued

During the nine and three months ended September 30, 2008, the Company granted 22,256 and 8,197 shares of restricted stock, respectively, pursuant to the 2006 Equity Incentive Plan. The shares "cliff" vest in three years. Compensation cost associated with the grant was \$106,511 and \$39,442 for the nine and three months ended September 30, 2008, respectively.

The following table shows the changes in the Company's restricted stock for the nine and three months ended September 30, 2008:

	<u>Nine months</u>	<u>Three months</u>
Outstanding at January 1, and July 1, respectively	16,195	28,435
Granted	22,256	8,197
Exercised	(1,819)	-
Forfeited	-	-
Outstanding at September 30, 2008	<u>36,632</u>	<u>36,632</u>

Note 4 - Stock Compensation Plan

On June 19, 2003, the Company established the 2003 First Reliance Bank Employee Stock Option Plan (Stock Plan) that provides for the granting of options to purchase up to 250,000 shares of the Company's common stock to directors, officers, or employees of the Company. This plan was preceded by the 1999 First Reliance Bank Employee Stock Option Plan, which provided for the granting of options to purchase up to 238,000 shares of the Company's common stock to directors, officers, or employees of the Company. The per-share exercise price of incentive stock options granted under the Stock Plan may not be less than the fair market value of a share on the date of grant. The per-share exercise price of stock options granted is determined by the Board of Directors. The expiration date of any option may not be greater than ten years from the date of grant. Options that expire unexercised or are canceled become available for reissuance. At September 30, 2008, there were no options available for grant under the 2003 plan and no options available for grant under the 1999 plan.

The following shows the status of the Company's stock option plan at September 30, 2008 and the changes in the plan for the nine and three months ended September 30, 2008:

	<u>Nine months ended</u>		<u>Three months ended</u>	
	<u>Shares</u>	<u>Weighted Average Price</u>	<u>Shares</u>	<u>Weighted Average Price</u>
Outstanding at January 1, and July 1, respectively	278,847	\$ 8.32	271,647	\$ 8.35
Granted	-	-	-	-
Exercised	(7,000)	5.38	(2,200)	6.44
Forfeited	(2,500)	11.00	-	-
Outstanding at September 30, 2008	<u>269,347</u>	<u>\$ 8.36</u>	<u>269,447</u>	<u>\$ 8.36</u>

## FIRST RELIANCE BANCSHARES, INC.

## Notes to Condensed Consolidated Financial Statements

**Note 5 - Earnings Per Share**

The following schedule reconciles the numerators and denominators of the basic and diluted earnings per share computations for the nine and three month periods ended September 30, 2008 and 2007. Dilutive common shares arise from the potentially dilutive effect of the Company's stock options and warrants that are outstanding. The assumed conversion of stock options and warrants can create a difference between basic and dilutive net income per common share.

	Nine Months Ended September 30, 2008		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
<b>Basic earnings per share</b>			
Income available to common shareholders	\$ 2,274,722	3,509,597	\$ .65
<b>Effect of dilutive securities</b>			
Stock options	-	18,503	
Non-vested restricted stock	-	3,098	
<b>Diluted earnings per share</b>			
Income available to common shareholders plus assumed conversions	\$ 2,274,722	3,531,198	\$ .64
	Nine Months Ended September 30, 2007		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
<b>Basic earnings per share</b>			
Income available to common shareholders	\$ 2,199,792	3,458,775	\$ .64
<b>Effect of dilutive securities</b>			
Stock options	-	85,230	
Non-vested restricted stock	-	4,310	
<b>Diluted earnings per share</b>			
Income available to common shareholders plus assumed conversions	\$ 2,199,792	3,548,315	\$ .62
	Three Months Ended September 30, 2008		
	Income (Numerator)	Shares (Denominator)	Per Share Amount
<b>Basic earnings per share</b>			
Income available to common shareholders	\$ 765,178	3,520,531	\$ .22
<b>Effect of dilutive securities</b>			
Stock options	-	692	
Non-vested restricted stock	-	188	
<b>Diluted earnings per share</b>			
Income available to common shareholders plus assumed conversions	\$ 765,178	3,521,411	\$ .22

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors  
First Reliance Bancshares, Inc. and Subsidiary  
Florence, South Carolina

We have audited the accompanying consolidated balance sheets of First Reliance Bancshares, Inc. and subsidiary (the "Company") as of December 31, 2007 and 2006, and the related consolidated statements of income, changes in shareholders' equity and comprehensive income, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of First Reliance Bancshares, Inc. and subsidiary as of December 31, 2007 and 2006, and the results of their operations and their cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

We were not engaged to examine management's assertion about the effectiveness of First Reliance Bancshares, Inc.'s internal control over financial reporting as of December 31, 2007 included in the accompanying Management's Report on Internal Control Over Financial Reporting and, accordingly, we do not express an opinion thereon.

Elliott Davis, LLC  
Columbia, South Carolina  
March 25, 2008

**FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY**

**Consolidated Balance Sheets**

	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>Assets:</b>		
Cash and cash equivalents:		
Cash and due from banks	\$ 7,164,650	\$ 17,328,075
Federal funds sold	-	14,135,000
Total cash and cash equivalents	7,164,650	31,463,075
Investment securities:		
Securities available-for-sale	58,580,313	35,931,271
Nonmarketable equity securities	3,930,400	2,187,600
Total investment securities	62,510,713	38,118,871
Mortgage loans held for sale	19,600,850	6,632,010
Loans receivable	468,137,690	353,491,036
Less allowance for loan losses	(5,270,607)	(4,001,881)
Loans, net	462,867,083	349,489,155
Premises, furniture and equipment, net	22,233,746	13,770,135
Accrued interest receivable	3,092,767	2,464,531
Other real estate owned	196,950	1,386,380
Cash surrender value of life insurance	10,540,273	10,134,036
Other assets	3,497,180	2,752,529
Total assets	<b>\$ 591,704,212</b>	<b>\$ 456,210,722</b>
<b>Liabilities:</b>		
Deposits:		
Noninterest-bearing transaction accounts	\$ 43,542,528	\$ 42,107,434
Interest-bearing transaction accounts	39,450,393	33,243,099
Savings	85,819,481	78,831,730
Time deposits \$100,000 and over	169,825,252	111,991,864
Other time deposits	110,860,061	106,763,956
Total deposits	449,497,715	372,938,083
Securities sold under agreements to repurchase	7,927,754	8,120,014
Federal Funds Purchased	13,359,000	-
Advances from Federal Home Loan Bank	69,000,000	28,500,000
Note payable	3,000,000	-
Junior subordinated debentures	10,310,000	10,310,000
Accrued interest payable	767,577	766,276
Other liabilities	814,262	1,483,086
Total liabilities	554,676,308	422,117,459
Commitments and contingencies (Notes 4, and 14)		
<b>Shareholders' Equity:</b>		
Common stock, \$0.01 par value, 20,000,000 shares authorized; 3,494,646 and 3,424,878 shares issued and outstanding at December 31, 2007 and 2006, respectively	34,946	34,249
Nonvested restricted stock	(152,762)	(66,131)
Capital surplus	25,875,012	25,257,814
Treasury stock (9,667 shares at cost at December 31, 2007)	(145,198)	-
Retained earnings	11,417,275	8,857,755
Accumulated other comprehensive income (loss)	(1,369)	9,576
Total shareholders' equity	37,027,904	34,093,263
Total liabilities and shareholders' equity	<b>\$ 591,704,212</b>	<b>\$ 456,210,722</b>

The accompanying notes are an integral part of the consolidated financial statements.

**FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY**

Consolidated Statements of Income

	For the years ended	
	December 31,	
	<u>2007</u>	<u>2006</u>
<b>Interest income:</b>		
Loans, including fees	\$ 35,325,242	\$ 29,222,425
Investment securities:		
Taxable	892,277	1,029,560
Tax exempt	780,191	639,710
Federal funds sold	390,944	687,352
Other interest income	<u>151,833</u>	<u>137,538</u>
Total	<u>37,540,487</u>	<u>31,716,585</u>
<b>Interest expense:</b>		
Time deposits \$100,000 and over	7,002,414	4,747,647
Other deposits	9,765,871	7,748,192
Other interest expense	<u>1,664,924</u>	<u>1,717,860</u>
Total	<u>18,433,209</u>	<u>14,213,699</u>
<b>Net interest income</b>	19,107,278	17,502,886
Provision for loan losses	<u>1,643,100</u>	<u>1,392,491</u>
<b>Net interest income after provision for loan losses</b>	<u>17,464,178</u>	<u>16,110,395</u>
<b>Noninterest income:</b>		
Service charges on deposit accounts	1,901,758	1,691,913
Gain on sale of mortgage loans	2,173,140	1,901,967
Brokerage fees	149,268	138,340
Credit life insurance commissions	6,100	23,173
Other service charges, commissions, and fees	366,172	263,610
Gain on sale of investment securities	5,996	-
Gain on sale of other real estate	29,186	7,387
Gain (loss) on sale of fixed assets	59,318	(13)
Other	<u>610,861</u>	<u>564,316</u>
Total	<u>5,301,799</u>	<u>4,590,693</u>
<b>Noninterest expenses:</b>		
Salaries and benefits	10,661,153	9,487,387
Occupancy	1,360,295	1,130,705
Furniture and equipment related expenses	834,879	727,457
Other operating	<u>6,104,948</u>	<u>4,926,835</u>
Total	<u>18,961,275</u>	<u>16,272,384</u>
<b>Income before income taxes</b>	3,804,702	4,428,704
Income tax expense	<u>1,245,182</u>	<u>1,182,796</u>
<b>Net income</b>	<u>\$ 2,559,520</u>	<u>\$ 3,245,908</u>
<b>Earnings per share:</b>		
Basic	<u>\$ 0.74</u>	<u>\$ 0.96</u>
Diluted	<u>\$ 0.72</u>	<u>\$ 0.91</u>

The accompanying notes are an integral part of the consolidated financial statements.

**FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY**

**Consolidated Statements of Changes in Shareholders' Equity and Comprehensive Income  
For the years ended December 31, 2007 and 2006**

	<u>Common Stock</u>		<u>Capital Surplus</u>	<u>Treasury Stock</u>	<u>Nonvested Restricted Stock</u>	<u>Retained Earnings</u>	<u>Accumulated Other Compre- hensive Income (Loss)</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>						
<b>Balance, December 31, 2005</b>	3,306,117	\$ 33,061	\$ 24,127,329	\$ (9,896)	\$ -	\$ 5,611,847	\$(111,706)	\$ 29,650,635
Net income						3,245,908		3,245,908
Other comprehensive income, net of tax expense of \$63,441							121,282	121,282
Comprehensive income								3,367,190
Sale of treasury stock				9,896				9,896
Issuance of advisory board shares	945	9	15,016					15,025
Restricted stock issuance	6,771	68	99,695		(66,131)			33,632
Issuance of shares to 404(c) plan	32,674	327	472,420					472,747
Exercise of stock options	<u>78,371</u>	<u>784</u>	<u>543,354</u>					<u>544,138</u>
<b>Balance, December 31, 2006</b>	3,424,878	34,249	25,257,814	-	(66,131)	8,857,755	9,576	34,093,263
Net income						2,559,520		2,559,520
Other comprehensive loss, net of tax benefit of \$5,639							(10,945)	(10,945)
Comprehensive income								2,548,575
Purchase of treasury stock				(145,198)				(145,198)
Issuance of advisory board shares	1,559	15	16,744					16,759
Restricted stock issuance	11,681	117	162,893		(86,631)			76,379
Issuance of shares to 404(c) plan	13,383	134	198,246					198,380
Exercise of stock options	<u>43,145</u>	<u>431</u>	<u>239,315</u>					<u>239,746</u>
<b>Balance, December 31, 2007</b>	<u>3,494,646</u>	<u>\$ 34,946</u>	<u>\$ 25,875,012</u>	<u>\$(145,198)</u>	<u>\$(152,762)</u>	<u>\$ 11,417,275</u>	<u>\$ (1,369)</u>	<u>\$ 37,027,904</u>

The accompanying notes are an integral part of the consolidated financial statements.

**FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY**

**Consolidated Statements of Cash Flows**

	For the years ended December 31,	
	2007	2006
<b>Cash flows from operating activities:</b>		
Net income	\$ 2,559,520	\$ 3,245,908
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Provision for loan losses	1,643,100	1,392,491
Depreciation and amortization expense	812,762	904,367
Gain on sales of securities available-for-sales	(3,496)	-
Gain on non marketable securities	(2,500)	-
Gain on sale of equipment	(59,318)	-
Gain on sale of other real estate owned	(29,186)	(7,387)
Discount accretion and premium amortization	49,316	62,497
Disbursements for mortgages held for sale	(146,067,873)	(129,199,377)
Proceeds from sales of mortgages held for sale	133,099,033	130,561,970
Writedown of other real estate owned	-	169,146
Deferred income tax benefit	(531,918)	(276,141)
Increase in interest receivable	(628,236)	(274,789)
Decrease in interest payable	1,301	319,973
Increase in other assets and cash surrender value of life insurance	(876,268)	(7,211,901)
Increase (decrease) in other liabilities	(663,890)	648,942
Net cash provided (used) by operating activities	(10,697,653)	335,699
<b>Cash flows from investing activities:</b>		
Purchases of securities available-for-sale	(34,969,570)	(1,521,226)
Maturities of securities available-for-sale	2,472,556	2,952,409
Proceeds from sales of nonmarketable equity securities	2,186,000	711,000
Proceeds on sale of securities available-for-sale	9,785,569	-
Purchases of nonmarketable equity securities	(3,927,000)	(1,271,500)
Net increase in loans receivable	(115,426,100)	(45,103,300)
Purchases of premises, furniture and equipment	(9,043,619)	(4,347,627)
Proceeds from disposal of premises, furniture and equipment	84,566	19,908
Proceeds from sale of other real estate owned	1,623,689	1,144,082
Net cash used by investing activities	(147,213,209)	(47,416,254)
<b>Cash flows from financing activities:</b>		
Net increase in demand deposits, interest-bearing transaction accounts and savings accounts	14,630,138	5,859,407
Net increase in certificates of deposit and other time deposits	61,929,493	32,641,778
Increase in advances from Federal Home Loan Bank	40,500,000	5,000,000
Increase in federal funds purchased	13,359,000	-
Net increase (decrease) in securities sold under agreements to repurchase	(192,260)	4,260,110
Proceeds from note payable	3,000,000	-
Proceeds from junior subordinated debentures	-	-
Exercise of stock options	239,746	544,138
Advisory board stock - issuance of advisory board shares	16,759	15,025
404(c) purchase - issuance of shares to 404(c)	198,380	472,747
Restricted stock	76,379	33,632
Sale (purchase) of treasury stock	(145,198)	9,896
Net cash provided by financing activities	133,612,437	48,836,733
<b>Net increase (decrease) in cash and cash equivalents</b>	24,298,425	1,756,178
<b>Cash and cash equivalents, beginning of year</b>	31,463,075	29,706,897
<b>Cash and cash equivalents, end of year</b>	<b>\$ 7,164,650</b>	<b>\$ 31,463,075</b>
<b>Cash paid during the year for:</b>		
Income taxes	<b>\$ 1,431,042</b>	<b>\$ 1,475,090</b>
Interest	<b>\$ 18,431,908</b>	<b>\$ 13,893,726</b>
<b>Supplemental noncash investing and financing activities:</b>		
Foreclosures on loans	<b>\$ 405,072</b>	<b>\$ 2,346,671</b>

The accompanying notes are an integral part of the consolidated financial statements.

## FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

### Notes to Consolidated Financial Statements

#### **NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Organization** - First Reliance Bancshares, Inc. (the Company) was incorporated to serve as a bank holding company for its subsidiary, First Reliance Bank (the Bank). First Reliance Bank was incorporated on August 9, 1999 and commenced business on August 16, 1999. The principal business activity of the Bank is to provide banking services to domestic markets, principally in Florence, Lexington, and Charleston Counties in South Carolina. The Bank is a state-chartered commercial bank, and its deposits are insured by the Federal Deposit Insurance Corporation. The consolidated financial statements include the accounts of the parent company and its wholly-owned subsidiary after elimination of all significant intercompany balances and transactions. In 2005, the Company formed First Reliance Capital Trust I (the "Trust") for the purpose of issuing trust preferred securities. In accordance with current accounting guidance, the Trust is not consolidated in these financial statements.

**Management's Estimates** - The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for losses on loans, including valuation allowances for impaired loans, and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the allowances for losses on loans and foreclosed real estate, management obtains independent appraisals for significant properties. Management must also make estimates in determining the estimated useful lives and methods for depreciating premises and equipment.

While management uses available information to recognize losses on loans and foreclosed real estate, future additions to the allowances may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowances for losses on loans and foreclosed real estate. Such agencies may require the Company to recognize additions to the allowances based on their judgments about information available to them at the time of their examinations. Because of these factors, it is reasonably possible that the allowances for losses on loans and foreclosed real estate may change materially in the near term.

**Concentrations of Credit Risk** - Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of loans receivable, investment securities, federal funds sold and amounts due from banks.

The Company makes loans to individuals and small businesses for various personal and commercial purposes primarily in Florence, Lexington, Charleston and Mount Pleasant, South Carolina. At December 31, 2007, the majority of the total loan portfolio was to borrowers from within these areas.

The Company's loan portfolio is not concentrated in loans to any single borrower or a relatively small number of borrowers. Additionally, management is not aware of any concentrations of loans to groups of borrowers or industries that would be similarly affected by sector specific economic conditions.

In addition to monitoring potential concentrations of loans to particular borrowers or groups of borrowers, industries and geographic regions, management monitors exposure to credit risk from concentrations of lending products and practices such as loans that subject borrowers to substantial payment increases (e.g. principal deferral periods, loans with initial interest-only periods, etc), and loans with high loan-to-value ratios. Management has determined that there is minimal concentration of credit risk associated with its lending policies or practices.

Additionally, there are industry practices that could subject the Company to increased credit risk should economic conditions change over the course of a loan's life. For example, the Company makes variable rate loans and fixed rate principal-amortizing loans with maturities prior to the loan being fully paid (i.e. balloon payment loans). These loans are underwritten and monitored to manage the associated risks. Therefore, management believes that these particular practices do not subject the Company to unusual credit risk.

The Company's investment portfolio consists principally of obligations of the United States and its agencies or its corporations. In the opinion of management, there is no concentration of credit risk in its investment portfolio. The Company places its deposits and correspondent accounts with and sells its federal funds to high quality institutions. Management believes credit risk associated with correspondent accounts is not significant.



## FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

### Notes to Consolidated Financial Statements

#### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - *continued*

**Securities Available-for-Sale** - Securities available-for-sale are carried at amortized cost and adjusted to estimated market value by recognizing the aggregate unrealized gains or losses in a valuation account. Aggregate market valuation adjustments are recorded as part of the comprehensive income in shareholders' equity net of deferred income taxes. Reductions in market value considered by management to be other than temporary are reported as a realized loss and a reduction in the cost basis of the security. The adjusted cost basis of investments available-for-sale is determined by specific identification and is used in computing the gain or loss upon sale.

**Nonmarketable Equity Securities** - Nonmarketable equity securities include the cost of the Company's investment in the stock of Federal Home Loan Bank and the stock of another community bank holding company. The stock has no quoted market value and no ready market exists. Investment in the Federal Home Loan Bank is a condition of borrowing from the Federal Home Loan Bank, and the stock is pledged to collateralize such borrowings. At December 31, 2007, the Company's investment in Federal Home Loan Bank stock was \$3,930,400. Dividends received on this stock are included as a separate component of interest income.

**Loans receivable** - Loans receivable are stated at their unpaid principal balance. Interest income is computed using the simple interest method and is recorded in the period earned.

When serious doubt exists as to the collectibility of a loan or when a loan becomes contractually ninety days past due as to principal or interest, interest income is generally discontinued unless the estimated net realizable value of collateral exceeds the principal balance and accrued interest. When interest accruals are discontinued, income earned but not collected is reversed.

Loan origination and commitment fees and certain direct loan origination costs (principally salaries and employee benefits) are deferred and amortized to income over the contractual life of the related loans or commitments, adjusted for prepayments, using the straight-line method.

**Allowance for Loan Losses** - The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

# FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

## Notes to Consolidated Financial Statements

### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - *continued*

**Allowance for Loan Losses** (*continued*) - A loan is considered impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Corporation does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

**Residential Mortgages Held-For-Sale** - The Company's mortgage activities are comprised of accepting residential mortgage loan applications, qualifying borrowers to standards established by investors, funding residential mortgages and selling mortgages to investors under pre-existing commitments. Funded residential mortgages held temporarily for sale to investors are recorded at the lower of cost or market value. Gains or losses are recognized when control over these assets has been surrendered in accordance with SFAS No. 140 "Accounting for Transfer and Servicing of Financial Assets and Extinguishment of Liabilities," and are included in gain on sale of mortgage loan in the consolidated statements of income.

**Other Real Estate Owned** - Other real estate owned includes real estate acquired through foreclosure. Other real estate owned is carried at the lower of cost (principal balance at the date of foreclosure) or fair value minus estimated costs to sell. Any write-downs at the date of foreclosure are charged to the allowance for loan losses. Expenses to maintain such assets, subsequent changes in the valuation allowance, and gains and losses on disposal are included in other expenses.

**Premises, Furniture and Equipment** - Premises, furniture and equipment are stated at cost, less accumulated depreciation. The provision for depreciation is computed by the straight-line method, based on the estimated useful lives for buildings of 40 years and furniture and equipment of 5 to 10 years. Leasehold improvements are being amortized over 20 years. The cost of assets sold or otherwise disposed of and the related allowance for depreciation is eliminated from the accounts and the resulting gains or losses are reflected in the income statement when incurred. Maintenance and repairs are charged to current expense. The costs of major renewals and improvements are capitalized based upon the Company's policy.

**Cash Surrender Value of Life Insurance** - Cash surrender value of life insurance represents the cash value of policies on certain officers of the Bank.

**Residential Mortgage Origination Fees** Residential mortgage origination fees include fees from residential mortgage loans originated by the Company and subsequently sold in the secondary market. These fees are recognized as income at the time of the sale to the investor.

**Income Taxes** - Income taxes are the sum of amounts currently payable to taxing authorities and the net changes in income taxes payable or refundable in future years. Income taxes deferred to future years are determined utilizing a liability approach. This method gives consideration to the future tax consequences associated with differences between financial accounting and tax bases of certain assets and liabilities which are principally the allowance for loan losses and depreciable premises and equipment.

In 2006, the FASB issued Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes - an Interpretation of SFAS No. 109." FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes." FIN 48 also prescribes a recognition threshold and measurement of a tax position taken or expected to be taken in an enterprise's tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. Accordingly, the Company adopted FIN 48 effective January 1, 2007. The adoption of FIN 48 did not have any impact on the Company's consolidated financial position.

# FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

## Notes to Consolidated Financial Statements

### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - *continued*

**Advertising Expense** - Advertising and public relations costs are generally expensed as incurred. External costs incurred in producing media advertising are expensed the first time the advertising takes place. External costs relating to direct mailing costs are expensed in the period in which the direct mailings are sent. Advertising and public relations costs of \$525,787 and \$373,005 were included in the Company's results of operations for 2007 and 2006, respectively.

**Retirement Benefits** - A trustee retirement savings plan is sponsored by the Company and provides retirement benefits to substantially all officers and employees who meet certain age and service requirements. The plan includes a "salary reduction" feature pursuant to Section 401(k) of the Internal Revenue Code. In 2004, the Company converted the 401(k) plan to a 404(c) plan. The 404(c) plan changes investment alternatives to include the Company's stock. Under the plan and present policies, participants are permitted to make contributions up to 15% of their annual compensation. At its discretion, the Company can make matching contributions up to 6% of the participants' compensation. The Company charged \$152,243 and \$229,032 to earnings for the retirement savings plan in 2007 and 2006, respectively.

During 2006, the Board of Directors approved a supplemental retirement plan for the directors and certain officers. These benefits are not qualified under the Internal Revenue Code and they are not funded. The current accrued but unfunded amount is \$242,837 and \$151,631 at December 31, 2007 and 2006, respectively. However, certain funding is provided informally and indirectly by bank owned life insurance policies. The cash surrender value of the life insurance policies are recorded as a separate line item in the accompanying consolidated balances sheets at \$10,540,273 and \$10,134,036 at December 31, 2007 and 2006, respectively.

**Equity Incentive Plan** - On January 19, 2006, the Company approved the 2006 Equity Incentive Plan. This plan provides for the granting of dividend equivalent rights, options, performance unit awards, phantom shares, stock appreciation rights and stock awards, each of which shall be subject to such conditions based upon continued employment, passage of time or satisfaction of performance criteria or other criteria as permitted by the plan. The plan allows granting up to 350,000 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 options may not be less than the market value of a share of common stock on the date the option is granted. Any options that expire unexercised or are canceled become available for re-issuance. The Company's equity incentive plan is further described in Note 16.

**Stock-Based Compensation** - On January 1, 2006, the Company adopted the fair value recognition provisions of Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards ("SFAS") No. 123(R), "Share-Based Payment," ("SFAS 123(R)") to account for compensation costs under its stock option and other equity incentive plans.

**Common Stock Owned by the 401(k) Plan and Employee Stock Ownership Plan (ESOP)** - All shares held by the 401(k) and ESOP Plans, collectively referred to as the "404(c)," are treated as outstanding for purposes of computing earnings per share. 404(c) purchases and redemptions of the Company's common stock are at estimated fair value as determined by independent valuations. Dividends on 404(c) shares are charged to retained earnings. At December 31, 2007, the 404(c) owned 116,227 shares of the Company's common stock with an estimated value of \$1,361,664. At December 31, 2006, the 404(c) owned 107,445 shares of the Company's common stock with an estimated value of \$1,676,142. All of these shares were allocated. Contributions to the 404(c) in 2007 and 2006 were \$152,243 and \$229,032, respectively.

**Earnings Per Share** - Basic earnings per share represents income available to shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate solely to outstanding stock options and are determined using the treasury stock method (see Note 15).

FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements

**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** - *continued*

**Comprehensive Income** - Accounting principles generally require that recognized income, expenses, gains, and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

The components of other comprehensive income and related tax effects are as follows:

	Pre-tax Amount	Tax Benefit	Net-of-tax Amount
<b>For the Year Ended December 31, 2007:</b>			
Unrealized losses on securities available-for-sale	\$ (20,080)	\$ 6,828	\$ (13,252)
Reclassification adjustment for gains (losses) realized in net income	3,496	(1,189)	2,307
	<b>\$ (16,584)</b>	<b>\$ 5,639</b>	<b>\$ (10,945)</b>
<b>For the Year Ended December 31, 2006:</b>			
Unrealized gains on securities available-for-sale	\$ 184,723	\$ (63,441)	\$ 121,282
Reclassification adjustment for gains (losses) realized in net income	-	-	-
	<b>\$ 184,723</b>	<b>\$ (63,441)</b>	<b>\$ 121,282</b>

**Derivative Instruments** - SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," establishes comprehensive accounting and reporting standards for derivative instruments and hedging activities. SFAS No. 133 requires that all derivative instruments be recorded in the statement of financial position at fair value. The accounting for the gain or loss due to change in fair value of the derivative instrument depends on whether the derivative instrument qualifies as a hedge. If the derivative does not qualify as a hedge, the gains or losses are reported in earnings when they occur. However, if the derivative instrument qualifies as a hedge, the accounting varies based on the type of risk being hedged.

The Company has no material embedded derivative instruments requiring separate accounting treatment. The Company has freestanding derivative instruments consisting of fixed rate conforming loan commitments and commitments to sell fixed rate conforming loans. The Company does not currently engage in hedging activities.

**Statements of Cash Flows** - For purposes of reporting cash flows in the consolidated financial statements, the Company considers certain highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents. Cash equivalents include amounts due from banks and federal funds sold. Generally, federal funds are sold for one-day periods.

Changes in the valuation account of securities available-for-sale, including the deferred tax effects, are considered noncash transactions for purposes of the statement of cash flows and are presented in detail in the notes to the consolidated financial statements.

**Off-Balance-Sheet Financial Instruments** - In the ordinary course of business, the Company enters into off-balance-sheet financial instruments consisting of commitments to extend credit and letters of credit. These financial instruments are recorded in the consolidated financial statements when they become payable by the customer.

**Recent Accounting Pronouncements** - The following is a summary of recent authoritative pronouncements that may affect accounting, reporting, and disclosure of financial information by the Company:

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements" ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This standard eliminates inconsistencies found in various prior pronouncements but does not require any new fair value measurements. SFAS 157 is effective for the Company on January 1, 2008 and will not impact the Company's accounting measurements but it is expected to result in additional disclosures.

## FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

### Notes to Consolidated Financial Statements

#### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - *continued*

**Recent Accounting Pronouncements** (*continued*) - In September 2006, The FASB ratified the consensus reached by the FASB's Emerging Issues Task Force ("EITF") relating to EITF 06-4, "Accounting for the Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements" ("EITF 06-4"). Entities purchase life insurance for various reasons including protection against loss of key employees and to fund postretirement benefits. The two most common types of life insurance arrangements are endorsement split dollar life and collateral assignment split dollar life. EITF 06-4 covers the former and EITF 06-10 (discussed below) covers the latter. EITF 06-4 states that entities with endorsement split-dollar life insurance arrangements that provide a benefit to an employee that extends to postretirement periods should recognize a liability for future benefits in accordance with SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions," (if, in substance, a postretirement benefit plan exists) or Accounting Principles Board ("APB") Opinion No. 12, "Omnibus Opinion - 1967" (if the arrangement is, in substance, an individual deferred compensation contract). Entities should recognize the effects of applying this Issue through either (a) a change in accounting principle through a cumulative-effect adjustment to retained earnings or to other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption or (b) a change in accounting principle through retrospective application to all prior periods. EITF 06-4 is effective for the Company on January 1, 2008. The Company does not believe the adoption of EITF 06-4 will have a material impact on its financial position, results of operations or cash flows.

In September 2006, the FASB ratified the consensus reached on EITF 06-5, "Accounting for Purchases of Life Insurance - Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, Accounting for Purchases of Life Insurance" ("EITF 06-5"). EITF 06-5 states that a policyholder should consider any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value in determining the amount that could be realized under the insurance contract. EITF 06-5 also states that a policyholder should determine the amount that could be realized under the life insurance contract assuming the surrender of an individual-life by individual-life policy (or certificate by certificate in a group policy). EITF 06-5 is effective for the Company on January 1, 2008. The Company does not believe the adoption of EITF 06-5 will have a material impact on its financial position, results of operations or cash flows.

In March 2007, the FASB ratified the consensus reached on EITF 06-10, "Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements" ("EITF 06-10"). The postretirement aspect of this EITF is substantially similar to EITF 06-4 discussed above and requires that an employer recognize a liability for the postretirement benefit related to a collateral assignment split-dollar life insurance arrangement in accordance with either FASB Statement No. 106 or APB Opinion No. 12, as appropriate, if the employer has agreed to maintain a life insurance policy during the employee's retirement or provide the employee with a death benefit based on the substantive agreement with the employee. In addition, a consensus was reached that an employer should recognize and measure an asset based on the nature and substance of the collateral assignment split-dollar life insurance arrangement. EITF 06-10 is effective for the Company on January 1, 2008. The Company does not believe the adoption of EITF 06-10 will have a material impact on its financial position, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115" ("SFAS 159"). This statement permits, but does not require, entities to measure many financial instruments at fair value. The objective is to provide entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Entities electing this option will apply it when the entity first recognizes an eligible instrument and will report unrealized gains and losses on such instruments in current earnings. This statement 1) applies to all entities, 2) specifies certain election dates, 3) can be applied on an instrument-by-instrument basis with some exceptions, 4) is irrevocable and 5) applies only to entire instruments. One exception is demand deposit liabilities which are explicitly excluded as qualifying for fair value. With respect to SFAS 115, available-for-sale and held-to-maturity securities at the effective date are eligible for the fair value option at that date. If the fair value option is elected for those securities at the effective date, cumulative unrealized gains and losses at that date shall be included in the cumulative-effect adjustment and thereafter, such securities will be accounted for as trading securities. SFAS 159 is effective for the Company on January 1, 2008. The Company is currently analyzing the fair value option that is permitted, but not required, under SFAS 159.

# FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

## Notes to Consolidated Financial Statements

### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES - *continued*

**Recent Accounting Pronouncements** (*continued*) - In June 2007, the FASB ratified the consensus reached by the EITF with respect to EITF 06-11, "Accounting for Income Tax Benefits of Dividends on Share-Based Payment Awards" ("EITF 06-11"). Under EITF 06-11, a realized income tax benefit from dividends or dividend equivalents that are charged to retained earnings and are paid to employees for equity-classified nonvested equity shares, nonvested equity share units and outstanding equity share options should be recognized as an increase in additional paid-in capital. This EITF is to be applied prospectively to the income tax benefits that result from dividends on equity-classified employee share-based payment awards that are declared beginning in 2008, and interim periods within those fiscal years. Early application is permitted. The Company does not believe the adoption of EITF 06-11 will have a material impact on its financial position, results of operations or cash flows.

In November 2007, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 109, "Written Loan Commitments Recorded at Fair Value Through Earnings" ("SAB 109"). SAB 109 expresses the current view of the SEC staff that the expected net future cash flows related to the associated servicing of the loan should be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. SEC registrants are expected to apply this guidance on a prospective basis to derivative loan commitments issued or modified in the first quarter of 2008 and thereafter. The Company is currently analyzing the impact of this guidance, which relates to the Company's mortgage loans held for sale.

In December 2007, the FASB issued SFAS No. 141(R), "Business Combinations," ("SFAS 141(R)") which replaces SFAS 141. SFAS 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. SFAS 141(R) is effective for acquisitions by the Company taking place on or after January 1, 2009. Early adoption is prohibited. Accordingly, a calendar year-end company is required to record and disclose business combinations following existing accounting guidance until January 1, 2009. The Company will assess the impact of SFAS 141(R) if and when a future acquisition occurs.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51" ("SFAS 160"). SFAS 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Before this statement, limited guidance existed for reporting noncontrolling interests (minority interest). As a result, diversity in practice exists. In some cases minority interest is reported as a liability and in others it is reported in the mezzanine section between liabilities and equity. Specifically, SFAS 160 requires the recognition of a noncontrolling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement. SFAS 160 clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the noncontrolling equity investment on the deconsolidation date. SFAS 160 also includes expanded disclosure requirements regarding the interests of the parent and its noncontrolling interests. SFAS 160 is effective for the Company on January 1, 2009. Earlier adoption is prohibited. The Company is currently evaluating the impact, if any, the adoption of SFAS 160 will have on its consolidated financial statements.

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

**FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements**

**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES** - *continued*

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

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

**Reclassifications** - Certain captions and amounts in the 2006 consolidated financial statements were reclassified to conform with the 2007 presentation.

**NOTE 2 - CASH AND DUE FROM BANKS**

The Company is required to maintain balances with The Federal Reserve computed as a percentage of deposits. At December 31, 2007 and 2006, this requirement was \$25,000 and \$1,389,000, respectively. This requirement was met by vault cash and balances on deposit with the Federal Reserve.

**NOTE 3 - INVESTMENT SECURITIES**

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

	<u>Amortized Cost</u>	<u>Gross Unrealized</u>		<u>Estimated Fair Value</u>
		<u>Gains</u>	<u>Losses</u>	
<b>December 31, 2007</b>				
Government sponsored enterprises	\$ -	\$ -	\$ -	\$ -
U.S. Government agencies	189,745	3,001	-	192,746
Mortgage-backed securities	27,028,064	152,788	113,890	27,066,962
Municipals	31,145,829	181,973	258,847	31,068,955
Other	218,750	32,900	-	251,650
	<u>\$ 58,582,388</u>	<u>\$ 370,662</u>	<u>\$ 372,737</u>	<u>\$ 58,580,313</u>
<b>December 31, 2006</b>				
Government sponsored enterprises	\$ 4,990,352	\$ -	\$ 40,039	\$ 4,950,313
U.S. Government agencies	380,315	1,226	321	381,220
Mortgage-backed securities	15,521,860	20,151	339,685	15,202,326
Municipals	14,805,485	281,449	1,027	15,085,907
Other	218,750	92,755	-	311,505
	<u>\$ 35,916,762</u>	<u>\$ 395,581</u>	<u>\$ 381,072</u>	<u>\$ 35,931,271</u>

**FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY**

Notes to Consolidated Financial Statements

**NOTE 3 - INVESTMENT SECURITIES** - *continued*

The following is a summary of maturities of securities available-for-sale as of December 31, 2007. 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 Available-For-Sale	
	Amortized Cost	Estimated Fair Value
Due within one year	\$ 18,426	\$ 18,508
Due after one year but within five years	1,266,081	1,277,045
Due after five years but within ten years	1,007,693	1,039,348
Due after ten years	29,043,374	28,926,800
	31,335,574	31,261,701
Mortgage-backed securities	27,028,064	27,066,962
Other	218,750	251,650
Total	<b>\$ 58,582,388</b>	<b>\$ 58,580,313</b>

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 December 31, 2007 and 2006.

**Securities Available for Sale**

	Less than twelve months		Twelve months or more		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
<b>December 31, 2007</b>						
Government sponsored enterprises	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
U.S. government agencies	-	-	-	-	-	-
Municipals	10,733,254	(258,847)	-	-	10,733,254	(258,847)
Mortgage-backed securities	-	-	6,426,610	(113,890)	6,426,610	(113,890)
Total	<b>\$ 10,733,254</b>	<b>\$ (258,847)</b>	<b>\$ 6,426,610</b>	<b>\$ (113,890)</b>	<b>\$ 17,159,864</b>	<b>\$ (372,737)</b>
<b>December 31, 2006</b>						
Government sponsored enterprises	\$ -	\$ -	\$ 4,950,313	\$ (40,039)	\$ 4,950,313	\$ (40,039)
U.S. government agencies	-	-	69,742	(321)	69,742	(321)
Municipals	2,035,393	(1,027)	-	-	2,035,393	(1,027)
Mortgage-backed securities	-	-	11,363,211	(339,685)	11,363,211	(339,685)
Total	<b>\$ 2,035,393</b>	<b>\$ (1,027)</b>	<b>\$ 16,383,266</b>	<b>\$ (380,045)</b>	<b>\$ 18,418,659</b>	<b>\$ (381,072)</b>

At December 31, 2007, securities classified as available-for-sale are recorded at fair market value. Approximately 30.56% of the unrealized losses, or 6 individual securities, consisted of securities in a continuous loss position for twelve months or more. The Company has the ability and intent to hold these securities until such time as the value recovers or the securities mature. The Company believes, based on industry analyst reports and credit ratings, that the deterioration in value is attributable to changes in market interest rates and is not in the credit quality of the issuer and therefore, these losses are not considered other-than-temporary.

As of December 31, 2007 and 2006, the par value and market value of the securities held by the third-party for the underlying agreements were \$8,303,216 and \$6,087,273, respectively, and \$8,391,834 and \$6,148,139, respectively.



**FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements**

**NOTE 4 - LOANS RECEIVABLE**

Major classifications of loans receivable are summarized as follows:

	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
Mortgage loans on real estate:		
Residential 1-4 family	\$ 66,259,730	\$ 50,844,955
Multifamily	9,822,699	7,826,863
Commercial	195,992,305	127,213,968
Construction	65,431,302	64,118,098
Second mortgages	4,611,341	4,513,048
Equity lines of credit	39,503,898	27,853,374
	381,621,275	282,370,306
Commercial and industrial	67,771,665	51,710,250
Consumer	11,342,435	12,728,353
Other	7,402,315	6,682,127
Total gross loans	<b><u>\$ 468,137,690</u></b>	<b><u>\$ 353,491,036</u></b>

The Company has pledged certain loans as collateral to secure its borrowings from the Federal Home Loan Bank. The total of loans pledged was \$147,655,969 at December 31, 2007.

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. At December 31, 2007, impaired loans totaled \$1,876,221 of which \$1,657,607 were in nonaccrual status, and there were no specific write downs on these loans. Accrued interest related to these loans totaled \$1,010. At December 31, 2006, impaired loans totaled \$1,313,993 of which \$670,650 were in nonaccrual status, and specific collected write downs on these loans totaled \$189,992. Accrued interest related to these loans totaled \$6,115. Average impaired loans at December 31, 2007 and 2006 were \$903,980 and \$808,286, respectively.

Transactions in the allowance for loan losses are summarized below:

	<b>For the years ended</b>	
	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
Balance, beginning of year	\$ 4,001,881	\$ 3,419,368
Provision charged to operations	1,643,100	1,392,491
Recoveries on loans previously charged-off	81,761	246,600
Loans charged-off	(456,135)	(1,056,578)
Balance, end of year	<b><u>\$ 5,270,607</u></b>	<b><u>\$ 4,001,881</u></b>

There were \$1,780,505 in loans past due ninety days or more and still accruing interest and \$1,657,607 in loans in nonaccrual status at December 31, 2007. As of December 31, 2006, there were \$463,991 in loans past due ninety days or more and still accruing interest and \$670,650 in loans on nonaccrual status.

Loans sold with limited recourse are 1-4 family residential mortgages originated by the Company and sold to various other financial institutions. These loans are sold with the agreement that a loan may be returned to the Company at any time in the event the Company fails to provide necessary documents related to the mortgages to the buyers, or if it makes false representations or warranties to the buyers. Loans sold under these agreements in 2007 total \$146,067,873. The Company uses the same credit policies in making loans held for sale as it does for on-balance-sheet instruments.

**FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements**

**NOTE 4 - LOANS RECEIVABLE** - *continued*

The Company is a party to 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 party to the instrument is represented by the contractual notional amount of the instrument. Since certain commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company uses the same credit policies in making commitments to extend credit as it does for on-balance-sheet instruments. Letters of credit are conditional commitments issued to guarantee a customer's performance to a third party and have essentially the same credit risk as other lending facilities.

Collateral held for commitments to extend credit and standby letters of credit varies but may include accounts receivable, inventory, property, plant, equipment, and income-producing commercial properties.

The following table summarizes the Company's off-balance-sheet financial instruments whose contract amounts represent credit risk:

	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
Commitments to extend credit	\$ 76,545,909	\$ 67,370,404
Standby letters of credit	2,721,249	3,543,270

The Company originates certain fixed rate residential mortgage loans and commits these loans for sale. The commitments to originate fixed rate residential mortgage loans and the sales commitments are freestanding derivative instruments. The fair value of these commitments was not significant at December 31, 2006. The Company has forward sales commitments, totaling \$19.6 million at December 31, 2007 to sell loans held for sale of \$19.6 million. Such forward sales commitments are to sell loans at par value and are generally funded within 60 days. The difference in the fair value of these commitments and the associated loan held for sale was not significant at December 31, 2007. The Company has no material embedded derivative instruments requiring separate accounting treatment.

**NOTE 5 - PREMISES, FURNITURE AND EQUIPMENT**

Premises, furniture and equipment consisted of the following:

	<b>December 31,</b>	
	<b>2007</b>	<b>2006</b>
Land	\$ 6,446,267	\$ 4,835,609
Building	6,679,702	4,349,778
Leasehold improvements	145,497	141,517
Furniture and equipment	4,367,496	2,676,121
Construction in progress	7,689,612	4,425,102
Total	25,328,574	16,428,127
Less, accumulated depreciation	3,094,828	2,657,992
Premises and equipment, net	<b>\$ 22,233,746</b>	<b>\$ 13,770,135</b>

Depreciation expense for the years ended December 31, 2007 and 2006 amounted to \$554,760 and \$558,262, respectively.

Construction in process consists of renovations to the Company's corporate office and architect fees and site work for new branches. The total amount of renovations unpaid at December 31, 2007 is \$109,136.

**FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements**

**NOTE 6 - DEPOSITS**

At December 31, 2007, the scheduled maturities of time deposits were as follows:

<u>Maturing In</u>	<u>Amount</u>
2008	\$ 271,389,605
2009	5,770,421
2010	1,484,942
2011	1,647,458
2012	<u>392,887</u>
Total	<u>\$ 280,685,313</u>

Included in total time deposits at December 31, 2007 and 2006 were brokered time deposits of \$85,330,473 and \$29,515,694, respectively.

**NOTE 7 - SHORT-TERM BORROWINGS**

Short-term borrowings payable are securities sold under agreements to repurchase which generally mature on a one to thirty day basis. Information concerning securities sold under agreements to repurchase is summarized as follows:

	<u>For the years ended</u>	
	<u>December 31,</u>	
	<u>2007</u>	<u>2006</u>
Balance at end of the year	\$ 7,927,754	\$ 8,120,014
Average balance during the year	9,127,643	6,064,366
Average interest rate during the year	4.39%	4.27%
Maximum month-end balance during the year	11,651,480	8,190,397

Under the terms of the repurchase agreement, the Company sells an interest in securities issued by United States Government agencies and agrees to repurchase the same securities the following business day. As of December 31, 2007 and 2006, the par value and market value of the securities held by the third-party for the underlying agreements were \$8,303,216 and \$6,087,273, respectively, and \$8,391,834 and \$6,148,139, respectively.

FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements

**NOTE 8 - ADVANCES FROM FEDERAL HOME LOAN BANK**

Advances from the Federal Home Loan Bank consisted of the following:

<u>Description</u>	<u>Interest Rate</u>	<u>December 31,</u>	
		<u>2007</u>	<u>2006</u>
<b>Fixed rate advances maturing:</b>			
January 12, 2007	3.72%	\$ -	2,000,000
April 9, 2007	3.13%	-	1,000,000
July 2, 2007	3.56%	-	500,000
December 19, 2007	3.44%	-	1,500,000
January 28, 2008	4.59%	5,000,000	-
February 28, 2008	4.58%	5,000,000	-
March 28, 2008	4.57%	5,000,000	-
April 8, 2008	3.46%	1,000,000	1,000,000
September 27, 2008	4.71%	5,000,000	-
October 14, 2008	4.86%	5,000,000	-
December 22, 2008	4.14%	5,000,000	-
March 09, 2008	4.94%	6,000,000	-
May 29, 2009	4.078%	8,000,000	-
November 30, 2009	4.028%	9,000,000	-
November 29, 2010	4.11%	8,000,000	-
<b>Variable rate advances maturing:</b>			
March 19, 2009	2.48%	3,000,000	3,000,000
June 29, 2009	5.30%	-	5,000,000
July 5, 2012	4.08%	1,000,000	1,000,000
March 10, 2015	3.44%	-	6,000,000
<b>Daily variable rate advances maturing:</b>			
Daily	Variable	<u>3,000,000</u>	<u>7,500,000</u>
		<b><u>\$ 69,000,000</u></b>	<b><u>\$ 28,500,000</u></b>

Scheduled principal reductions of Federal Home Loan Bank advances are as follows:

	<u>Amount</u>
2008	\$ 40,000,000
2009	20,000,000
2010	8,000,000
2011	-
2012	<u>1,000,000</u>
Total	<b><u>\$ 69,000,000</u></b>

FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements

**NOTE 9 - JUNIOR SUBORDINATED DEBENTURES AND TRUST PREFERRED**

On June 30, 2005 the Company formed First Reliance Capital Trust I (the "Trust") for the purpose of issuing trust preferred securities, which enable the Company to obtain Tier 1 capital on a consolidated basis for regulatory purposes. On July 1, 2005, the Company closed a private offering of \$10,000,000 of floating rate preferred securities offered and sold by the Trust. The proceeds from such issuance, together with the proceeds from a related issuance of common securities of the Trust purchased by the Company in the amount of \$310,000, were invested by the Trust in floating rate Junior Subordinated Debentures issued by the Company (the "Debentures") totaling \$10,310,000. The Debentures are due and payable on November 23, 2035 and may be redeemed by the Company after five years, and sooner in certain specific events, including in the event that certain circumstances render the Debentures ineligible for treatment as Tier 1 capital, subject to prior approval by the Federal Reserve Board, if then required. The Debentures presently qualify as Tier 1 capital for regulatory reporting. The sole assets of the Trust are the Debentures. The Company owns 100% of the common securities of the Trust. The Debentures are unsecured and rank junior to all senior debt of the Company. At December 31, 2007, the floating rate preferred securities and the Debentures had an annual interest rate of 5.93%. This interest rate is fixed until August 23, 2010, when the interest rate will adjust quarterly. After August 23, 2010, the interest rate will equal three-month LIBOR plus 1.83%.

On December 28, 2007 the Company borrowed 3,000,000, which was injected into the Bank as permanent capital. The debt is unsecured and has a fixed interest rate of 6.00%, and is due and payable on December 28, 2008.

**NOTE 10 - RESTRICTIONS ON SHAREHOLDERS' EQUITY**

South Carolina banking regulations restrict the amount of dividends that can be paid to shareholders. All of the Bank's dividends to First Reliance Bancshares, Inc. are payable only from the undivided profits of the Bank. At December 31, 2007, the Bank had undivided profits of \$12,397,058. The Bank is authorized to upstream 100% of net income in any calendar year without obtaining the prior approval of the Commissioner of Banking provided that the Bank received a composite rating of one or two at the last Federal or State regulatory examination. Under Federal Reserve Board regulations, the amounts of loans or advances from the Bank to the parent company are also restricted.

**NOTE 11 - OTHER OPERATING EXPENSE**

Other operating expenses are summarized below:

	For the years ended	
	December 31,	
	2007	2006
Professional fees	\$ 634,214	\$ 470,927
Office supplies, forms, and stationery	327,537	275,028
Advertising	525,787	373,005
Employee education and conventions	53,282	65,239
Computer supplies and software amortization	493,674	441,276
Telephone	315,201	197,085
Directors fees	175,309	172,426
Other	3,579,944	2,931,849
Total	<u>\$ 6,104,948</u>	<u>\$ 4,926,835</u>

FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements

**NOTE 12 - INCOME TAXES**

Income tax expense is summarized as follows:

	For the years ended December 31,	
	2007	2006
Currently payable		
Federal	\$ 1,534,994	\$ 1,294,202
State	117,553	164,735
Total current	1,652,547	1,458,937
Deferred income taxes	(413,004)	(212,700)
Total income tax expense	<b>\$ 1,239,543</b>	<b>\$ 1,246,237</b>

Income tax expense is allocated as follows:

To continuing operations	\$ 1,245,182	\$ 1,182,796
To shareholders' equity	(5,639)	63,441
	<b>\$ 1,239,543</b>	<b>\$ 1,246,237</b>

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

	December 31,	
	2007	2006
Deferred tax assets:		
Allowance for loan losses	\$ 1,532,913	\$ 1,072,758
Organizational costs	-	1,202
Non-accrual interest	44,936	44,645
Unrealized loss on securities available for sale	705	-
Deferred compensation	122,868	51,555
Other	42,913	86,410
Total gross deferred tax assets	1,744,335	1,256,570
Deferred tax liabilities:		
Accumulated depreciation	159,140	106,937
Prepaid expenses	88,657	67,603
Other	60,098	58,594
Total gross deferred tax liabilities	307,895	233,134
Net deferred tax asset recognized	<b>\$ 1,436,440</b>	<b>\$ 1,023,436</b>

Deferred tax assets represent the future tax benefit of deductible differences and, if it is more likely than not that a tax asset will not be realized, a valuation allowance is required to reduce the recorded deferred tax assets to net realizable value. As of December 31, 2007, management has determined that it is more likely than not that the total deferred tax asset will be realized and, accordingly, has not established a valuation allowance. Net deferred tax assets are included in other assets at December 31, 2007 and 2006.

# FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

## Notes to Consolidated Financial Statements

### NOTE 12 - INCOME TAXES - *continued*

A reconciliation between the income tax expense and the amount computed by applying the federal statutory rate of 34% to income before income taxes follows:

	For the years ended	
	December 31,	
	2007	2006
Tax expense at statutory rate	\$ 1,293,599	\$ 1,505,759
State income tax, net of federal income tax benefit	77,585	108,725
Tax-exempt interest income	(265,265)	(217,501)
Disallowed interest expense	43,884	31,004
Life insurance surrender value	(138,121)	(129,836)
Other, net	233,500	(115,355)
	<u>\$ 1,245,182</u>	<u>\$ 1,182,796</u>

The Company had analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions in accordance with FIN 48.

### NOTE 13 - RELATED PARTY TRANSACTIONS

Certain parties (principally certain directors and executive officers of the Company, their immediate families and business interests) were loan customers of and had other transactions in the normal course of business with the Company.

Related party loans are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and do not involve more than the normal risk of collectibility. As of December 31, 2007 and 2006, the Company had related party loans totaling \$3,433,523 and \$2,929,127, respectively. During 2007, \$1,335,425 of advances were made to related parties and repayments totaled \$831,029. As of December 31, 2007, all related party loans were current.

Deposits from directors and executive officers and their related interests totaled \$4,591,514 and \$4,324,992 at December 31, 2007 and 2006, respectively.

During 2005, the Company entered into a lease agreement with SP Financial LLC (the LLC), a limited liability company owned 50% each by two of the Bank's executive officers. The LLC obtained third party financing to purchase the property which is leased to the Bank. The debt related to this property is guaranteed by these officers but not by the Company. Additionally, the Company has no investment risk related to the property, and has a valid lease agreement which will remain in place even if an ownership transfer occurs. For these reasons the LLC is not considered a Variable Interest Entity under FIN 46(R), and its financial statements have not been consolidated with the Company's. The lease has an initial five year term and is included in the total future rental payments discussed in Note 14. Total lease and tax payments to the LLC for December 31, 2007 and 2006 were \$288,000 and \$305,147.

### NOTE 14 - COMMITMENTS AND CONTINGENCIES

In the ordinary course of business, the Company may, from time to time, become a party to legal claims and disputes. At December 31, 2007, management and legal counsel are not aware of any pending or threatened litigation or unasserted claims or assessments that could result in losses, if any, that would be material to the consolidated financial statements.

The Company has entered into eight separate lease agreements for properties in West Columbia, Columbia, Florence, Charleston, Mount Pleasant and Lexington, South Carolina for branch banking and mortgage operations. The leases have various initial terms and expire on various dates. The lease agreements generally provide that the Bank is responsible for ongoing repairs and maintenance, insurance and real estate taxes. The leases also provide for renewal options and certain scheduled increases in monthly lease payments. Rental expenses recorded under leases for the years ended December 31, 2007 and 2006 were \$645,353 and \$528,230, respectively.

**FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements**

**NOTE 14 - COMMITMENTS AND CONTINGENCIES** - *continued*

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

2008	\$ 686,426
2009	659,567
2010	638,900
2011	617,253
2012 and thereafter	<u>13,620,503</u>
	<u>\$ 16,222,649</u>

**NOTE 15 - EARNINGS PER SHARE**

Earnings per share - basic is computed by dividing net income by the weighted average number of common shares outstanding. Earnings per share - diluted is computed by dividing net income by the weighted average number of common shares outstanding and dilutive common share equivalents using the treasury stock method. Dilutive common share equivalents include common shares issuable upon exercise of outstanding stock options.

	<b>For the years ended December 31,</b>	
	<u>2007</u>	<u>2006</u>
<b>Basic earnings per share:</b>		
Net income available to common shareholders	<u>\$ 2,559,520</u>	<u>\$ 3,245,908</u>
Average common shares outstanding - basic	<u>3,466,008</u>	<u>3,388,457</u>
Basic earnings per share	<u>\$ 0.74</u>	<u>\$ 0.96</u>
<b>Diluted earnings per share:</b>		
Net income available to common shareholders	<u>\$ 2,559,520</u>	<u>\$ 3,245,908</u>
Average common shares outstanding - basic	3,466,008	3,388,457
Incremental shares from assumed conversion of stock options	<u>70,953</u>	<u>171,100</u>
Average common shares outstanding - diluted	<u>3,536,961</u>	<u>3,559,557</u>
Diluted earnings per share	<u>\$ 0.72</u>	<u>\$ 0.91</u>

**NOTE 16 - EQUITY INCENTIVE PLAN**

The 2006 Equity Incentive Plan provides for the granting of dividend equivalent rights options, performance unit awards, phantom shares, stock appreciation rights and stock awards, each of which shall be subject to such conditions based upon continued employment, passage of time or satisfaction of performance criteria or other criteria as permitted by the plan. The plan allows granting up to 350,000 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.



FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements

**NOTE 16 - EQUITY INCENTIVE PLAN - continued**

Restricted shares may be subject to one or more objective employment, performance or other forfeiture conditions as established by the Plan Committee at the time of grant. 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 2007 we issued 12,987 shares of restricted stock pursuant to the 2006 Equity Incentive Plan. The shares cliff vest in three years and are fully vested on January 19, 2010. The weighted-average market value of restricted stock issued during 2007 was \$13.99. Total compensation cost associated with this issuance was \$178,574 for the year ended December 31, 2007, of which there was \$42,747 compensation expense recognized in 2007 and \$135,827 of total unrecognized compensation cost related to nonvested share based compensation. The remaining cost is expected to be recognized over a weighted-average period of 2.25 years. During 2007 there were 1,287 restricted shares forfeited with a weighted-average exercise price of \$14.91 and 2,276 restricted shares exercised with a weighted-average exercise price of \$14.86.

During 2007 we also granted 62,481 Stock Appreciation Rights ("SARs") under the 2006 Equity Incentive Plan. 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 compensation costs are classified as liabilities. The shares start vesting after five years and vest at 20% per year until fully vested.

At December 31, 2007, we had 235,044 stock awards available for grant under the 2006 Equity Incentive Plan.

A summary of the status of the Company's SARs as of December 31, 2007 is presented below:

	Shares	Weighted-Average Exercise Price
Outstanding at January 1	45,501	\$ 14.87
Granted	62,481	15.00
Exercised	-	
Forfeited	(14,001)	14.94
Outstanding at December 31, 2007	<b>93,981</b>	<b>14.95</b>

A summary of the status of the Company's SARs as of December 31, 2006 is presented below:

	Shares	Weighted-Average Exercise Price
Outstanding at January 1	-	\$ -
Granted	45,774	14.87
Exercised	-	-
Forfeited	(273)	14.85
Outstanding at December 31, 2006	<b>45,501</b>	<b>14.87</b>

# FIRST RELIANCE BANCSHARES, INC. AND SUBSIDIARY

## Notes to Consolidated Financial Statements

### NOTE 16 - EQUITY INCENTIVE PLAN - continued

The Company measures compensation cost based on the fair value of SARs awards on the date of grant using the Black-Scholes option pricing model using the following assumptions: the risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of the grant; the dividend yield is based on the Company's dividend yield at the time of the grant subject to adjustment if the dividend yield on the grant date is not expected to approximate the dividend yield over the expected life of the options; the volatility factor is based on the historical volatility of the Company's stock (subject to adjustment if historical volatility is reasonably expected to differ from the past); the weighted-average expected life is based on the historical behavior of employees related to exercises, forfeitures and cancellations. These assumptions are summarized in the table following:

In calculating the pro forma disclosures for 2005, and the stock appreciation rights granted in 2007, and 2006, the fair value of options granted is estimated as of the date granted using the Black-Scholes option pricing model with the following weighted-average assumptions:

	<u>2007</u>	<u>2006</u>
Dividend yield	0.00%	0.00%
Expected volatility	26.00%	20.0%
Risk-free interest rate	4.78%	4.38%
Expected life	10 years	10 years

Compensation expense associated with the SARs grant was \$43,397 for the year ended December 31, 2007. The grant date per share weighted average fair value of the SARs granted during 2007 was \$15.00. As of December 31, 2007, there was \$411,207 of total unrecognized compensation cost related to nonvested SARs. The cost is expected to be recognized over a weighted-average period of 9.06 years.

### NOTE 17 - STOCK COMPENSATION PLAN

On June 19, 2003, the Company established the 2003 First Reliance Bank Employee Stock Option Plan (Stock Plan) that provides for the granting of options to purchase up to 250,000 shares of the Company's common stock to directors, officers, or employees of the Company. This plan was preceded by the 1999 First Reliance Bank Employee Stock Option Plan, which provided for the granting of options to purchase up to 238,000 shares of the Company's common stock to directors, officers, or employees of the Company. The per-share exercise price of incentive stock options granted under the Stock Plan may not be less than the fair market value of a share on the date of grant. The per-share exercise price of stock options granted is determined by the Board of Directors. The expiration date of any option may not be greater than ten years from the date of grant. Options that expire unexercised or are canceled become available for reissuance. At December 31, 2007, there were no options available for grant under the 2003 plan and no options available for grant under the 1999 plan. In 2005, the Company accelerated vesting of all options outstanding at the end of that year.

The decision to accelerate vesting in 2005 of the 2003 plan-related options avoided recognition of pre-tax compensation expense by the Company upon the adoption of SFAS 123(R). In the Company's view, the future compensation expense could outweigh the incentive and retention value associated with the stock options. The future pre-tax compensation expense that was or will be avoided, based upon the effective date of January 1, 2006, is approximately \$419,263 and \$108,981 in fiscal years 2006 and 2007, respectively. The Company believes that the acceleration of vesting stock options meets the criteria for variable accounting under FIN No. 44. Based upon past experience, the Company believes the grantees of these stock options will remain as an employee of the Company.