

FIRST RELIANCE BANCSHARES INC
Form 10-Q
November 14, 2006

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C.

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2006

OR

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

For the Transition Period from _____ to _____

Commission File Number 000-49757

FIRST RELIANCE BANCSHARES, INC.

(Exact name of the registrant as specified in its charter)

South Carolina
(State or other jurisdiction of incorporation or organization)

80-0030931
(I.R.S. Employer Identification No.)

2170 West Palmetto Street
Florence, South Carolina 29501
(Address of principal executive offices, including zip code)

(843) 656-5000
(Issuer's telephone number, including area code)

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

3,417,162 shares of common stock, par value \$0.01 per share, as of November 1, 2006

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

Yes No

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

Large Accelerated Filer Accelerated Filer Non-Accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

FIRST RELIANCE BANCSHARES, INC.

Item 1. Financial Statements

The financial statements of First Reliance Bancshares, Inc. are set forth in the following pages.

Condensed Consolidated Balance Sheets

| | September 30, 2006 | December 31, 2005 |
|--|-----------------------|-----------------------|
| | (Unaudited) | (Audited) |
| Assets | | |
| Cash and due from banks | \$ 4,921,941 | \$ 7,264,897 |
| Federal funds sold | 11,061,000 | 22,442,000 |
| Total cash and cash equivalents | 15,982,941 | 29,706,897 |
| Securities available-for-sale | 36,073,452 | 37,121,479 |
| Nonmarketable equity securities | 2,136,350 | 1,745,850 |
| Investment in trust | 310,000 | 310,000 |
| Total investment securities | 38,519,802 | 39,177,329 |
| Loans held for sale | 9,580,370 | 7,994,603 |
| Loans receivable | 360,080,594 | 311,544,385 |
| Less allowance for loan losses | (3,961,005) | (3,419,368) |
| Loans, net | 356,119,589 | 308,125,017 |
| Premises and equipment, net | 11,928,161 | 10,020,537 |
| Accrued interest receivable | 2,263,822 | 2,189,742 |
| Other real estate owned | 1,610,985 | 345,550 |
| Cash surrender value life insurance | 10,026,407 | 3,752,165 |
| Other assets | 2,563,360 | 1,726,044 |
| Total assets | \$ 448,595,437 | \$ 403,037,884 |
| Liabilities and Shareholders Equity | | |
| Deposits | | |
| Noninterest-bearing transaction accounts | \$ 40,988,616 | \$ 39,222,574 |
| Interest-bearing transaction accounts | 30,442,146 | 29,437,107 |
| Savings | 82,545,388 | 79,663,175 |
| Time deposits \$100,000 and over | 117,579,499 | 113,268,921 |
| Other time deposits | 101,807,719 | 72,845,121 |
| Total deposits | 373,363,368 | 334,436,898 |
| Securities sold under agreement to repurchase | 7,457,270 | 3,859,904 |
| Advances from Federal Home Loan Bank | 22,500,000 | 23,500,000 |
| Junior subordinated debentures | 10,310,000 | 10,310,000 |
| Accrued interest payable | 700,496 | 446,303 |
| Other liabilities | 1,397,991 | 834,144 |
| Total liabilities | 415,729,125 | 373,387,249 |
| Shareholders Equity | | |
| Common stock, \$.01 par value; 20,000,000 shares authorized, 3,416,117 and 3,306,117 shares issued and outstanding at September 30, 2006 and December 31, 2005, respectively | 34,161 | 33,061 |
| Capital surplus | 25,126,679 | 24,127,329 |

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| | | |
|---|-----------------------------|-----------------------------|
| Treasury stock | | (9,896) |
| Restricted stock | (74,979) | |
| Retained earnings | 7,873,378 | 5,611,847 |
| Accumulated other comprehensive income (loss) | (92,927) | (111,706) |
| | <u> </u> | <u> </u> |
| Total shareholders' equity | 32,866,312 | 29,650,635 |
| | <u> </u> | <u> </u> |
| Total liabilities and shareholders' equity | \$ 448,595,437 | \$ 403,037,884 |
| | <u> </u> | <u> </u> |

See notes to condensed consolidated financial statements.

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

| | Nine Months Ended September 30, | | Three Months Ended September 30, | |
|--|------------------------------------|---------------------|-------------------------------------|-------------------|
| | 2006 | 2005 | 2006 | 2005 |
| Interest income: | | | | |
| Loans, including fees | \$ 21,274,745 | \$ 15,246,458 | \$ 7,794,896 | \$ 5,771,583 |
| Investment securities: | | | | |
| Taxable | 782,600 | 529,973 | 252,060 | 178,495 |
| Nontaxable | 477,460 | 400,923 | 162,552 | 147,302 |
| Federal funds sold | 514,916 | 240,234 | 239,121 | 163,834 |
| Other interest income | 95,302 | 63,844 | 36,149 | 26,944 |
| Total | 23,145,023 | 16,481,432 | 8,484,778 | 6,228,158 |
| Interest expense: | | | | |
| Time Deposits over \$100,000 | 3,395,663 | 2,487,182 | 1,267,808 | 933,601 |
| Other deposits | 5,560,118 | 2,772,156 | 2,187,338 | 1,158,179 |
| Other interest expense | 1,256,653 | 983,802 | 482,954 | 417,424 |
| Total | 10,212,434 | 6,243,140 | 3,938,100 | 2,509,204 |
| Net interest income | 12,932,589 | 10,238,292 | 4,546,678 | 3,718,954 |
| Provision for loan losses | 1,167,991 | 1,016,545 | 477,205 | 450,393 |
| Net interest income after provision for loan losses | 11,764,598 | 9,221,747 | 4,069,473 | 3,268,561 |
| Noninterest income: | | | | |
| Service charges on deposit accounts | 1,225,798 | 1,020,408 | 451,211 | 345,961 |
| Gain on sales of mortgage loans | 1,445,891 | 571,297 | 506,710 | 262,308 |
| Brokerage fees | 97,226 | 122,294 | 37,451 | 52,398 |
| Credit life insurance commissions | 19,365 | 22,598 | 8,757 | 7,321 |
| Other charges, commissions and fees | 192,873 | 148,478 | 66,999 | 51,693 |
| Gain (loss) on sale of other real estate | 23,529 | (66,815) | 5,872 | (3,474) |
| Other non-interest income | 419,437 | 229,086 | 155,896 | 80,361 |
| Total | 3,424,119 | 2,047,346 | 1,232,896 | 796,568 |
| Noninterest expenses: | | | | |
| Salaries and employee benefits | 6,872,949 | 5,486,807 | 2,373,243 | 1,908,637 |
| Occupancy expense | 844,153 | 642,838 | 282,565 | 260,767 |
| Furniture and equipment expense | 512,991 | 523,862 | 153,718 | 163,398 |
| Other operating expenses | 3,701,679 | 2,772,251 | 1,214,863 | 1,035,573 |
| Total | 11,931,772 | 9,425,758 | 4,024,389 | 3,368,375 |
| Income before income taxes | 3,256,945 | 1,843,335 | 1,277,980 | 696,754 |
| Income tax expense | 995,414 | 537,905 | 413,068 | 206,326 |
| Net income | \$ 2,261,531 | \$ 1,305,430 | \$ 865,912 | \$ 490,428 |
| Earnings per share | | | | |
| Basic earnings per share | \$ 0.67 | \$ 0.40 | \$ 0.25 | \$ 0.15 |
| Diluted earnings per share | \$ 0.65 | \$ 0.38 | \$ 0.25 | \$ 0.14 |

See notes to condensed consolidated financial statements.

FIRST RELIANCE BANCSHARES, INC.
Condensed Consolidated Statements of Shareholders Equity and Comprehensive Income
For the nine months ended September 30, 2006 and 2005
(Unaudited)

| | Common Stock | | Surplus | Restricted Stock | Treasury Stock | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total |
|--|------------------|------------------|----------------------|--------------------|-------------------|---------------------|---|----------------------|
| | Shares | Amount | | | | | | |
| Balance, December 31, 2004 | 3,203,942 | \$ 32,039 | \$ 23,428,034 | | \$ (7,396) | \$ 3,664,301 | \$ 241,671 | \$ 27,358,649 |
| Net income for the period | | | | | | 1,305,430 | | 1,305,430 |
| Other comprehensive loss, net of tax benefit of \$76,724 | | | | | | | (148,947) | (148,947) |
| Comprehensive income | | | | | | | | 1,156,483 |
| Issuance of shares to ESOP | 13,989 | 140 | 180,287 | | | | | 180,427 |
| Purchase of treasury stock | | | | | (2,500) | | | (2,500) |
| Exercise of stock options | 64,000 | 640 | 325,720 | | | | | 326,360 |
| Balance, September 30, 2005 | 3,281,931 | \$ 32,819 | \$ 23,934,041 | | \$ (9,896) | \$ 4,969,731 | \$ 92,724 | \$ 29,019,419 |
| Balance, December 31, 2005 | 3,306,117 | \$ 33,061 | \$ 24,127,329 | | \$ (9,896) | \$ 5,611,847 | \$ (111,706) | \$ 29,650,635 |
| Net income for the period | | | | | | 2,261,531 | | 2,261,531 |
| Other comprehensive loss, net of tax benefit of \$9,674 | | | | | | | 18,779 | 18,779 |
| Comprehensive income | | | | | | | | 2,280,310 |
| Issuance of shares to 401K | 24,800 | 248 | 355,930 | | | | | 356,178 |
| Restricted Stock | 6,800 | 68 | 100,066 | (74,979) | | | | 25,155 |
| Sale of treasury stock | | | | | 9,896 | | | 9,896 |
| Exercise of stock options | 78,400 | 784 | 543,354 | | | | | 544,138 |
| Balance, September 30, 2006 | 3,416,117 | \$ 34,161 | \$ 25,126,679 | \$ (74,979) | | \$ 7,873,378 | \$ (92,927) | \$ 32,866,312 |

See notes to condensed consolidated financial statements.

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

| | Nine Months Ended September 30, | |
|---|------------------------------------|----------------------|
| | 2006 | 2005 |
| Cash flows from operating activities: | | |
| Net income | \$ 2,261,531 | \$ 1,305,430 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 1,167,991 | 1,016,545 |
| Depreciation and amortization expense | 663,571 | 616,029 |
| Writedown of other real estate owned | 119,146 | 75,550 |
| Accretion and premium amortization | 47,804 | 66,581 |
| Disbursements from loans held-for-sale | (95,702,610) | (51,804,647) |
| Proceeds from sales of mortgages held-for-sale | 94,116,843 | 47,402,686 |
| Deferred income tax provision | (567,977) | (75,258) |
| Gain on sales of other real estate | (23,529) | |
| Increase in interest receivable | (74,080) | (339,834) |
| Increase (decrease) in interest payable | 254,193 | (280,213) |
| Increase in other liabilities | 563,847 | 673,813 |
| Increase in other assets | (6,795,185) | (506,795) |
| Net cash provided (used) by operating activities | (3,968,455) | 1,850,113 |
| Cash flows from investing activities: | | |
| Net increase in loans to customers | (50,970,409) | (68,941,589) |
| Purchases of securities available-for-sale | (1,421,226) | (7,840,442) |
| Calls and maturities on securities available-for-sale | 2,450,864 | 3,932,107 |
| Purchases of non marketable equity securities | (390,500) | (1,660,150) |
| Proceed on sales of nonmarketable equity securities | | 1,449,000 |
| Proceeds on sales of other real estate | 446,794 | 285,142 |
| Proceeds on sales of premise and equipment | | 70,137 |
| Purchases of premises and equipment | (2,330,227) | (2,143,787) |
| Net cash used by investing activities | (52,214,704) | (74,849,582) |
| Cash flows from financing activities: | | |
| Net increase in deposit accounts | 38,926,470 | 86,917,636 |
| Net increase in securities sold under agreements to repurchase | 3,597,366 | 313,357 |
| Advances from the Federal Home Loan Bank | (1,000,000) | (400,000) |
| Proceeds from Jr Subordinated Debentures | | 10,000,000 |
| Proceeds from issuance of shares to 401K | 356,178 | |
| Sale (purchase) of treasury stock | 9,896 | (2,500) |
| Proceeds from stock issuance | | 506,787 |
| Proceeds from the exercise of stock options | 544,138 | |
| Issuance of restricted stock | 25,155 | |
| Net cash provided by financing activities | 42,459,203 | 97,335,280 |
| Net increase (decrease) in cash and cash equivalents | (13,723,956) | 20,635,585 |
| Cash and cash equivalents, beginning of period | 29,706,897 | 4,793,102 |
| Cash and cash equivalents, end of period | \$ 15,982,941 | \$ 25,481,120 |
| Cash paid during the period for | | |
| Income taxes | \$ 1,277,049 | \$ 588,308 |
| Interest | \$ 9,958,241 | \$ 6,437,697 |

See notes to condensed consolidated financial statements.

FIRST RELIANCE BANCSHARES, INC
Notes to Condensed Consolidated Financial Statements
(Unaudited)

Note 1 - Nature of Business and Basis of Presentation

Business activity

First Reliance Bancshares, Inc. (the Company) is a South Carolina corporation that owns all of the capital stock of First Reliance Bank (the Bank) and all of the stock of First Reliance Capital Trust 1 (the Trust). The Bank is a state chartered bank organized under the laws of South Carolina headquartered in Florence County, South Carolina. The Bank has offices in Florence, Mt. Pleasant, Charleston, and Lexington, South Carolina. The Bank is primarily engaged in the business of accepting demand deposits and savings deposits insured by the Federal Deposit Insurance Corporation, and providing commercial, consumer and mortgage loans to the general public. The Trusts are special purpose subsidiaries for the sole purpose of issuing trust preferred securities. In accordance with current accounting guidances, the Trusts are not consolidated in the financial statements.

Basis of Presentation

The accompanying financial statements have been prepared in accordance with the requirements for interim financial statements and, accordingly, they are condensed and omit disclosures, which would substantially duplicate those contained in the most recent annual report to shareholders. The financial statements as of September 30, 2006 and 2005 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, 2005 has been derived from the 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 2005 Annual Report on Form 10-KSB.

Note 2 - Recently Issued Accounting Pronouncements

Recently Issued Accounting Pronouncements

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

In February 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments an amendment of FASB Statements No. 133 and 140. This Statement amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. This Statement resolves issues addressed in SFAS No. 133 Implementation Issue No. D1, Application of Statement 133 to Beneficial Interests in Securitized Financial Assets. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company does not believe that the adoption of SFAS No. 155 will have a material impact on its financial position, results of operations and cash flows.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140. This Statement amends FASB No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, with respect to the accounting for separately recognized servicing assets and servicing liabilities. SFAS No. 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract; requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable; permits an entity to choose its subsequent measurement methods for each class of separately recognized servicing assets and servicing liabilities; at its initial adoption, permits a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights, without calling into question the treatment of other available-for-sale securities under Statement 115, provided that the available-for-sale securities are identified in some manner as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value; and requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value in the statement of financial position and additional disclosures for all separately recognized servicing assets and servicing liabilities. An entity should adopt SFAS No. 156 as of the beginning of its first fiscal year that begins after September 15, 2006. The Company does not believe the adoption of SFAS No. 156 will have a material impact on its financial position, results of operations and cash flows.

FIRST RELIANCE BANCSHARES, INC
Notes to Condensed Consolidated Financial Statements
(Unaudited)

Note 2 - Recently Issued Accounting Pronouncements - *continued*

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes . FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprises financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes . FIN 48 prescribes a recognition threshold and measurement attributable for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosures and transitions. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently analyzing the effects of FIN 48.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for the Company on January 1, 2008 and is not expected to have a significant impact on the Company s financial statements.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans (SFAS 158), which amends SFAS 87 and SFAS 106 to require recognition of the overfunded or underfunded status of pension and other postretirement benefit plans on the balance sheet. Under SFAS 158, gains and losses, prior service costs and credits, and any remaining transition amounts under SFAS 87 and SFAS 106 that have not yet been recognized through net periodic benefit cost will be recognized in accumulated other comprehensive income, net of tax effects, until they are amortized as a component of net periodic cost. The measurement date the date at which the benefit obligation and plan assets are measured is required to be the company s fiscal year end. SFAS 158 is effective for publicly held companies for fiscal years ending after December 15, 2006, except for the measurement date provisions, which are effective for fiscal years ending after December 15, 2008. The Company is currently analyzing the effects of SFAS 158 but does not expect its implementation will have a significant impact on the Company s financial conditions or results of operations.

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 addresses employer accounting for 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 FASB Statement of Financial Accounting Standards (SFAS) No. 106, Employers Accounting for Postretirement Benefits Other Than Pensions , or Accounting Principles Board (APB) Opinion No. 12, Omnibus Opinion 1967 . EITF 06-4 is effective for fiscal years beginning after December 15, 2006. 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. The Company does not believe the adoption of EITF 06-4 will have a material impact on its financial position, results of operations and cash flows.

On September 13, 2006, the SEC issued Staff Accounting Bulletin No. 108 (SAB 108). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a potential current year misstatement. Prior to SAB 108, Companies might evaluate the materiality of financial statement misstatements using either the income statement or balance sheet approach, with the income statement approach focusing on new misstatements added in the current year, and the balance sheet approach focusing on the cumulative amount of misstatement present in a company s balance sheet. Misstatements that would be material under one approach could be viewed as immaterial under another approach, and not be corrected. SAB 108 now requires that companies view financial statement misstatements as material if they are material according to either the income statement or balance sheet approach. The Company has analyzed SAB 108 and determined that upon adoption it will have no impact on the reported results of operations or financial conditions.

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 and cash flows.

FIRST RELIANCE BANCSHARES, INC
Notes to Condensed Consolidated Financial Statements
(Unaudited)

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 unity 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, 2006, the Company granted 45,774 stock appreciation rights. The stock appreciation right entitles the 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, 2006 was \$20,089.

A summary of the status of the Company's stock appreciation rights as of the three months ended September 30, 2006 is presented below:

| | Three months ended September 30, 2006 | |
|-----------------------|--|--|
| | Shares | Weighted Average Exercise Price |
| Outstanding at July 1 | 45,501 | \$ 14.87 |
| Granted | | |
| Exercised | | |
| Forfeited | | |
| | 45,501 | \$ 14.87 |

A summary of the status of the Company's stock appreciation rights as of the nine months ended September 30, 2006 is presented below:

| | Nine months ended September 30, 2006 | |
|--------------------------|---|--|
| | Shares | Weighted Average Exercise Price |
| Outstanding at January 1 | | \$ |
| Granted | 45,774 | 14.87 |
| Exercised | | |
| Forfeited | (273) | 14.85 |
| | 45,501 | \$ 14.87 |

During the nine months ended September 30, 2006, the Company granted 6,796 shares of restricted stock, pursuant to the 2006 Equity Incentive Plan. The shares cliff vest in three years and are fully vested on March 28, 2009. The weighted average fair value of restricted stock granted in the nine months ended September 30, 2006 was \$14.86. Compensation cost associated with the grant was \$25,155 for the nine months ended September 30, 2006.

FIRST RELIANCE BANCSHARES, INC
Notes to Condensed Consolidated Financial Statements
(Unaudited)

Note 3 - Equity Incentive Plan, continued

A summary of the status of the Company's restricted stock as of the three months ended September 30, 2006 is presented below:

| | Three months ended September 30, 2006 | |
|-----------------------------------|--|--|
| | Shares | Weighted Average Exercise Price |
| Outstanding at July 1 | 6,771 | \$ 14.86 |
| Granted | | |
| Exercised | | |
| Forfeited | | |
| Outstanding at September 30, 2006 | 6,771 | \$ 14.86 |

A summary of the status of the Company's restricted stock as of the nine months ended September 30, 2006 is presented below:

| | Nine months ended September 30, 2006 | |
|-----------------------------------|---|--|
| | Shares | Weighted Average Exercise Price |
| Outstanding at January 1 | | \$ |
| Granted | 6,796 | 14.86 |
| Exercised | | |
| Forfeited | (25) | 14.85 |
| Outstanding at September 30, 2006 | 6,771 | \$ 14.86 |

Note 4 - 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), *Accounting for Stock-Based Compensation*, to account for compensation costs under its stock option and other equity incentive plans. The Company previously utilized the intrinsic value method under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees (as amended)* (APB 25). Under the intrinsic value method prescribed by APB 25, no compensation costs were recognized for the Company's stock options because the option exercise price in its plans equals the market price on the date of grant. Prior to January 1, 2006, the Company only disclosed the pro forma effects on net income and earnings per share as if the fair value recognition provisions of SFAS 123(R) had been utilized.

During the second quarter of 2005, the Company accelerated the vesting of all outstanding options and recognized the pro forma effects in that quarter. No options have been issued since June 2005. As discussed in Note 3, compensation expense related to stock appreciation rights amounted to \$20,089 for the third quarter of 2006. The following table illustrates the effect on net income and earnings per share as if the fair value based method had been applied to all outstanding and unvested awards in each period.

FIRST RELIANCE BANCSHARES, INC.
Notes to Condensed Consolidated Financial Statements
(Unaudited)

Note 4 - Stock-Based Compensation - continued

| | Nine months ended September 30, | |
|---|-------------------------------------|-------------------|
| | 2006 | 2005 |
| Net income, as reported | \$ 2,261,531 | \$ 1,305,430 |
| Add: Stock-based compensation expense included in reported net income, net of related tax effects | 20,089 | |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (20,089) | 767,326 |
| Pro forma net income | \$ 2,261,531 | \$ 538,104 |
| Earnings per share: | | |
| Basic - as reported | \$ 0.67 | \$ 0.40 |
| Basic - pro forma | \$ 0.67 | \$ 0.17 |
| Diluted - as reported | \$ 0.65 | \$ 0.38 |
| Diluted - pro forma | \$ 0.65 | \$ 0.16 |
| | | |
| | Three months ended September 30, | |
| | 2006 | 2005 |
| Net income, as reported | \$ 864,912 | \$ 490,428 |
| Add: Stock-based compensation expense included in reported net income, net of related tax effects | 7,316 | |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (7,316) | |
| Pro forma net income | \$ 864,912 | \$ 490,428 |
| Earnings per share: | | |
| Basic - as reported | \$ 0.25 | \$ 0.15 |
| Basic - pro forma | \$ 0.25 | \$ 0.15 |
| Diluted - as reported | \$ 0.25 | \$ 0.14 |
| Diluted - pro forma | \$ 0.25 | \$ 0.14 |

FIRST RELIANCE BANCSHARES, INC.
Notes to Condensed Consolidated Financial Statements
(Unaudited)

Note 5 - Earnings Per Share

The following schedule reconciles the numerators and denominators of the basic and diluted earnings per share computations for the three and nine month periods ended September 30, 2006 and 2005. 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, 2006 | | |
|--|--------------------------------------|-------------------------|---------------------|
| | Income (Numerator) | Shares (Denominator) | Per Share Amount |
| Basic earnings per share | | | |
| Income available to common shareholders | \$ 2,261,531 | 3,379,624 | \$ <u>0.67</u> |
| Effect of dilutive securities | | | |
| Stock options | | 112,057 | |
| Non vested restricted stock | | 747 | |
| Diluted earnings per share | | | |
| Income available to common shareholders plus assumed conversions | \$ <u>2,261,531</u> | <u>3,492,428</u> | \$ <u>0.65</u> |
| | | | |
| | Nine Months Ended September 30, 2005 | | |
| | Income (Numerator) | Shares (Denominator) | Per Share Amount |
| Basic earnings per share | | | |
| Income available to common shareholders | \$ 1,305,430 | 3,249,698 | \$ <u>0.40</u> |
| Effect of dilutive securities | | | |
| Stock options | | 183,060 | |
| Diluted earnings per share | | | |
| Income available to common shareholders plus assumed conversions | \$ <u>1,305,430</u> | <u>3,432,758</u> | \$ <u>0.38</u> |

FIRST RELIANCE BANCSHARES, INC.
Notes to Condensed Consolidated Financial Statements
(Unaudited)

Note 5 - Earnings Per Share - continued

| | Three Months Ended September 30, 2006 | | |
|--|--|---------------------------------|-----------------------------|
| | Income (Numerator) | Shares (Denominator) | Per Share Amount |
| Basic earnings per share | | | |
| Income available to common shareholders | \$ 864,912 | 3,406,109 | \$ 0.25 |
| Effect of dilutive securities | | | |
| Stock options | | 104,447 | |
| Non-vested restricted stock | | 777 | |
| Diluted earnings per share | | | |
| Income available to common shareholders plus assumed conversions | \$ 864,912 | 3,511,333 | \$ 0.25 |
| Three Months Ended September 30, 2005 | | | |
| | Income (Numerator) | Shares (Denominator) | Per Share Amount |
| Basic earnings per share | | | |
| Income available to common shareholders | \$ 490,428 | 3,280,182 | \$ 0.15 |
| Effect of dilutive securities | | | |
| Stock options | | 178,343 | |
| Diluted earnings per share | | | |
| Income available to common shareholders plus assumed conversions | \$ 490,428 | 3,458,525 | \$ 0.14 |

Note 6 - 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, 2006, there were no options available for grant under the 2003 plan and no options available for grant under the 1999 plan.

A summary of the status of the Company's stock option plan as of the nine months ended September 30, 2006 changes during the period is presented below:

| Nine months ended September 30, 2006 | |
|---|---------------------------------------|
| Shares | Average Exercise Price |
| | |

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| | | | |
|-----------------------------------|----------------|-----------|-------------|
| Outstanding at January 1 | 400,363 | \$ | 7.75 |
| Granted | | | |
| Exercised | (78,371) | | 6.94 |
| Forfeited | | | |
| | | | |
| Outstanding at September 30, 2006 | 321,992 | \$ | 7.95 |

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FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation

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

DISCUSSION OF FORWARD-LOOKING STATEMENTS

The statements contained in this report on Form 10-Q that are not historical facts are forward-looking statements subject to the safe harbor created by the Private Securities Litigation Reform Act of 1995. We caution readers of this report that such forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company to be materially different from those expressed or implied by such forward-looking statements. Although we believe that our expectations of future performance is based on reasonable assumptions within the bounds of our knowledge of our business and operations, there can be no assurance that actual results will not differ materially from our expectations.

Factors which could cause actual results to differ from expectations include, among other things:

- the challenges, costs and complications associated with the continued development of our branches;
- the potential that loan charge-offs may exceed the allowance for loan losses or that such allowance will be increased as a result of factors beyond the control of us;
- our dependence on senior management;
- competition from existing financial institutions operating in our market areas as well as the entry into such areas of new competitors with greater resources, broader branch networks and more comprehensive services;
- adverse conditions in the stock market, the public debt market, and other capital markets (including changes in interest rate conditions);
- changes in deposit rates, the net interest margin, and funding sources;
- inflation, interest rate, market, and monetary fluctuations;
- risks inherent in making loans including repayment risks and value of collateral;
- the strength of the United States economy in general and the strength of the local economies in which we conduct operations may be different than expected resulting in, among other things, a deterioration in credit quality or a reduced demand for credit, including the resultant effect on our loan portfolio and allowance for loan losses;
- fluctuations in consumer spending and saving habits;
- the demand for our products and services;
- technological changes;
- the challenges and uncertainties in the implementation of our expansion and development strategies;
- the ability to increase market share;
- the adequacy of expense projections and estimates of impairment loss;
- the impact of changes in accounting policies by the Securities and Exchange Commission;
- unanticipated regulatory or judicial proceedings;
- the potential negative effects of future legislation affecting financial institutions (including without limitation laws concerning taxes, banking, securities, and insurance);
- the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System;
- the timely development and acceptance of products and services, including products and services offered through alternative delivery channels such as the Internet;
- the impact on our business, as well as on the risks set forth above, of various domestic or international military or terrorist activities or conflicts;
- other factors described in this report and in other reports we have filed with the Securities and Exchange Commission; and
- our success at managing the risks involved in the foregoing.

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

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued

Overview

First Reliance Bank (the Bank) is a state-chartered bank headquartered in Florence, South Carolina. The Bank opened for business on August 16, 1999. The principal business activity of the Bank is to provide banking services to domestic markets, principally in Florence County, Lexington County, and Charleston County, South Carolina. The deposits of the Bank are insured by the Federal Deposit Insurance Corporation.

On June 7, 2001, the shareholders of the Bank approved a plan of corporate reorganization (the Reorganization) under which the Bank would become a wholly owned subsidiary of First Reliance Bancshares, Inc. (the Company), a South Carolina corporation. The Reorganization was accomplished through a statutory share exchange between the Bank and the Company, whereby each outstanding share of common stock of the Bank was exchanged for one share of common stock of the Company. The Reorganization was completed on April 1, 2002, and the Bank became a wholly-owned subsidiary of First Reliance Bancshares, Inc.

Organizing activities for the Bank began on November 23, 1998. Upon the completion of the application process with the South Carolina State Board of Financial Institutions for a state charter and with the Federal Deposit Insurance Corporation for deposit insurance, the Bank issued 723,518 shares of common stock at a price of \$10.00 per share, resulting in capital totaling \$7,173,293, net of selling expenses of \$61,887.

The Bank began operations on August 16, 1999 at its temporary facility on West Palmetto Street in Florence, South Carolina. In June of 2000, the Bank moved into its headquarters at 2170 West Palmetto Street in Florence, South Carolina. The Bank also opened a banking office on Second Loop Road in Florence, South Carolina in April of 2001. On May 15, 2002, the Bank purchased an additional facility located at 2145 Fernleaf Drive in Florence, South Carolina. The Fernleaf Drive site contains approximately 0.5 acres of land and includes a 7,500 square foot building. The facility serves as additional space for operational activities of the Bank, including data processing and auditing. No customer services are being conducted in this facility.

On November 12, 2002, the Company commenced a stock offering whereby a minimum of 125,000 shares and a maximum of 1,250,000 shares of common stock were offered to fund continued expansion through First Reliance Bank. The offering price was \$8.00 per share. This was a best efforts offering and was conducted without an underwriter. The Company had sold 1,007,430 shares resulting in additional capital of \$8,059,439 net of selling expenses of \$162,965, at the close of the offering in May 2003. Also 10,400 stock options were exercised in 2003 for a total amount of \$52,000.

During the second quarter of 2004, the Bank opened its third branch in Lexington, South Carolina. On March 15, 2005, the Bank opened its fourth branch in Charleston, South Carolina located at 51 State Street. On October 3, 2005, the Bank opened its fifth branch in Mount Pleasant, South Carolina located at 800 South Shelmore Boulevard.

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 Notes issued by the Company (the Notes) totaling \$10.3 million. The Notes 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 Notes ineligible for treatment as Tier 1 capital, subject to prior approval by the Federal Reserve Board, if then required. The Notes presently qualify as Tier 1 capital for regulatory reporting. The sole assets of the Trust are the Notes. The Company owns 100% of the common securities of the Trust. The Notes are unsecured and rank junior to all senior debt of the Company. For the quarter ended September 30, 2006, the floating rate preferred securities and the Notes 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%.

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued

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

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

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

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

Critical Accounting Policies

We have adopted various accounting policies that govern the application of accounting principles generally accepted in the United States and with general practices within the banking industry in the preparation of our financial statements. Our significant accounting policies are described in the footnotes to our audited consolidated financial statements as of December 31, 2005, as filed in our annual report on Form 10-KSB.

Certain accounting policies involve significant judgments and assumptions by us that have a material impact on the carrying value of certain assets and liabilities. We consider these accounting policies to be critical accounting policies. The judgment and assumptions we use are based on historical experience and other factors, which we believe to be reasonable under the circumstances. Because of the nature of the judgment and assumptions we make, actual results could differ from these judgments and estimates that could have a material impact on the carrying values of our assets and liabilities and our results of operations.

We believe the allowance for loan losses is the critical accounting policy that requires the most significant judgment and estimates used in preparation of our consolidated financial statements. Some of the more critical judgments supporting the amount of our allowance for loan losses include judgments about the credit worthiness of borrowers, the estimated value of the underlying collateral, the assumptions about cash flow, determination of loss factors for estimating credit losses, the impact of current events, and conditions, and other factors impacting the level of probable inherent losses. Under different conditions, the actual amount of credit losses incurred by us may be different from management's estimates provided in our consolidated financial statements. Refer to the portion of this discussion that addresses our allowance for loan losses for a more complete discussion of our processes and methodology for determining our allowance for loan losses.

Reclassifications

Certain captions and amounts in the 2005 consolidated financial statements were reclassified to conform with the 2006 presentation.

Effect of Economic Trends

Beginning in July of 2004 and through the first nine months of 2006, our short-term or variable rate interest-bearing liabilities increased as the Federal Reserve began to increase short-term rates as the economy showed signs of strengthening following an economic decline and historically low interest rates. During this period, the Federal Reserve increased rates 17 times for a total of 400 basis points. Two of these rate increases occurred during the second quarter of 2006 for a total of 50 basis points. Economists have mixed opinions on whether the Federal Reserve will continue to increase rates during 2006. The following discussion includes our analysis of the effect we anticipate these rising interest rates will have on our financial condition. However, no assurance can be given that the Federal Reserve will actually continue to raise interest rates or that the results we anticipate will actually occur.

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued

Results of Operations

Income Statement Review

Three months ended September 30, 2006 and 2005:

Our net income was \$864,912 and \$490,428 for the three months ended September 30, 2006 and 2005, respectively, an increase of \$374,484, or 76.4%. The \$374,484 increase in net income resulted primarily from an increase of \$827,724 in net interest income and \$436,328 in non-interest income which was partially offset by an increase of \$26,812 in the provision for loan losses, \$656,014 of additional noninterest expense and \$206,742 increase in income tax expense.

Nine months ended September 30, 2006 and 2005

Our net income was \$2.3 million and \$1.3 million for the nine months ended September 30, 2006 and 2005, respectively, an increase of \$956,101, or 73.2%. The \$956,101 increase in net income resulted primarily from an increase of \$2.7 million in net interest income and \$1.4 in non-interest income which was partially offset by an increase of \$151,446 in the provision for loan losses, \$2.5 million of additional noninterest expense and a \$457,510 increase in income tax expense.

Net Interest Income

Our level of net interest income is determined by the level of earning assets and the management of our net interest margin. The continuous growth in our loan portfolio is the primary driver of the increase in net interest income. During the nine months ended September 30, 2006, our average loan portfolio increased \$55.0 million compared to the average for the nine months ended September 30, 2005. The loan growth in the nine months of 2006 was \$48.5 million. We anticipate the growth in loans will continue to drive the growth in assets and the growth in net interest income. However, no assurance can be given that we will be able to continue to increase loans at the same levels we have experienced in the past.

Our decision to grow the loan portfolio at the current pace created the need for a higher level of capital and the need to increase deposits and borrowings. This loan growth strategy also resulted in a significant portion of our assets being in higher earning loans than in lower yielding investments. At September 30, 2006, net loans represented 79.4% of total assets, while investments represented 8.6% of total assets. While we plan to continue our focus on increasing the loan portfolio, as rates on investment securities begin to rise and additional deposits are obtained, we also anticipate increasing the size of the investment portfolio.

The historically low interest rate environment in the last three years allowed us to obtain short-term borrowings and wholesale certificates of deposit at relatively low rates. We continue to aggressively target core deposit growth by offering the best in market deposit and loan rates. This, along with our successful marketing campaigns and cross selling, is producing a more seasoned deposit base. At September 30, 2006, retail deposits represented \$240.8 million, or 53.4% of total assets, borrowings represented \$40.3 million, or 9.0% of total assets, and wholesale non-core deposits represented \$132.6 million, or 29.6% of total assets.

As more fully discussed in the - Market Risk and - Liquidity and Interest Rate Sensitivity sections below, at September 30, 2006, 60.3% of our loans had variable rates. Given our high percentage of rate-sensitive loans, our primary focus during the past three years has been to obtain short-term liabilities to fund our asset growth. This strategy improves our ability to manage the impact on our earnings resulting from anticipated increases in market interest rates.

At September 30, 2006, 89.2% of interest-bearing liabilities had a maturity of less than one year. Therefore, we believe that we are positioned to benefit from future increases in short-term rates. At September 30, 2006, we had \$88.4 million more assets than liabilities that reprice within the next three months.

We intend to maintain a capital level for the bank that exceeds requirements to be classified as a well capitalized bank. To provide the additional capital needed to support our bank's growth in assets, in 2005 we issued \$10.3 million in junior subordinated debentures. As of September 30, 2006, the company's regulatory capital levels were over \$8 million in excess of the various well capitalized requirements.

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued

In addition to the growth in both assets and liabilities, and the timing of repricing of our assets and liabilities, net interest income is also affected by the ratio of interest-earning assets to interest-bearing liabilities and the changes in interest rates earned on our assets and interest rates paid on our liabilities.

Our net interest income margin for the three months and nine months ended September 30, 2006, exceeded our net interest spread because we had more interest-earning assets than interest-bearing liabilities. Average interest-earning assets exceeded average interest-bearing liabilities by \$46.4 million for the three months and nine months ended September 30, 2006.

During the three and nine months ended September 30, 2006, our rates on both short-term or variable rate earning-assets and short-term or variable rate interest-bearing liabilities continued to increase primarily as a result of the actions taken by the Federal Reserve over the last twelve months to raise short-term rates. The impact of the Federal Reserve's actions resulted in an increase in both the yields on our variable rate assets and the rates that we paid for our short-term deposits and borrowings. Our net interest spread has increased moderately since more of our rate sensitive assets repriced sooner than our rate sensitive liabilities during the 12 month period ending September 30, 2006.

Our net interest spread for the three months and nine months ended September 30, 2006 was 3.83% and 3.90%, respectively. Because we had more interest-earning assets than interest-bearing liabilities that repriced, our net interest spread increased 20 basis points and 17 basis points in the three months and nine months ended September 30, 2006, respectively versus the prior year's interest spread.

For the three months and nine months ended September 30, 2006, our net interest margin was 4.29% and 4.37%, respectively. The change in our net interest margin was 2 basis points higher than the change in net interest spread for the three month period ended September 30, 2006 and 5 basis points higher for the nine months period ended September 30, 2006 when compared to the same period in 2005. The additional 2 and 5 basis points resulted primarily because our interest-earning assets exceeded interest-bearing liabilities by \$46.4 million for the three and nine month period ended September 30, 2006, compared to \$50.1 million and \$45.8 million for the same period in 2005.

We have included a number of tables to assist in our description of various measures of our financial performance. For example, the Average Balances table shows the average balance of each category of our assets and liabilities as well as the yield we earned or the rate we paid with respect to each category during both the three months ended September 30, 2006 and 2005 and the nine months of 2006 and 2005. A review of this table shows that our loans typically provide higher interest yields than do other types of interest-earning assets, which is why we direct a substantial percentage of our earning assets into our loan portfolio. Similarly, the Rate/Volume Analysis table demonstrates the effect of changing interest rates and changing volume of assets and liabilities on our financial condition during the periods shown. A review of these tables shows that as short-term rates continue to rise, the increase in net interest income is more effected by the changes in rates than in prior years. We also track the sensitivity of our various categories of assets and liabilities to changes in interest rates, and we have included tables to illustrate our interest rate sensitivity with respect to interest-earning accounts and interest-bearing accounts. Finally, we have included various tables that provide detail about our investment securities, our loans, our deposits, and other borrowings.

The following table sets forth information related to our average balance sheets, average yields on assets, and average costs of liabilities. We derived these yields by dividing income or expense by the average balance of the corresponding assets or liabilities. We derived average balances from the daily balances throughout the periods indicated.

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continuedAverage Balances, Income and Expenses, and Rates
For the Three Months Ended September 30,

| (Dollars in thousands) | 2006 | | | 2005 | | |
|--|-----------------|----------|------------|-----------------|----------|------------|
| | Average Balance | Interest | Yield/Rate | Average Balance | Interest | Yield/Rate |
| ASSETS | | | | | | |
| Securities, taxable | \$ 21,080 | \$ 252 | 4.74% | \$ 16,528 | \$ 178 | 4.28% |
| Securities, nontaxable | 14,984 | 163 | 4.30% | 13,792 | 147 | 4.24% |
| Loans | 361,320 | 7,795 | 8.56% | 309,717 | 5,712 | 7.32% |
| Fed funds sold and other (incl. FHLB) | 20,606 | 252 | 4.86% | 20,741 | 167 | 3.19% |
| Nonmarketable Equity Securities | 2,169 | 23 | 4.22% | 1,983 | 24 | 4.78% |
| Total earning assets | 420,159 | 8,485 | 8.01% | 362,761 | 6,228 | 6.81% |
| Non-earning assets | 31,110 | | | 16,586 | | |
| Total assets | 451,269 | | | 379,347 | | |
| LIABILITIES AND STOCKHOLDERS EQUITY | | | | | | |
| Interest bearing transaction accounts | 27,347 | 44 | 0.64% | 21,725 | 41 | 0.75% |
| Savings and money market accounts | 92,733 | 920 | 3.93% | 76,291 | 548 | 2.85% |
| Time deposits | 213,347 | 2,491 | 4.63% | 173,254 | 1,503 | 3.44% |
| Total interest bearing deposits | 333,426 | 3,455 | 4.11% | 271,270 | 2,092 | 3.06% |
| Junior subordinated debentures | 10,310 | 156 | 6.01% | 9,189 | 150 | 6.47% |
| Other borrowings | 29,995 | 327 | 4.32% | 32,192 | 267 | 3.29% |
| Total other interest bearing liabilities | 40,305 | 483 | 4.75% | 41,381 | 417 | 4.00% |
| Total interest-bearing liabilities | 373,731 | 3,938 | 4.18% | 312,651 | 2,509 | 3.18% |
| Non-interest-bearing deposits | 45,622 | | | 38,156 | | |
| Stockholders' equity | 31,916 | | | 28,540 | | |
| Total liabilities & equity | \$ 451,269 | | | \$ 379,347 | | |
| Net interest income/interest rate spread | | 4,547 | 3.83% | | 3,719 | 3.63% |
| Net yield on earning assets | | | 4.29% | | | 4.07% |

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued

Our net interest spread was 3.83% for the three months ended September 30, 2006, compared to 3.63% for the three months ended September 30, 2005. The net interest spread is the difference between the yield we earn on our interest-earning assets and the rate we pay on our interest-bearing liabilities.

Our net interest margin is calculated as net interest income divided by average interest-earning assets. Our net interest margin for the three months ended September 30, 2006 was 4.29%, compared to 4.07% for the three months ended September 30, 2005. During the three months ended September 30, 2006, interest-earning assets averaged \$420.2 million, compared to \$362.8 million in the three months ended September 30, 2005. Interest earning assets exceeded interest bearing liabilities by \$46.4 million and \$50.1 million for the three month periods ended September 30, 2006 and 2005, respectively.

Our loan yield increased 124 basis points for the three months ended September 30, 2006 compared to the three months ended September 30, 2005 as a result of approximately 54.0% of the loan portfolio having variable rates, combined with the increase in prime rates over the twelve months ended September 30, 2006. Offsetting the increase in our loan yield is a 105 basis point increase in the cost of our interest-bearing deposits for the third quarter of 2006 compared to the same period in 2005. The increase in the rate on our time deposits is due to the renewal rates on time deposits being much higher than the original rates due to the number of increases in the prime rate. In addition, the cost of our savings and money market accounts has increased by 108 basis points as we have increased the rates we offer on these products in relation to the increase in short-term market rates to stay competitive. The 103 basis point increase in other borrowings in the third quarter of 2006 compared to the same period in 2005 resulted primarily from the impact of the increase in short-term market rates over the past twelve months. As of September 30, 2006, approximately 33.3% of our FHLB advances had fixed rates, while all of our other borrowings had variable rates.

Net interest income, the largest component of our income, was \$4.5 million and \$3.7 million for the three months ended September 30, 2006 and 2005, respectively. The significant increase in the third quarter of 2006 related to higher levels of both average earning assets and interest-bearing liabilities. Average earning assets were \$57.4 million higher during the three months ended September 30, 2006 compared to the same period in 2005.

Interest income for the three months ended September 30, 2006 was \$8.5 million, consisting of \$7.8 million of interest and fees on loans, \$414,612 of investment income, interest of \$239,121 on federal funds sold, and \$36,149 in other interest income. Interest on loans for the three months ended September 30, 2006 and 2005 represented 91.9% and 92.7%, respectively, of total interest income, while income from investments, federal funds sold, and other interest income represented only 8.1% and 7.3% of total interest income. The high percentage of interest income from loans relates to our strategy to maintain a significant portion of our assets in higher earning loans compared to lower yielding investments. Average loans represented 86.0% and 85.4% of average interest-earning assets for the three months ended September 30, 2006 and 2005, respectively.

Interest expense for the three months ended September 30, 2006 was \$3.9 million, consisting of \$3.5 million related to deposits and \$482,954 related to borrowings. Interest expense for the three months ended September 30, 2005 was \$2.5 million, consisting of \$2.1 million related to deposits and \$417,424 related to borrowings. Interest expense on deposits for the three months ended September 30, 2006 and 2005 represented 87.7% and 83.4%, respectively, of total interest expense, while interest expense on borrowings represented 12.3% and 16.6%, respectively, of total interest expense for the same three month periods. During the three months ended September 30, 2006, average interest-bearing deposits increased by \$62.2 million over the same period in 2005, while other interest bearing liabilities during the three months ended September 30, 2006 decreased \$1.1 million over the same period in 2005. Alternative borrowings decreased primarily as a result of successful marketing campaigns focusing on core deposit growth and branch expansion.

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continuedAverage Balances, Income and Expenses, and Rates
For the Nine Months Ended September 30,

| (Dollars in thousands) | 2006 | | | 2005 | | |
|---|-----------------|---------------|--------------|-----------------|---------------|--------------|
| | Average Balance | Interest | Yield/Rate | Average Balance | Interest | Yield/Rate |
| ASSETS | | | | | | |
| Securities, taxable | 21,871 | 783 | 4.78% | 16,403 | 530 | 4.32% |
| Securities, nontaxable | 14,725 | 477 | 4.34% | 12,571 | 401 | 4.26% |
| Loans | 342,634 | 21,275 | 8.30% | 287,608 | 15,246 | 7.09% |
| Fed funds sold and other (incl. FHLB) | 14,787 | 546 | 4.94% | 11,484 | 247 | 2.88% |
| Nonmarketable Equity Securities | 1,973 | 64 | 4.33% | 2,121 | 57 | 3.57% |
| Total earning assets | 395,990 | 23,145 | 7.81% | 330,187 | 16,481 | 6.67% |
| Non-earning assets | 28,840 | | | 16,081 | | |
| Total assets | 424,830 | | | 346,268 | | |
| LIABILITIES AND STOCKHOLDERS EQUITY | | | | | | |
| Interest bearing transaction accounts | 26,727 | 144 | 0.72% | 18,791 | 102 | 0.73% |
| Savings and money market accounts | 86,693 | 2,396 | 3.69% | 64,902 | 1,260 | 2.60% |
| Time deposits | 199,928 | 6,416 | 4.29% | 161,051 | 3,897 | 3.23% |
| Total interest bearing deposits | 313,348 | 8,956 | 3.82% | 244,744 | 5,259 | 2.87% |
| Junior subordinated debentures | 10,310 | 462 | 5.99% | 3,097 | 150 | 6.47% |
| Other borrowings | 25,971 | 794 | 4.09% | 36,503 | 834 | 3.05% |
| Total other interest bearing liabilities | 36,281 | 1,256 | 4.63% | 39,600 | 984 | 3.32% |
| Total interest-bearing liabilities | 349,629 | 10,212 | 3.91% | 284,344 | 6,243 | 2.94% |
| Non-interest-bearing deposits | 44,144 | | | 33,995 | | |
| Stockholders' equity | 31,057 | | | 27,929 | | |
| Total liabilities & equity | 424,830 | | | 346,268 | | |
| Net interest income/interest rate spread | | 12,933 | 3.90% | | 10,238 | 3.73% |
| Net interest margin | | | 4.37% | | | 4.15% |

Our net interest spread was 3.90% for the nine months ended September 30, 2006, compared to 3.73% for the nine months ended September 30, 2005. The net interest spread is the difference between the yield we earn on our interest-earning assets and the rate we pay on our interest-bearing liabilities.

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued

Our net interest margin is calculated as net interest income divided by average interest-earning assets. Our net interest margin for the nine months ended September 30, 2006 was 4.37%, compared to 4.15% for the nine months ended September 30, 2005. During the nine months ended September 30, 2006, interest-earning assets averaged \$396.0 million, compared to \$330.2 million in the nine months ended September 30, 2005. Interest earning assets exceeded interest bearing liabilities by \$46.4 million and \$45.8 million for the nine month periods ended September 30, 2006 and 2005, respectively.

Our loan yield increased 121 basis points for the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005 as a result of approximately 54.0% of the loan portfolio having variable rates, combined with the increase in prime rates over the twelve months ended September 30, 2006. Offsetting the increase in our loan yield is a 95 basis point increase in the cost of our interest-bearing deposits for the nine months ended September 30, 2006 compared to the same period in 2005. The increase in the rate on our time deposits is due to the renewal rates on time deposits being much higher than the original rates due to the number of increases in the prime rate. In addition, the cost of our savings and money market accounts has increased by 109 basis points as we have increased the rates we offer on these products in relation to the increase in short-term market rates to stay competitive. The 104 basis point increase in other borrowings for the nine months ended September 30, 2006 compared to the same period in 2005 resulted primarily from the impact of the increase in short-term market rates over the past twelve months. As of September 30, 2006, approximately 33.3% of our FHLB advances had fixed rates, while all of our other borrowings had variable rates.

Net interest income, the largest component of our income, was \$12.9 million and \$10.2 million for the nine months ended September 30, 2006 and 2005, respectively. The significant increase for the nine months ended September 30, 2006 related to higher levels of both average earning assets and interest-bearing liabilities. Average earning assets were \$65.8 million higher during the nine months ended September 30, 2006 compared to the same period in 2005.

Interest income for the nine months ended September 30, 2006 was \$23.1 million, consisting of \$21.3 million of interest and fees on loans, \$1.3 million of investment income, interest of \$514,916 on federal funds sold, and \$95,302 in other interest income. Interest income for the nine months ended September 30, 2005 was \$16.5 million, consisting of \$15.2 million of interest and fees on loans, \$930,896 of investment income, interest of \$240,234 on federal funds sold, and \$63,844 in other interest income. Interest on loans for the nine months ended September 30, 2006 and 2005 represented 91.9% and 92.5%, respectively, of total interest income, while income from investments, federal funds sold, and other interest income represented only 8.1% and 7.5% of total interest income. The high percentage of interest income from loans relates to our strategy to maintain a significant portion of our assets in higher earning loans compared to lower yielding investments. Average loans represented 86.5% and 87.1% of average interest-earning assets for the nine months ended September 30, 2006 and 2005, respectively.

Interest expense for the nine months ended September 30, 2006 was \$10.2 million, consisting of \$9.0 million related to deposits and \$1.3 million related to borrowings. Interest expense on deposits for the nine months ended September 30, 2006 and 2005 represented 87.7% and 84.2%, respectively, of total interest expense, while interest expense on borrowings represented 12.3% and 15.8%, respectively, of total interest expense for the same nine month periods. During the nine months ended September 30, 2006, average interest-bearing deposits increased by \$68.6 million over the same period in 2005, while other borrowings during the nine months ended September 30, 2006 decreased \$10.5 million over the same period in 2005. Alternative borrowings decreased primarily as a result of successful marketing campaigns focusing on core deposit growth and branch expansion.

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued*Rate/Volume Analysis*

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

| Three Months Ended September 30, 2006 compared to 2005 | | | | |
|---|--------------|---------------|--------------------|--------------|
| | Rate | Volume | Rate/Volume | Total |
| Securities, taxable | 76 | 195 | (197) | 74 |
| Securities, nontaxable | 8 | 51 | (43) | 16 |
| Loans | 3,840 | 3,777 | (5,534) | 2,083 |
| Fed funds sold and other (incl. FHLB) | 346 | (4) | (257) | 85 |
| Nonmarketable Equity Securities | (11) | 9 | 1 | (1) |
| Total earning assets | 4,259 | 4,028 | (6,030) | 2,257 |
| Interest bearing transaction accounts | (24) | 42 | (15) | 3 |
| Regular savings accounts | 824 | 469 | (921) | 372 |
| Time deposits | 2,062 | 1,379 | (2,453) | 988 |
| Total Deposits | 2,862 | 1,890 | (3,389) | 1,363 |
| Junior subordinated debentures | (15) | 467 | (446) | 6 |
| Other borrowings | 328 | (72) | (196) | 60 |
| Total other interest bearing liabilities | 313 | 395 | (642) | 66 |
| Total interest-bearing liabilities | 3,175 | 2,285 | (4,031) | 1,429 |
| Net interest income | 1,084 | 1,743 | (1,999) | 828 |

| Nine Months Ended September 30, 2006 compared to 2005 | | | | |
|--|--------------|---------------|--------------------|--------------|
| | Rate | Volume | Rate/Volume | Total |
| Securities, taxable | 75 | 236 | (58) | 253 |
| Securities, nontaxable | 10 | 92 | (26) | 76 |
| Loans | 3,480 | 3,901 | (1,353) | 6,028 |
| Fed funds sold and other (incl. FHLB) | 237 | 95 | (33) | 299 |
| Nonmarketable Equity Securities | 16 | (5) | (4) | 7 |
| Total earning assets | 3,818 | 4,319 | (1,473) | 6,664 |
| Interest bearing transaction accounts | (2) | 58 | (14) | 42 |
| Regular savings accounts | 707 | 567 | (139) | 1,135 |
| Time deposits | 1,707 | 1,256 | (444) | 2,519 |
| Total Deposits | 2,412 | 1,881 | (597) | 3,696 |
| Junior subordinated debentures | (15) | 467 | (140) | 312 |
| Other borrowings | 380 | (321) | (98) | (39) |

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| | | | | |
|--|-------|-------|-------|-------|
| Total other interest bearing liabilities | 365 | 146 | (238) | 273 |
| Total interest-bearing liabilities | 2,777 | 2,027 | (835) | 3,969 |
| Net interest income | 1,041 | 2,292 | (638) | 2,695 |

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FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued*Provision for Loan Losses*

We have established an allowance for loan losses through a provision for loan losses charged as an expense on our statement of income. We review our loan portfolio periodically to evaluate our outstanding loans and to measure both the performance of the portfolio and the adequacy of the allowance for loan losses. Please see the discussion below under *Balance Sheet Review - Provision and Allowance for Loan Losses* for a description of the factors we consider in determining the amount of the provision we expense each period to maintain this allowance.

Three months ended September 30, 2006 and 2005

The provision for loan losses is the charge to operating earnings that we feel is necessary to maintain the allowance for loan losses at an adequate level. For the three months ended September 30, 2006, the provision for loan losses was \$477,205. For the three months ended September 30, 2005, the provision for loan losses was \$450,393. Based on present information, we believe the allowance for loan losses was adequate at September 30, 2006 to meet presently known and inherent risks in the loan portfolio. The allowance for loan losses was 1.10% of total loans at September 30, 2006 and 2005. There are risks inherent in making all loans, including risks with respect to the period of time over which loans may be repaid, risks resulting from changes in economic and industry conditions, risks inherent in dealing with individual borrowers, and, in the case of a collateralized loan, risks resulting from uncertainties about the future value of the collateral. We maintain an allowance for loan losses based on, among other things, historical experience, an evaluation of economic conditions, and regular reviews of delinquencies and loan portfolio quality. The allowance is based upon a number of assumptions about future events, which management believes to be reasonable, but which may not prove to be accurate. Thus, there is a risk that charge-offs in future periods could exceed the allowance for loan losses or that substantial additional increases in the allowance for loan losses could be required. Additions to the allowance for loan losses would result in a decrease in net income and, possibly, in capital.

Nine months ended September 30, 2006 and 2005

The provision for loan losses is the charge to operating earnings that we feel is necessary to maintain the allowance for loan losses at an adequate level. For the nine months ended September 30, 2006, the provision for loan losses was \$1.2 million. For the nine months ended September 30, 2005, the provision for loan losses was \$1.0 million. Based on present information, we believe the allowance for loan losses was adequate at September 30, 2006 to meet presently known and inherent risks in the loan portfolio. The allowance for loan losses was 1.10% of total loans at September 30, 2006 and 2005. There are risks inherent in making all loans, including risks with respect to the period of time over which loans may be repaid, risks resulting from changes in economic and industry conditions, risks inherent in dealing with individual borrowers, and, in the case of a collateralized loan, risks resulting from uncertainties about the future value of the collateral. We maintain an allowance for loan losses based on, among other things, historical experience, an evaluation of economic conditions, and regular reviews of delinquencies and loan portfolio quality. The allowance is based upon a number of assumptions about future events, which management believes to be reasonable, but which may not prove to be accurate. Thus, there is a risk that charge-offs in future periods could exceed the allowance for loan losses or that substantial additional increases in the allowance for loan losses could be required. Additions to the allowance for loan losses would result in a decrease in net income and, possibly, in capital.

Noninterest Income

The following table sets forth information related to our noninterest income.

| | Three months ended September 30, | | Nine months ended September 30, | |
|----------------------------------|-------------------------------------|-------------------|------------------------------------|---------------------|
| | 2006 | 2005 | 2006 | 2005 |
| Loan fee income | 506,710 | \$ 262,308 | 1,445,891 | \$ 571,297 |
| Service fees on deposit accounts | 451,211 | 345,962 | 1,225,798 | 1,020,408 |
| Other income | 274,975 | 188,298 | 752,430 | 455,641 |
| Total noninterest income | 1,232,896 | \$ 796,568 | 3,424,120 | \$ 2,047,346 |

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued

Three months ended September 30, 2006 and 2005

Noninterest income in the three month period ended September 30, 2006 was \$1.2 million an increase of 54.8% over noninterest income of \$796,568 in the same period of 2005.

Loan fee income consists primarily of fees from mortgage origination fees, mortgage administrative fees, and mortgage yield spread premium from secondary market. Loan fees were \$506,710 and \$262,308 for the three months ended September 30, 2006 and 2005, respectively. The \$244,402 increase for the three months ended September 30, 2006 compared to the same period in 2005 related primarily to an increase of \$75,613 in mortgage yield spread premium, a \$41,941 increase in mortgage origination fees, and a \$74,785 in mortgage administrative fees.

Service fees on deposits consist primarily of income from NSF fees and service charges on transaction accounts. Service fees on deposits were \$451,211 and \$345,961 for the three months ended September 30, 2006 and 2005, respectively. NSF income was \$429,636 and \$319,742 for the three months ended September 30, 2006 and 2005, respectively, representing 95.2% of total service fees on deposits in the 2006 period compared to 92.4% of total service fees on deposits in the 2005 period. In addition, service charges on deposit accounts decreased to \$21,575 for the three months ended September 30, 2006 compared to \$26,169 for the same period ended September 30, 2005. The lower service charges are a result of the bank introducing a totally free business checking product which offsets the service fees that would have been charged on these accounts.

Other income consisted primarily of fees received on cash value of life insurance and rental income. Other income was \$274,975 and \$188,299 for the three months ended September 30, 2006 and 2005, respectively. The \$86,676 increase is directly related to the purchase of additional BOLI policies, resulting in additional cash value of life insurance income.

Nine months ended September 30, 2006 and 2005

Noninterest income in the nine month period ended September 30, 2006 was \$3.4 million, an increase of 67.2% over noninterest income of \$2.0 million in the same period of 2005.

Loan fee income consists primarily of fees from mortgage origination fees, mortgage administrative fees, and mortgage yield spread premium from secondary market. Loan fees were \$1.4 million and \$571,297 for the nine months ended September 30, 2006 and 2005, respectively. The \$874,594 increase for the nine months ended September 30, 2006 compared to the same period in 2005 related primarily to an increase of \$454,838 in mortgage yield spread premium, and a \$176,045 increase in mortgage origination fees. Mortgage application fees were \$38,216 and \$60,809 for the nine months ended September 30, 2006 and 2005, respectively.

Service fees on deposits consist primarily of income from NSF fees and service charges on transaction accounts. Service fees on deposits were \$1.2 million and \$1.0 million for the nine months ended September 30, 2006 and 2005, respectively. NSF income was \$1.2 million and \$937,803 for the nine months ended September 30, 2006 and 2005, respectively, representing 94.5% of total service fees on deposits in the 2006 period compared to 91.9% of total service fees on deposits in the 2005 period. In addition, service charges on deposit accounts decreased to \$66,764 for the nine months ended September 30, 2006 compared to \$82,605 for the same period ended September 30, 2005. The lower service charges are a result of the bank introducing a totally free business checking product which offsets the service fees that would have been charged on these accounts.

Other income consisted primarily of fees received on cash value of life insurance and rental income. Other income was \$752,430 and \$455,641 for the nine months ended September 30, 2006 and 2005, respectively. The \$296,789 increase is directly related to the purchase of additional BOLI policies, resulting in additional cash value of life insurance income.

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued

Noninterest Expense

Three months ended September 30, 2006 and 2005

Total noninterest expense for the three months ended September 30, 2006 was \$4.0 million, an increase of \$656,014, or 19.5% over the three months ended September 30, 2005. The primary reason was the \$464,606 increase in salaries and employee benefits over the two periods as we continued to hire employees and expand into the Charleston, South Carolina market. In addition, occupancy expense increased \$21,798, or 8.4%, for the three months ending September 30, 2006 as compared to the three months ending September 30, 2005. This increase is also primarily a result of additional expenses associated with the growth of the Bank through its expansion into the Charleston and Lexington markets. Other operating expenses increased \$179,290 or 17.3% for the three months ended September 30, 2006. Income tax expense was \$413,068 for the three months ended September 30, 2006 compared to \$206,326 during the same period in 2005. The increase related to the higher level of income before taxes.

Nine months ended September 30, 2006 and 2005

Total noninterest expense for the nine months ended September 30, 2006 was \$11.9 million, an increase of \$2.5 million, or 26.6% over the nine months ended September 30, 2005. As was the case with the three months ended, the primary reason was the \$1.4 million increase in salaries and employee benefits over the two periods as we continued to hire employees and expand into the Charleston, South Carolina market. In addition, occupancy expense increased \$201,315, or 31.3%, for the nine months ending September 30, 2006 as compared to the nine months ending September 30, 2005. Other operating expenses increased 33.53% to \$929,428 for the nine months ended September 30, 2006. Income tax expense was \$995,414 for the nine months ended September 30, 2006 compared to \$537,905 during the same period in 2005. The increase related to the higher level of income before taxes.

Balance Sheet Review

General

At September 30, 2006, we had total assets of \$448.6 million, consisting principally of \$356.1 million in net loans, \$38.5 million in investments, and \$16.0 million in cash and due from banks. Our liabilities at September 30, 2006 totaled \$415.7 million, which consisted principally of \$373.3 million in deposits, \$22.5 million in FHLB advances, \$7.5 million in short-term borrowings, and \$10.3 million in junior subordinated debentures. At September 30, 2006, our shareholders' equity was \$32.9 million.

At December 31, 2005, we had total assets of \$403.0 million, consisting principally of \$308.1 million in net loans, \$39.2 million in investments, \$22.4 million in federal funds sold, and \$7.3 million in cash and due from banks. Our liabilities at December 31, 2005 totaled \$373.4 million, consisting principally of \$334.4 million in deposits, \$23.5 million in FHLB advances, \$3.9 million of short-term borrowings, and \$10.3 million of junior subordinated debentures. At December 31, 2005, our shareholders' equity was \$29.7 million.

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued*Investments*

Contractual maturities and yields on our investments that are available for sale and are held to maturity at September 30, 2006 are shown in the following table. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| Investment Securities Maturity Distribution & Yields | September 30, 2006 | |
|--|----------------------|----------------------|
| | Estimated Fair Value | Tax Equivalent Yield |
| Within One Year | | |
| US Gov t Agencies and Corporations | \$ | % |
| Municipals | | % |
| Mortgage Back Securities | 6 | 7.69% |
| TOTAL | \$ 6 | 7.69% |
| One to Five Years | | |
| US Gov t Agencies and Corporations | \$ 5,324 | 5.12% |
| Municipals | 764 | 5.33% |
| Mortgage Back Securities | 1,016 | 3.80% |
| TOTAL | \$ 7,104 | 4.96% |
| Five to Ten Years | | |
| US Gov t Agencies and Corporations | \$ | % |
| Municipals | 598 | 5.26% |
| Mortgage Back Securities | 1,378 | 3.66% |
| TOTAL | \$ 1,739 | 4.21% |
| Over Ten Years | | |
| US Gov t Agencies and Corporations | \$ 3,871 | 5.35% |
| Municipals | 13,770 | 6.48% |
| Mortgage Back Securities | 9,583 | 4.49% |
| TOTAL | \$ 27,224 | 5.62% |

The amortized costs and the fair value of our investments at September 30, 2006 and December 31, 2005 are shown in the following table.

| | September 30, 2006 | | December 31, 2005 | |
|--|-----------------------------|----------------------|-----------------------------|----------------------|
| | Amortized Cost (Book Value) | Estimated Fair Value | Amortized Cost (Book Value) | Estimated Fair Value |
| Total US Gov t Agencies & Corporations | 9,268 | 9,195 | 9,554 | 9,439 |
| Total Mortgage Back Securities | 12,132 | 11,747 | 13,790 | 13,430 |
| Total Municipal Securities | 14,814 | 15,132 | 13,948 | 14,253 |
| Total | \$ 36,214 | \$ 36,073 | \$ 37,292 | \$ 37,122 |

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued*Investments*

At September 30, 2006, we had \$36.1 million in our investment securities portfolio which represented approximately 8.0% of our total assets. We held U.S. Government agency securities, municipal securities, and mortgage-backed securities with a fair value of \$36.1 million and an amortized cost of \$36.2 million for an unrealized loss of \$140,798. We believe, based on industry analyst reports and credit ratings that the deterioration in value is attributed to changes in market interest rates and not in the credit quality of the issuer and therefore, these losses are not considered other-than-temporary. We have the ability and intent to hold these securities until such time as the value recovers or the securities mature.

At December 31, 2005, the \$37.1 million in our investment securities portfolio represented approximately 9.2% of our total assets. We held U.S. Government agency securities, municipal securities, and mortgage-backed securities with a fair value of \$37.1 million and an amortized cost of \$37.3 million for an unrealized loss of \$170,214. As a result of the strong growth in our loan portfolio and the historical low fixed rates that were available during the last two and one-half years, we have maintained a lower than normal level of investments. As rates on investment securities rise and additional capital and deposits are obtained, we anticipate increasing the size of the investment portfolio.

Contractual maturities and yields on our available for sale investments at December 31, 2005 are shown in the following table. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. At December 31, 2005, we had no securities with a maturity of within one year.

| Investment Securities Maturity Distribution & Yields | December 31, 2005 | |
|--|----------------------|----------------------|
| | Estimated Fair Value | Tax Equivalent Yield |
| One to Five Years | | |
| US Gov t Agencies and Corporations | 5,318 | 5.07% |
| Municipals | 148 | 6.01% |
| Mortgage Back Securities | 1,238 | 3.86% |
| TOTAL | \$ 6,704 | 4.87% |
| Five to Ten Years | | |
| US Gov t Agencies and Corporations | 149 | 5.79% |
| Municipals | 1,492 | 5.42% |
| Mortgage Back Securities | 1,378 | 3.79% |
| TOTAL | \$ 3,019 | 4.69% |
| Over Ten Years | | |
| US Gov t Agencies and Corporations | 3,972 | 2.81% |
| Municipals | 12,613 | 6.58% |
| Mortgage Back Securities | 10,814 | 4.46% |
| TOTAL | \$ 27,399 | 5.20% |

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued*Loans*

Since loans typically provide higher interest yields than other types of interest earning assets, a substantial percentage of our earning assets are invested in our loan portfolio. For the nine months ended September 30, 2006 and 2005, average loans were \$342.6 million and \$287.6 million, respectively. Before the allowance for loan losses, total loans outstanding at September 30, 2006 were \$360.1 million. Average loans for the year ended December 31, 2005 were \$294.7 million. Before the allowance for loan losses, total loans outstanding at December 31, 2005 were \$311.5 million.

The following table summarizes the composition of our loan portfolio September 30, 2006 and December 31, 2005.

| | September 30, 2006 | % of Total | December 31, 2005 | % of Total |
|--------------------------------------|-----------------------|---------------|-----------------------|---------------|
| Mortgage Loans on Real Estate | | | | |
| Residential 1-4 Family | \$ 57,732,616 | 16.0% | \$ 50,937,658 | 16.4% |
| Multifamily | 8,046,693 | 2.2% | 6,322,957 | 2.0% |
| Commercial | 132,737,660 | 36.9% | 106,125,103 | 34.1% |
| Construction | 65,132,698 | 18.1% | 52,267,759 | 16.8% |
| Second Mortgages | 4,422,870 | 1.2% | 4,885,095 | 1.6% |
| Equity Lines of Credit | 27,060,129 | 7.5% | 24,570,163 | 7.9% |
| Total Mortgage Loans | \$ 295,132,666 | 81.9% | \$ 245,108,735 | 78.7% |
| Commercial and Industrial | 47,785,418 | 13.3% | 50,320,434 | 16.2% |
| Consumer | 12,686,973 | 3.5% | 13,953,632 | 4.5% |
| Other, net | 4,475,537 | 1.3% | 2,161,584 | 0.7% |
| Total Gross Loans | \$ 360,080,594 | | \$ 311,544,385 | |

Maturities and Sensitivity of Loans to Changes in Interest Rates

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

The following table summarizes the loan maturity distribution by type and related interest rate characteristics at September 30, 2006.

Loan Maturity Schedule and Sensitivity to Changes in Interest Rates

| September 30, 2006 (Dollars in thousands) | One Year or Less | Over One Year Through Five Years | Over Five Years | Total |
|---|---------------------|---|--------------------|------------|
| Commercial and industrial | \$ 18,352 | \$ 28,827 | \$ 606 | \$ 47,785 |
| Real estate | 102,387 | 162,921 | 29,825 | 295,133 |
| Consumer and other | 5,782 | 11,216 | 165 | 17,163 |
| | 126,521 | 202,964 | 30,596 | \$ 360,081 |
| Loans maturing after one year with: Fixed interest rates | | | | \$ 102,227 |

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| | |
|-------------------------|-------------------|
| Floating interest rates | 131,333 |
| | <u> </u> |
| | \$ 233,560 |
| | <u> </u> |

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued*Provision and Allowance for Loan Losses*

We have established an allowance for loan losses through a provision for loan losses charged to expense on our statement of income. The allowance for loan losses represents an amount which we believe will be adequate to absorb probable losses on existing loans that may become uncollectible. Our judgment as to the adequacy of the allowance for loan losses is based on a number of assumptions about future events, which we believe to be reasonable, but which may or may not prove to be accurate. Our determination of the allowance for loan losses is based on evaluations of the collectibility of loans, including consideration of factors such as the balance of impaired loans, the quality, mix, and size of our overall loan portfolio, economic conditions that may affect the borrower's ability to repay, the amount and quality of collateral securing the loans, our historical loan loss experience, and a review of specific problem loans. We also consider subjective issues such as changes in the lending policies and procedures, changes in the local/national economy, changes in volume or type of credits, changes in volume/severity of problem loans, quality of loan review and board of director oversight, concentrations of credit, and peer group comparisons. Due to our limited operating history, the provision for loan losses has been made primarily as a result of our assessment of general loan loss risk compared to banks of similar size and maturity. Due to the rapid growth of our bank over the past several years and our short operating history, a large portion of the loans in our loan portfolio and of our lending relationships are of relatively recent origin. In general, loans do not begin to show signs of credit deterioration or default until they have been outstanding for some period of time, a process known as seasoning. As a result, a portfolio of older loans will usually behave more predictably than a newer portfolio. Because our loan portfolio is relatively new, the current level of delinquencies and defaults may not be representative of the level that will prevail when the portfolio becomes more seasoned, which may be higher than current levels. If delinquencies and defaults increase, we may be required to increase our provision for loan losses, which would adversely affect our results of operations and financial condition. Periodically, we adjust the amount of the allowance based on changing circumstances. We charge recognized losses to the allowance and add subsequent recoveries back to the allowance for loan losses. There can be no assurance that charge-offs of loans in future periods will not exceed the allowance for loan losses as estimated at any point in time or that provisions for loan losses will not be significant to a particular accounting period.

The following table summarizes the activity related to our allowance for loan losses for the nine months ended September 30, 2006 and 2005:

| Risk Elements in the Loan Portfolio | September 30, 2006 | December 31, 2005 |
|--|-----------------------|-----------------------|
| Loans | | |
| Nonaccrual Loans | \$ 1,217,687 | \$ 1,793,255 |
| Accruing loans more than 90 days past due | 397,836 | 936,970 |
| | | |
| Allowance for Loan Losses | September 30, 2006 | September 30, 2005 |
| Balance January 1, | \$ 3,419,368 | \$ 2,758,225 |
| Provision for Loan Losses during Period | 1,167,991 | 1,016,545 |
| Net Loans (charged-off) recovered for Period | (626,354) | (401,879) |
| | \$ 3,961,005 | \$ 3,372,891 |
| | | |
| Gross Loans Outstanding | \$ 360,080,594 | \$ 306,521,358 |
| | | |
| Allowance for Loan Losses to Loans Outstanding | 1.10% | 1.10% |

We do not allocate the allowance for loan losses to specific categories of loans. Instead, we evaluate the adequacy of the allowance for loan losses on an overall portfolio basis utilizing our credit grading system which we apply to each loan.

The allowance for loan losses was \$3.9 million and \$3.4 million at September 30, 2006 and September 30, 2005, respectively, or 1.10% of outstanding loans. During the nine months ended September 30, 2006, we had net charged off loans of \$626,354. During the nine months ended September 30, 2005 we had net charge-offs of \$401,879.

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued

At September 30, 2006 and December 31, 2005, nonaccrual loans represented 0.34% and 0.58% of net loans, respectively. At September 30, 2006 and December 31, 2005, we had \$1.2 million and \$1.8 million of loans, respectively, on nonaccrual status. Generally, a loan is placed on nonaccrual status when it becomes 90 days past due as to principal or interest, or when we believe, after considering economic and business conditions and collection efforts, that the borrower's financial condition is such that collection of the loan is doubtful. A payment of interest on a loan that is classified as nonaccrual is recognized as income when received.

Deposits and Other Interest-Bearing Liabilities

Our primary source of funds for loans and investments is our deposits, advances from the FHLB, and short-term repurchase agreements. Through successful marketing campaigns and branch expansion, we have been able to increase our deposits in our local markets. Sometimes it is necessary to obtain a portion of our certificates of deposits from areas outside of our market. The deposits obtained outside of our market area generally have comparable rates compared to rates being offered for certificates of deposits in our local market. We also utilize out-of-market deposits in certain instances to obtain longer-term deposits than are readily available in our local market. We anticipate that the amount of out-of-market deposits will continue to decline as our new retail deposit offices become established. The amount of out-of-market deposits was \$50.9 million at September 30, 2006 and \$39.2 million at December 31, 2005.

We anticipate being able to either renew or replace these out-of-market deposits when they mature, although we may not be able to replace them with deposits with the same terms or rates. Our loan-to-deposit ratio was 96.4% and 93.2% at September 30, 2006 and December 31, 2005, respectively.

The following table shows the average balance amounts and the average rates paid on deposits held by us for the nine months ended September 30, 2006 and 2005.

| | 2006 | | 2005 | |
|-------------------------------------|-------------------|--------------|-------------------|--------------|
| | Average Amount | Average Rate | Average Amount | Average Rate |
| (Dollars in thousands) | | | | |
| Noninterest bearing demand deposits | \$ 44,144 | | 33,995 | |
| Interest bearing demand deposits | 26,727 | 0.72% | 18,791 | 0.73% |
| Saving accounts | 86,693 | 3.69% | 64,902 | 2.60% |
| Time deposits | 199,928 | 4.29% | 161,050 | 3.23% |
| Total deposits | \$ 357,492 | 3.35% | \$ 278,739 | 2.52% |

The increase in time deposits for the nine months ended September 30, 2006 resulted from an increase in retail time deposits, which was offset by a decrease in wholesale deposits. A significant portion of the increase in retail time deposits is attributed to successful pricing and marketing promotions.

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued

All of our time deposits are certificates of deposits. The maturity distribution of our time deposits of \$100,000 or more at September 30, 2006 (in thousands) was as follows:

| | September 30, 2006 |
|-----------------------------------|-------------------------------|
| Three months or less | \$ 23,400 |
| Over three through twelve months | 73,191 |
| Over one year through three years | 20,153 |
| Over three years | 835 |
| Total | \$ 117,579 |

Capital Resources

Total shareholders' equity at September 30, 2006 was \$32.9 million. At December 31, 2005, total shareholders' equity was \$29.7 million. The increase during the first nine months of 2006 resulted primarily from the \$2.3 million of net income earned.

The following table shows the return on average assets (net income divided by average total assets), return on average equity (net income divided by average equity), and equity to assets ratio (average equity divided by average total assets) for the nine months ended September 30, 2006 and the year ended December 31, 2005. Since our inception, we have not paid cash dividends.

| | September 30, 2006 | December 31, 2005 |
|--------------------------|-------------------------------|------------------------------|
| Return on average assets | 0.71% | 0.54% |
| Return on average equity | 9.74% | 6.82% |
| Equity to assets ratio | 7.31% | 7.96% |

Our return on average assets was 0.71% for the nine months ended September 30, 2006, an increase from 0.54% for the year ended December 31, 2005. In addition, our return on average equity increased to 9.74% from 6.82% for the nine months ended September 30, 2006 and the year ended December 31, 2005, respectively. The decrease in the equity to assets ratio from December 31, 2005 is a function of the \$78.6 million increase in average assets compared to the \$3.1 million increase in average equity.

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a material effect on the Company's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Company's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum ratios of Tier 1 and total capital as a percentage of assets and off-balance-sheet exposures, adjusted for risk weights ranging from 0% to 100%. Tier 1 capital of the Company consists of common shareholders' equity, excluding the unrealized gain or loss on securities available-for-sale, minus certain intangible assets. The Company's Tier 2 capital consists of the allowance for loan losses subject to certain limitations. Total capital for purposes of computing the capital ratios consists of the sum of Tier 1 and Tier 2 capital. The regulatory minimum requirements are 4% for Tier 1 capital and 8% for total risk-based capital.

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued

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

The following table sets forth the holding company's and the bank's various capital ratios at September 30, 2006 and at December 31, 2005. For all periods, the bank was considered well capitalized and the holding company met or exceeded its applicable regulatory capital requirements.

| | September 30, 2006 | | December 31, 2005 | |
|--|--------------------|--------|-------------------|--------|
| | Holding Company | Bank | Holding Company | Bank |
| Total capital (to risk-weighted assets) | 12.13% | 11.58% | 13.05% | 12.68% |
| Tier 1 capital (to risk-weighted assets) | 11.12% | 10.57% | 12.02% | 11.65% |
| Tier 1 capital (to average assets) | 10.30% | 9.18% | 10.02% | 9.80% |

Borrowings

The following table outlines our various sources of borrowed funds during the nine months ended September 30, 2006 and the year ended December 31, 2005, the amounts outstanding at the end of each period, at the maximum point for each component during the periods and on average for each period, and the average interest rate that we paid for each borrowing source. The maximum month-end balance represents the high indebtedness for each component of borrowed funds at any time during each of the periods shown.

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued

| | Ending Balance | Period- End Rate | Maximum Month-end Balance | Average for the Period | |
|--|-------------------|---------------------|---------------------------------|---------------------------|-------|
| | | | | Balance | Rate |
| (Dollars in thousands) | | | | | |
| <u>At or for the Nine Months ended September 30, 2006</u> | | | | | |
| Federal Home Loan Bank advances | \$ 22,500 | 2.43% | \$ 23,500 | \$ 20,269 | 2.70% |
| Securities sold under agreement to repurchase | 7,457 | 2.26% | 8,091 | 5,367 | 3.13% |
| Federal funds purchased | | | 955 | 334 | 3.51% |
| Junior subordinated debentures | 10,310 | 5.97% | 10,310 | 10,310 | 5.97% |
| <u>At or for the Year ended December 31, 2005</u> | | | | | |
| Federal Home Loan Bank advances | \$ 23,500 | 4.21% | \$ 36,000 | \$ 31,301 | 3.16% |
| Securities sold under agreement to repurchase | 3,860 | 2.37% | 4,223 | 3,600 | 2.54% |
| Federal funds purchased | | | | 141 | 3.18% |
| Junior subordinated debentures | 10,310 | 2.97% | 10,310 | 4,875 | 6.22% |

Effect of Inflation and Changing Prices

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

Unlike most industrial companies, our assets and liabilities are primarily monetary in nature. Therefore, the effect of changes in interest rates will have a more significant impact on our performance than will the effect of changing prices and inflation in general. In addition, interest rates may generally increase as the rate of inflation increases, although not necessarily in the same magnitude. As discussed previously, we seek to manage the relationships between interest sensitive assets and liabilities in order to protect against wide rate fluctuations, including those resulting from inflation.

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued**Off-Balance Sheet Risk**

Through our operations, we have made contractual commitments to extend credit in the ordinary course of our business activities. These commitments are legally binding agreements to lend money to our customers at predetermined interest rates for a specified period of time. At September 30, 2006, we had issued commitments to extend credit of \$73.4 million and standby letters of credit of \$3.8 million through various types of commercial lending arrangements. Approximately \$60.3 million of these commitments to extend credit had variable rates.

The following table sets forth the length of time until maturity for unused commitments to extend credit and standby letters of credit at September 30, 2006.

| <i>(Dollars in thousands)</i> | Within One Month | After One Through Three Months | After Three Through Twelve Months | Within One Year | Greater Than One Year | Total |
|-------------------------------------|------------------------|---|--|--------------------|-----------------------------|------------------|
| Unused commitments to extend credit | \$ 3,869 | \$ 2,874 | \$ 25,456 | \$ 32,199 | \$ 41,168 | \$ 73,367 |
| Standby letters of credit | 162 | 376 | 3,054 | 3,592 | 243 | 3,835 |
| Total | \$ 4,031 | \$ 3,250 | \$ 28,510 | \$ 35,791 | \$ 41,411 | \$ 77,202 |

We evaluate each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by us upon extension of credit, is based on our credit evaluation of the borrower. Collateral varies but may include accounts receivable, inventory, property, plant and equipment, commercial and residential real estate.

Market Risk

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

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

We were asset sensitive during most of the year ended December 31, 2005 and during the nine months ended September 30, 2006. As of September 30, 2006, we expect to be asset sensitive for the next three months, then we expect to be liability sensitive for the following nine months because a significant portion of our variable rate loans and a majority of our deposits reprice over a 12-month period. Approximately 54.0% of our loans were variable rate loans at September 30, 2006. The ratio of cumulative gap to total earning assets after 12 months was 11.12% because \$105.4 million more assets will reprice in a 12 month period than liabilities. However, our gap analysis is not a precise indicator of our interest sensitivity position. The analysis presents only a static view of the timing of maturities and repricing opportunities, without taking into consideration that changes in interest rates do not affect all assets and liabilities equally. For example, rates paid on a substantial portion of core deposits may change contractually within a relatively short time frame, but those rates are viewed by us as significantly less interest-sensitive than market-based rates such as those paid on noncore deposits. Net interest income may be affected by other significant factors in a given interest rate environment, including changes in the volume and mix of interest-earning assets and interest-bearing liabilities.

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued

Liquidity and Interest Rate Sensitivity

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

At September 30, 2006, our liquid assets, consisting of cash and due from banks and federal funds sold, amounted to \$16.0 million, or 3.6% of total assets. Our investment securities at September 30, 2006 amounted to \$38.5 million, or 8.6% of total assets. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, \$6.3 million of these securities are pledged against repurchase agreements, other required deposit accounts, and unused FHLB borrowing lines. At December 31, 2005, our liquid assets amounted to \$29.7 million, or 7.4% of total assets. Our investment securities at December 31, 2005 amounted to \$39.2 million, or 9.7% of total assets. However, \$6.2 million of these securities were pledged.

Our ability to maintain and expand our deposit base and borrowing capabilities serves as our primary source of liquidity. We plan to meet our future cash needs through the liquidation of temporary investments, the generation of deposits, and from additional borrowings. In addition, we will receive cash upon the maturity and sale of loans and the maturity of investment securities. During most of 2005 and the first nine months of 2006, as a result of historically low rates that were being earned on short-term liquidity investments, we chose to maintain a lower than normal level of short-term liquidity securities. In addition, we maintain nine federal funds purchased lines of credit with correspondent banks giving us credit availability totaling \$32.5 million. There were no borrowings against the lines at September 30, 2006. We are also a member of the Federal Home Loan Bank of Atlanta, from which applications for borrowings can be made for leverage purposes. The FHLB requires that securities, qualifying mortgage loans, and stock of the FHLB owned by the bank be pledged to secure any advances from the FHLB. The Company has an available line to borrow funds from the Federal Home Loan Bank up to 30% of the Bank's total assets which provide additional available funds of \$130.0 million at September 30, 2006. At September 30, 2006 the bank had \$22.5 million outstanding in FHLB advances. We believe that these funds will be sufficient to meet our future liquidity needs.

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

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued

The following table sets forth information regarding our rate sensitivity as of September 30, 2006 for each of the time intervals indicated. The information in the table may not be indicative of our rate sensitivity position at other points in time. In addition, the maturity distribution indicated in the table may differ from the contractual maturities of the earning assets and interest-bearing liabilities presented due to consideration of prepayment speeds under various interest rate change scenarios in the application of the interest rate sensitivity methods described above.

Interest Sensitivity Analysis

| September 30, 2006 (Dollars in thousands) | Within One Month | After One Through Three Months | After Three Through Twelve Months | Within One Year | Greater Than One Year or Non- Sensitive | Total |
|---|------------------------|---|--|-----------------------|--|----------------|
| Assets | | | | | | |
| Interest-earning assets | | | | | | |
| Loans | \$ 238,381 | \$ 4,717 | \$ 14,980 | \$ 258,078 | \$ 102,003 | \$ 360,081 |
| Loans Held for Sale | | | | | 9,580 | 9,580 |
| Securities, taxable | 187 | 367 | 1,600 | 2,154 | 18,788 | 20,942 |
| Securities, nontaxable | | | | | 15,132 | 15,132 |
| Nonmarketable securities | 2,136 | | | 2,136 | | 2,136 |
| Federal funds sold | 11,061 | | | 11,061 | | 11,061 |
| Investment in trust | | | | | 310 | 310 |
| Total earning assets | 251,765 | 5,084 | 16,580 | 273,429 | 145,813 | 419,242 |
| Liabilities | | | | | | |
| Interest-bearing liabilities | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Demand deposits | 30,442 | | | 30,442 | | 30,442 |
| Savings deposits | 82,545 | | | 82,545 | | 82,545 |
| Time deposits | 5,170 | 38,369 | 148,294 | 191,833 | 27,554 | 219,387 |
| Total interest-bearing deposits | 118,157 | 38,369 | 148,294 | 304,820 | 27,554 | 332,374 |
| Federal Home Loan Bank advances | | 4,500 | 15,500 | 20,000 | 2,500 | 22,500 |
| Junior sub debentures | | | | | 10,310 | 10,310 |
| Repurchase agreements | 7,457 | | | 7,457 | | 7,457 |
| Total interest-bearing liabilities | 125,614 | 42,869 | 163,794 | 332,277 | 40,364 | 372,641 |
| Period gap | \$ 126,151 | \$ (37,785) | \$ (147,214) | \$ (58,848) | \$ 105,449 | |
| Cumulative gap | \$ 126,151 | \$ 88,366 | \$ (58,848) | \$ (58,848) | \$ 46,601 | |
| Ratio of cumulative gap to total earning assets | 30.09% | 21.08% | -14.04% | -14.04% | 11.12% | |

FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation - continued

The following table sets forth information regarding our rate sensitivity, as of December 31, 2005, at each of the time intervals.

Interest Sensitivity Analysis

| December 31, 2005 (Dollars in thousands) | Within One Month | After One Through Three Months | After Three Through Twelve Months | Within One Year | Greater Than One Year or Non- Sensitive | Total |
|---|---------------------|---|--|--------------------|--|----------------|
| Assets | | | | | | |
| Interest-earning assets | | | | | | |
| Loans | \$ 170,353 | \$ 19,855 | \$ 20,046 | \$ 210,254 | \$ 101,290 | \$ 311,544 |
| Loans held for sale | | | | | 7,995 | 7,995 |
| Securities, taxable | | | | | 22,868 | 22,868 |
| Securities, nontaxable | | | | | 14,253 | 14,253 |
| Nonmarketable securities | 1,746 | | | 1,746 | | 1,746 |
| Federal funds sold | 22,442 | | | 22,442 | | 22,442 |
| Investment in trust | | | | | 310 | 310 |
| Total earning assets | 194,541 | 19,855 | 20,046 | 234,442 | 146,716 | 381,158 |
| Liabilities | | | | | | |
| Interest-bearing liabilities | | | | | | |
| Interest-bearing deposits: | | | | | | |
| Demand deposits | 29,437 | | | 29,437 | | 29,437 |
| Savings deposits | 79,663 | | | 79,663 | | 79,663 |
| Time deposits | 15,599 | 27,453 | 91,430 | 134,482 | 51,632 | 186,114 |
| Total interest-bearing deposits | 124,699 | 27,453 | 91,430 | 243,582 | 51,632 | 295,214 |
| Federal Home Loan Bank advances | | 5,000 | 2,500 | 7,500 | 16,000 | 23,500 |
| Junior sub debentures | | | | | 10,310 | 10,310 |
| Repurchase agreements | 3,860 | | | 3,860 | | 3,860 |
| Total interest-bearing liabilities | 128,559 | 32,453 | 93,930 | 254,942 | 77,942 | 332,884 |
| Period gap | \$ 65,982 | \$ (22,598) | \$ (73,884) | \$ (20,500) | \$ 68,774 | |
| Cumulative gap | \$ 65,982 | \$ 53,384 | \$ (20,500) | \$ (20,500) | \$ 48,274 | |
| Ratio of cumulative gap to total earning assets | 17.31% | 14.01% | -5.38% | -5.38% | 12.67% | |

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

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

FIRST RELIANCE BANCSHARES, INC.

Item 4. Controls and Procedures

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

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

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

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

FIRST RELIANCE BANCSHARES, INC.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

There are no material, pending legal proceedings to which the Company or its subsidiary is a party or of which any of their property is the subject.

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1. Business under the heading Risk Factors in our Annual Report on Form 10-KSB for the year ended December 31, 2005, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-KSB are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

- (a) Not applicable
- (b) Not applicable
- (c) Not applicable

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Submission of Matters to a Vote of Securities

None.

Item 5. Other Information

None.

FIRST RELIANCE BANCSHARES, INC.

Item 6. Exhibits

(a) Exhibits

| Exhibit Number | Exhibit |
|---------------------------|---|
| 31.1 | Certification pursuant to Rule 13a-14 under the Securities Exchange Act of 1934, as amended. |
| 31.2 | Certification pursuant to Rule 13a-14 under the Securities Exchange Act of 1934, as amended. |
| 32.1 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

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FIRST RELIANCE BANCSHARES, INC.

SIGNATURE

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

FIRST RELIANCE BANCSHARES, INC.

By: /s/ F. R. SAUNDERS, JR.

F. R. Saunders, Jr.
President & Chief Executive Officer

Date: _____, 2006

By: /s/ JEFFERY A. PAOLUCCI

Jeffery A. Paolucci
Senior Vice President and Chief Financial Officer