

FIRST RELIANCE BANCSHARES INC
Form 10QSB
May 14, 2004
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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C.

FORM 10-QSB

(Mark One)

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

For the Quarterly Period Ended March 31, 2004

OR

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

For the Transition Period from _____ to _____

Commission File Number 000-49757

FIRST RELIANCE BANCSHARES, INC.

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

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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) 662-8802

(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:

2,494,560 shares of common stock, par value \$0.01 per share, as of April 30, 2004

Transitional Small Business Disclosure Format (Check one): Yes No

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| | March 31, | December 31, |
|---|-----------------------|-----------------------|
| | 2004 | 2003 |
| | (Unaudited) | (Audited) |
| Assets | | |
| Cash and cash equivalents: | | |
| Cash and due from banks | \$ 2,966,418 | \$ 4,693,102 |
| Federal funds sold | 1,499,000 | 100,000 |
| Total cash and cash equivalents | 4,465,418 | 4,793,102 |
| Securities available-for-sale | 26,558,428 | 27,688,992 |
| Nonmarketable equity securities | 1,120,000 | 1,055,000 |
| Total investment securities | 27,678,428 | 28,743,992 |
| Loans held for sale | 1,734,244 | 971,627 |
| Loans receivable | 151,165,366 | 139,389,064 |
| Less allowance for loan losses | (1,781,804) | (1,752,282) |
| Loans, net | 149,383,562 | 137,636,782 |
| Premises and equipment, net | 5,805,962 | 5,796,819 |
| Accrued interest receivable | 832,243 | 949,663 |
| Other real estate owned | 366,002 | 279,393 |
| Other assets | 4,342,843 | 1,192,505 |
| Total assets | \$ 194,608,702 | \$ 180,363,883 |
| Liabilities and Shareholders Equity | | |
| Liabilities | | |
| Deposits | | |
| Noninterest-bearing transaction accounts | \$ 20,310,063 | \$ 19,084,520 |
| Interest-bearing transaction accounts | 16,150,105 | 15,866,254 |
| Savings | 19,700,954 | 18,217,378 |
| Time deposits \$100,000 and over | 64,272,328 | 54,364,004 |
| Other time deposits | 32,047,713 | 31,882,795 |
| Total deposits | 152,481,163 | 139,414,951 |
| Securities sold under agreement to repurchase | 2,244,760 | 2,363,570 |
| Federal funds purchased | | 1,043,000 |
| Advances from Federal Home Loan Bank | 20,400,000 | 19,100,000 |
| Accrued interest payable | 530,820 | 442,233 |
| Other liabilities | 479,931 | 297,490 |

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| | | |
|---|-----------------------|-----------------------|
| Total liabilities | 176,136,674 | 162,661,244 |
| Shareholders Equity | | |
| Common stock, \$0.01 par value; 5,000,000 shares authorized, 2,494,560 shares and 2,466,660 shares issued and outstanding at March 31, 2004 and December 31, 2003, respectively | 24,946 | 24,667 |
| Capital Surplus | 15,371,677 | 15,106,070 |
| Retained earnings | 2,646,776 | 2,325,602 |
| Accumulated other comprehensive income | 428,629 | 246,300 |
| Total shareholders equity | 18,472,028 | 17,702,639 |
| Total liabilities and shareholders equity | \$ 194,608,702 | \$ 180,363,883 |

See notes to condensed consolidated financial statements.

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

| | Three Months Ended | |
|--|---------------------------|------------------|
| | March 31, | |
| | 2004 | 2003 |
| Interest income | | |
| Loans, including fees | \$ 2,356,597 | \$ 1,601,233 |
| Investment securities | | |
| Taxable | 190,413 | 143,374 |
| Nontaxable | 101,147 | 97,016 |
| Federal funds sold and other | 1,395 | 9,197 |
| Total | 2,649,552 | 1,850,820 |
| Interest expense | | |
| Time deposits \$100,000 and over | 336,876 | 166,325 |
| Other deposits | 314,821 | 346,044 |
| Advances from Federal Home Loan Bank | 117,958 | 39,421 |
| Federal funds purchased and securities sold under agreements to repurchase | 5,188 | 3,202 |
| Total | 774,843 | 554,992 |
| Net interest income | 1,874,709 | 1,295,828 |
| Provision for loan losses | 109,928 | 65,000 |
| Net interest income after provision for loan losses | 1,764,781 | 1,230,828 |
| Noninterest income | | |
| Residential mortgage origination fees | 99,005 | 204,878 |
| Service charges on deposit accounts | 248,387 | 216,519 |
| Securities and insurance brokerage commissions | 30,297 | 11,574 |
| Credit life insurance commissions | 22,879 | 15,038 |
| Other charges, commissions and fees | 90,374 | 48,558 |
| Total | 490,942 | 496,567 |
| Noninterest expenses | | |
| Salaries and benefits | 1,071,596 | 743,660 |
| Occupancy expense | 76,857 | 43,693 |
| Furniture and equipment expense | 143,488 | 51,547 |
| Other operating expenses | 503,361 | 458,652 |

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| | | |
|----------------------------|-----------------------------|-----------------------------|
| Total | 1,795,302 | 1,297,552 |
| | <u> </u> | <u> </u> |
| Income before taxes | 460,421 | 429,843 |
| Income tax provision | 139,247 | 124,107 |
| | <u> </u> | <u> </u> |
| Net income | \$ 321,174 | \$ 305,736 |
| | <u> </u> | <u> </u> |
| Basic earnings per share | \$.13 | \$.21 |
| Diluted earnings per share | \$.13 | \$.20 |

See notes to condensed consolidated financial statements.

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FIRST RELIANCE BANCSHARES, INC.

Condensed Consolidated Statements of Shareholders Equity and Comprehensive Income

For the Three Months Ended March 31, 2004 and 2003

(Unaudited)

| | Common Stock | | Capital surplus | Retained earnings | Accumulated other comprehensive income | Total |
|---|------------------|------------------|----------------------|----------------------|---|----------------------|
| | Shares | Amount | | | | |
| Balance, December 31, 2002 | 1,448,830 | \$ 11,488 | \$ 7,091,562 | \$ 1,309,803 | \$ 228,325 | \$ 8,644,178 |
| Net income | | | | 305,736 | | 305,736 |
| Other comprehensive loss, net of tax benefit of \$77,959 | | | | | (151,333) | (151,333) |
| Comprehensive income | | | | | | 154,403 |
| Stock issuance costs | | | (86,653) | | | (85,653) |
| Exercise of stock options | 10,000 | 100 | 49,900 | | | 50,000 |
| Balance, March 31, 2003 | 1,458,830 | \$ 14,588 | \$ 7,054,809 | \$ 1,615,539 | \$ 76,992 | \$ 8,761,928 |
| Balance, December 31, 2002 | 2,466,660 | 24,667 | 15,106,070 | 2,325,602 | 246,300 | 17,702,639 |
| Net income | | | | 321,174 | | 321,174 |
| Other comprehensive income, net of tax expense of \$93,926 | | | | | 182,329 | 182,329 |
| Comprehensive income | | | | | | 503,503 |
| Issuance of stock | 27,900 | 279 | 265,607 | | | 265,886 |
| Balance, March 31, 2004 | 2,494,560 | \$ 24,946 | \$ 15,371,677 | \$ 2,646,776 | \$ 428,629 | \$ 18,472,028 |

See notes to condensed consolidated financial statements

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

| | Three Months Ended | |
|---|---------------------------|--------------------|
| | March 31, | |
| | 2004 | 2003 |
| Cash flows from operating activities: | | |
| Net income | \$ 321,174 | \$ 305,736 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | (49,908) | 65,000 |
| Depreciation and amortization expense | 130,460 | 59,726 |
| Discount accretion and premium amortization | 27,314 | 42,547 |
| Deferred income tax provision | (205,772) | 3,058 |
| Decrease in interest receivable | 117,420 | 68,438 |
| Increase in interest payable | 88,587 | 57,016 |
| Disbursements for loans held for sale | (5,076,584) | (7,093,646) |
| Proceeds from loans held for sale | 4,313,967 | 7,085,997 |
| Decrease (increase) in other assets | (2,961,810) | 116,937 |
| Increase (decrease) in other liabilities | 88,515 | (91,821) |
| | <u>(3,206,637)</u> | <u>618,988</u> |
| Net cash provided by operating activities | | |
| Cash flows from investing activities: | | |
| Net increase in loans made to customers | (11,783,481) | (7,367,492) |
| Maturities of securities available-for-sale | 1,379,505 | 1,273,460 |
| Purchase of Federal Home Loan Bank stock | (65,000) | (120,200) |
| Purchases of premises and equipment | (122,359) | (1,253,014) |
| | <u>(10,591,335)</u> | <u>(7,467,246)</u> |
| Net cash used by investing activities | | |
| Cash flows from financing activities: | | |
| Net increase in demand deposits, interest-bearing transaction accounts and savings accounts | 2,992,970 | 2,399,277 |
| Net increase (decrease) in certificates of deposit and other time deposits | 10,073,242 | (686,153) |
| Net increase (decrease) in securities sold under agreements to repurchase | (118,810) | 1,443,852 |
| Advances from the Federal Home Loan Bank | 1,300,000 | |
| Federal funds purchased | (1,043,000) | |
| Proceeds from the exercise of stock options | | (36,652) |
| Proceeds from issuance of stock | 265,886 | |
| | <u>13,470,288</u> | <u>3,120,324</u> |
| Net cash provided by financing activities | | |
| Net increase (decrease) in cash and cash equivalents | <u>(327,684)</u> | <u>(3,727,934)</u> |
| Cash and cash equivalents, beginning | <u>4,793,102</u> | <u>6,645,927</u> |

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| | | |
|---|---------------------|---------------------|
| Cash and cash equivalents, end | \$ 4,465,418 | \$ 2,917,993 |
| Cash paid during the period for: | | |
| Income taxes | \$ 90,136 | \$ |
| Interest | \$ 686,256 | \$ 497,976 |

See notes to condensed consolidated financial statements

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Table of Contents**FIRST RELIANCE BANCSHARES, INC.****Notes to Condensed Consolidated Financial Statements****Note 1 - Basis of Presentation**

The accompanying financial statements have been prepared in accordance with the requirements for interim financial statements and, accordingly, they are condensed and omit certain disclosures, which would appear in audited annual financial statements. The financial statements as of March 31, 2004 and for the interim periods ended March 31, 2004 and 2003 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, 2003 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 2003 audited financial statements in Form 10-KSB.

Note 2 - Recently Issued Accounting Pronouncements

No recent authoritative pronouncements that affect accounting, reporting, and disclosure of financial information by us have occurred during the quarter ending March 31, 2004.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies that do not require adoption until a future date are not expected to have a material impact on the consolidated financial statements upon adoption.

Note 3 - Stock-Based Compensation

The Company has a stock-based employee compensation plan which is accounted for under the recognition and measurement principles of Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. No stock-based employee compensation cost is reflected in net income, as all stock options granted under these plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share as if we had applied the fair value recognition provisions of Financial Accounting Standards Board (FASB) SFAS No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

| | Three Months Ended March 31, | |
|-------------------------|-------------------------------------|----------------------|
| | 2004 | 2003 |
| Net income, as reported | \$ 321,174 48,263 | \$ 305,736 13,690 |

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Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects

| | | |
|-----------------------|-------------------|-------------------|
| Pro forma net income | <u>\$ 272,911</u> | <u>\$ 292,046</u> |
| Earnings per share: | | |
| Basic - as reported | <u>\$ 0.13</u> | <u>\$ 0.21</u> |
| Basic - pro forma | <u>\$ 0.10</u> | <u>\$ 0.20</u> |
| Diluted - as reported | <u>\$ 0.13</u> | <u>\$ 0.20</u> |
| Diluted - pro forma | <u>\$ 0.10</u> | <u>\$ 0.19</u> |

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Notes to Condensed Consolidated Financial Statements

Note 4 - Earnings Per Share

A reconciliation of the numerators and denominators used to calculate basic and diluted earnings per share for the three month periods ended March 31, 2004 and 2003 are as follows:

| | <u>Three Months Ended March 31, 2004</u> | | |
|--|--|---------------------------------------|-----------------------------------|
| | <u>Income</u> <u>(Numerator)</u> | <u>Shares</u> <u>(Denominator)</u> | <u>Per Share</u> <u>Amount</u> |
| Basic earnings per share | | | |
| Income available to common shareholders | \$ 321,174 | 2,470,646 | \$ 0.13 |
| Effect of dilutive securities | | | |
| Stock options | | 33,370 | |
| Diluted earnings per share | | | |
| Income available to common shareholders plus assumed conversions | \$ 321,174 | 2,504,016 | \$ 0.13 |
| | | | |
| | <u>Three Months Ended March 31, 2003</u> | | |
| | <u>Income</u> <u>(Numerator)</u> | <u>Shares</u> <u>(Denominator)</u> | <u>Per Share</u> <u>Amount</u> |
| Basic earnings per share | | | |
| Income available to common shareholders | \$ 305,736 | 1,458,830 | \$ 0.21 |
| Effect of dilutive securities | | | |
| Stock options | | 67,533 | |
| Diluted earnings per share | | | |
| Income available to common shareholders plus assumed conversions | \$ 305,736 | 1,526,363 | \$ 0.20 |

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FIRST RELIANCE BANCSHARES, INC.

Notes to Condensed Consolidated Financial Statements

Note 5 - Comprehensive Income

Comprehensive income includes net income and other comprehensive income, which is defined as nonowner related transactions in equity. The following table sets forth the amounts of other comprehensive income included in equity along with the related tax effect.

| | <u>Pre-tax Amount</u> | <u>Income Tax Expense</u> | <u>Net-of-tax Amount</u> |
|---|---------------------------|-------------------------------|------------------------------|
| For the Three Months Ended March 31, 2004: | | | |
| Unrealized gains (losses) on available-for-sale securities: | | | |
| Unrealized holding gains (losses) arising during the period | \$ 276,255 | \$ (93,926) | \$ 182,329 |
| Plus: reclassification adjustment for (gains) losses realized in net income | | | |
| | <u>276,255</u> | <u>(93,926)</u> | <u>182,329</u> |
| Net unrealized gains (losses) on securities | 276,255 | (93,926) | 182,329 |
| Other comprehensive income (loss) | <u>\$ 276,255</u> | <u>\$ (93,926)</u> | <u>\$ 182,329</u> |
| | <u>Pre-tax Amount</u> | <u>Income Tax Benefit</u> | <u>Net-of-tax Amount</u> |
| For the Three Months Ended March 31, 2003: | | | |
| Unrealized gains (losses) on available-for-sale securities: | | | |
| Unrealized holding gains (losses) arising during the period | \$ (229,292) | \$ 77,959 | \$ (151,333) |
| Plus: reclassification adjustment for (gains) losses realized in net income | | | |
| | <u>(229,292)</u> | <u>77,959</u> | <u>(151,333)</u> |
| Net unrealized gains (losses) on securities | (229,292) | 77,959 | (151,333) |
| Other comprehensive income (loss) | <u>\$ (229,292)</u> | <u>\$ 77,959</u> | <u>\$ (151,333)</u> |

Accumulated other comprehensive income (loss) consists solely of the unrealized gain (loss) on securities available-for-sale, net of the deferred tax effects.

Note 6 - Advances from the Federal Home Loan Bank

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Advances from the Federal Home Loan Bank of Atlanta were \$20,400,000 as of March 31, 2004. Of this amount, the following have scheduled maturities greater than one year:

| <u>Maturing on</u> | <u>Interest Rate</u> | <u>Principal</u> |
|--------------------|----------------------|----------------------|
| 04/08/05 | 2.040% | \$ 1,000,000 |
| 07/01/05 | 4.120 | 500,000 |
| 04/10/06 | 2.600 | 1,000,000 |
| 10/12/06 | 0.640 | 3,500,000 |
| 12/19/06 | 2.870 | 1,500,000 |
| 04/09/07 | 3.130 | 1,000,000 |
| 12/19/07 | 3.440 | 1,500,000 |
| 04/08/08 | 3.400 | 1,000,000 |
| 03/19/09 | 2.480 | 3,000,000 |
| 01/17/12 | 3.825 | 1,000,000 |
| 07/05/12 | 4.080 | 1,000,000 |
| | | <u>\$ 16,000,000</u> |

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FIRST RELIANCE BANCSHARES, INC.

Item 2. Management's Discussion and Analysis or Plan of Operation

The following discussion of financial condition as of March 31, 2004 compared to December 31, 2003, and the results of operations for the three months ended March 31, 2004 compared to the three months ended March 31, 2003 should be read in conjunction with the condensed financial statements and accompanying footnotes appearing in this report.

Advisory Note Regarding Forward-Looking Statements

The statements contained in this report on Form 10-QSB 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 us 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;

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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.

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FIRST RELIANCE BANCSHARES, INC.

Critical Accounting Policies

We have adopted various accounting policies which govern the application of accounting principles generally accepted in the United States in the preparation of our financial statements. Our significant accounting policies are described in the notes to the consolidated financial statements at December 31, 2003 as filed on our annual report on Form 10-KSB. Certain accounting policies involve significant judgments and assumptions by us which have a material impact on the carrying value of certain assets and liabilities. We consider these accounting policies to be critical accounting policies. The judgments and assumptions we use are based on the historical experience and other factors, which we believe to be reasonable under the circumstances. Because of the nature of the judgments and assumptions we make, actual results could differ from these judgments and estimates which could have a major impact on our carrying values of assets and liabilities and our results of operations.

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

Regulatory Matters

We are not aware of any current recommendations by regulatory authorities which, if they were to be implemented, would have a material effect on liquidity, capital resources or operations.

Results of Operations

Net Interest Income

For the three months ended March 31, 2004, net interest income was \$1,874,709, which is an increase of \$578,881, or 44.67%, over the same period in 2003. Interest income from loans, including fees, increased \$755,364, or 47.17%, from the three months ended March 31, 2003 to the comparable period in 2004 and is primarily due to an increase in our loan portfolio. Interest expense for the three months ended March 31, 2004 was \$774,843 compared to \$554,992 compared for the same period in 2003. The increase is primarily attributable to an increase in interest-bearing deposits. The net interest margin realized on earning assets was 4.13% for the three months ended March 31, 2004, as compared to 4.79% for the three months ended March 31, 2003. The interest rate spread was 3.71% for the three months ended March 31, 2004 as compared to 4.37% for the three months ended March 31, 2003. This decrease is primarily attributable to competitive market conditions in our area.

Provision and Allowance for Loan Losses

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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 March 31, 2004, the provision for loan losses was \$109,928. For the three months ended March 31, 2003, the provision for loan losses was \$65,000. Based on present information, we believe the allowance for loan losses was adequate at March 31, 2004 to meet presently known and inherent risks in the loan portfolio. The allowance for loan losses was 1.31% and 1.18% of total loans at March 31, 2003 and 2004, respectively. 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.

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FIRST RELIANCE BANCSHARES, INC.

Noninterest Income

Noninterest income during the three months ended March 31, 2004 was \$490,942, a decrease of \$5,625, or 1.13%, from the comparable period in 2003. The decrease is primarily a result of a decrease in residential mortgage origination fees from \$204,878 for the three months ended March 31, 2003 to \$99,005 for the three months ended March 31, 2004. Record low interest rates in early 2003 led to a significant number of home mortgage refinancings. Refinancings leveled off during the fourth quarter of 2003 and remained that way during the first quarter of 2004. Service charges on deposit accounts increased \$31,868, or 14.72%, to \$248,387 for the three months ended March 31, 2004, as compared to the same period in 2003. This was the result of increased deposits between the two periods.

Noninterest Expense

Total noninterest expense for the three months ended March 31, 2004 was \$1,795,302, or 38.36%, higher than the three months ended March 31, 2003. The primary reason was the \$327,936 increase in salaries and employee benefits over the two periods as we continued to hire employees as we expand into the Lexington, South Carolina market. In addition, furniture and equipment expense increased \$91,941, or 178.36%, for the three months ending March 31, 2004 as compared to the three months ending March 31, 2003. This increase is also primarily a result of additional expenses associated with the growth of the Bank through its expansion into the Lexington market.

Income Taxes

The income tax provision for the three months ended March 31, 2004 and for the three months ended March 31, 2003 was \$136,246 and \$124,107, respectively. The provision was based on an effective tax rate of 29% and 30% for the three months ended March 31, 2004 and for the three months ended March 31, 2003, respectively.

Net Income

The combination of the above factors resulted in net income, after income taxes provisions, for the three months ended March 31, 2004 and for the three months ended March 31, 2003 of \$321,175 and \$305,736, respectively. Net income before taxes for the two periods was \$460,421 and \$429,843, respectively. The net income results for both periods is primarily due to significant increases in loan volume and decreases in rates paid on deposit accounts during each respective period.

Assets and Liabilities

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During the first three months of 2004, total assets increased \$14,244,819, or 7.90%, when compared to December 31, 2003. The primary source of growth in assets was the increase in loans receivable. Net loans increased by \$11,746,780, or 8.53%, during the first three months of 2004, from \$137,636,782 at December 31, 2003 to \$149,383,562 at March 31, 2004. Total deposits increased \$13,066,212, or 9.37%, over total deposits at December 31, 2003 to \$152,481,163 at March 31, 2004. The largest increase in deposits was in interest-bearing transaction accounts, which increased \$11,840,669, or 9.84%, to \$132,171,100 at March 31, 2004. The primary reasons for increases in our net loans and deposits are provided below.

Investment Securities

Investment securities classified as available for sale totaled \$26,558,428 at March 31, 2004. This total represents a decrease of \$1,130,564, or 4.08%, since December 31, 2003. We also purchased an additional \$65,000 of Federal Home Loan Bank stock during the quarter that brought the balance of nonmarketable equity securities to \$1,120,000 at March 31, 2004.

Table of Contents**FIRST RELIANCE BANCSHARES, INC.****Loans**

Net loans increased \$11,746,780, or 8.53%, during the three months ended March 31, 2004. The primary reason for the significant growth is a result of our ability to compete favorably with other financial institutions in the area. Balances within the major loans receivable categories as of March 31, 2004 and December 31, 2003 are as follows:

| | March 31, | December 31, |
|-------------------------------|-----------------------|-----------------------|
| | 2004 | 2003 |
| | <u> </u> | <u> </u> |
| Mortgage loans on real estate | | |
| Residential 1-4 family | \$ 33,313,227 | \$ 31,343,019 |
| Commercial | 34,521,402 | 32,826,091 |
| Construction | 22,317,040 | 18,343,137 |
| Second mortgages | 5,391,928 | 5,124,025 |
| Equity lines of credit | 6,316,678 | 5,799,778 |
| | <u> </u> | <u> </u> |
| Total mortgage loans | 101,860,275 | 93,436,050 |
| | <u> </u> | <u> </u> |
| Commercial and industrial | 30,662,888 | 27,893,370 |
| Consumer | 13,793,227 | 13,199,988 |
| Other, net | 4,848,976 | 4,859,656 |
| | <u> </u> | <u> </u> |
| Total gross loans | \$ 151,165,366 | \$ 139,389,064 |
| | <u> </u> | <u> </u> |

Risk Elements in the Loan Portfolio

The following is a summary of risk elements in the loan portfolio:

| | March 31, | December 31, |
|--|-------------------|---------------------|
| | 2004 | 2003 |
| | <u> </u> | <u> </u> |
| Loans | | |
| Nonaccrual loans | \$ 554,867 | \$ 357,438 |
| Accruing loans more than 90 days past due | 295,744 | 214,000 |
| Loans identified by the internal review mechanism: | | |
| Criticized | 2,428,440 | 1,142,976 |
| Classified | 1,472,945 | 898,457 |

Activity in the Allowance for Loan Losses is as follows:

| | March 31, | |
|--|-------------------|-------------------|
| | 2004 | 2003 |
| | <u> </u> | <u> </u> |
| Balance, January 1, | \$ 1,752,282 | \$ 1,137,337 |
| Provision for loan losses for the period | 109,928 | 65,000 |
| Net loans (charged-off) recovered for the period | (80,406) | (35,389) |

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| | | |
|--|-----------------------|----------------------|
| Balance, end of period | <u>\$ 1,781,804</u> | <u>\$ 1,166,948</u> |
| Gross loans outstanding, end of period | <u>\$ 151,165,366</u> | <u>\$ 88,880,309</u> |
| Allowance for loan losses to loans outstanding | 1.18% | 1.31% |

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Table of Contents**FIRST RELIANCE BANCSHARES, INC.****Deposits**

Total deposits increased \$13,066,212, or 9.37%, from December 31, 2003. Time deposits \$100,000 and over comprised the largest category of deposits, totaling \$64,272,328 at March 31, 2004. Expressed in percentages, noninterest-bearing deposits increased 6.42% and all other interest-bearing deposits increased 9.84%.

Balances within the major deposit categories as of March 31, 2004 and December 31, 2003 are as follows:

| | March 31, | December 31, |
|--|-----------------------|-----------------------|
| | 2004 | 2003 |
| Noninterest-bearing transaction accounts | \$ 20,310,063 | \$ 19,084,520 |
| Interest-bearing demand deposits | 16,150,105 | 15,866,254 |
| Savings deposits | 19,700,954 | 18,217,378 |
| Time deposits \$100,000 and over | 64,272,328 | 54,364,004 |
| Other time deposits | 32,047,713 | 31,882,795 |
| Total deposits | \$ 152,481,163 | \$ 139,414,951 |

Included in total time deposits at March 31, 2004 and December 31, 2003 were brokered time deposits of \$27,717,000 and \$22,772,000, respectively.

Advances from Federal Home Loan Bank

Advances from the Federal Home Loan Bank of Atlanta totaled \$20,400,000 as of March 31, 2004. Of this amount, the following have scheduled maturities greater than one year:

| Maturing on | Interest Rate | Principal |
|--------------------|----------------------|------------------|
| 04/08/05 | 2.040% | \$ 1,000,000 |
| 07/01/05 | 4.120 | 500,000 |
| 04/10/06 | 2.600 | 1,000,000 |
| 10/12/06 | 0.640 | 3,500,000 |
| 12/19/06 | 2.870 | 1,500,000 |
| 04/09/07 | 3.130 | 1,000,000 |

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| | | |
|----------|-------|----------------------|
| 12/19/07 | 3.440 | 1,500,000 |
| 04/08/08 | 3.400 | 1,000,000 |
| 03/19/09 | 2.480 | 3,000,000 |
| 01/17/12 | 3.825 | 1,000,000 |
| 07/05/12 | 4.080 | 1,000,000 |
| | | \$ 16,000,000 |

Liquidity

Liquidity needs are met through scheduled maturities of loans and investments on the asset side and through pricing policies on the liability side for interest-bearing deposit accounts and advances from the Federal Home Loan Bank. The level of liquidity is measured by the loan-to-total funds ratio, which was at 86.32% at March 31, 2004 and 86.64% at December 31, 2003.

Securities available-for-sale, which totaled \$26,558,428 at March 31, 2004, serve as a ready source of liquidity. We also have lines of credit available with correspondent banks to purchase federal funds for periods from one to fourteen days. At March 31, 2004, unused lines of credit totaled \$23,597,229. Based on qualifying collateral reports filed on a quarterly basis with the Federal Home Loan Bank, we also have a line of credit to borrow funds from the Federal Home Loan Bank up to \$29,526,000 as of March 31, 2004. As of March 31, 2004, we had borrowed \$20,400,000 on this line.

Table of Contents**FIRST RELIANCE BANCSHARES, INC.****Capital Resources**

Total shareholders' equity increased \$769,389 from December 31, 2003 to \$18,472,028 at March 31, 2004. The main reason for this increase was net income generated by the Bank's operations, which totaled \$321,175 for the three months ended March 31, 2004. In addition, we issued 27,900 shares of stock through our Employee Stock Ownership Plan which resulted in proceeds of \$265,886. Also, the change in accumulated other comprehensive income resulted in a positive impact on equity of \$182,329.

We are subject to various regulatory capital requirements administered by the federal banking agencies. Quantitative measures established by regulation to ensure capital adequacy require us 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%. Our Tier 1 capital consists of common stockholders' equity, excluding the unrealized gain or loss on securities available-for-sale, minus certain intangible assets. Our 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 and 8% for total risk-based capital.

We are also required to maintain capital at a minimum level based on adjusted 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 summarizes the Bank's risk-based capital at March 31, 2004:

| | |
|--|-----------------------|
| Shareholders' equity | \$ 18,472,028 |
| Less: unrealized gain on available-for-sale securities | 428,629 |
| | <hr/> |
| Tier 1 capital | 18,043,399 |
| Plus: allowance for loan losses ⁽¹⁾ | 1,781,804 |
| | <hr/> |
| Total capital | \$ 19,825,203 |
| | <hr/> |
| Risk-weighted assets | \$ 152,613,000 |
| | <hr/> |
| Average total assets | \$ 185,791,000 |
| | <hr/> |
| Risk-based capital ratios | |
| Tier 1 capital (to risk-weighted assets) | 11.80% |
| Total capital (to risk-weighted assets) | 12.97% |
| Leverage or Tier 1 capital (to total average assets) | 9.71% |

⁽¹⁾ Limited to 1.25% of gross risk-weighted assets

Table of Contents**FIRST RELIANCE BANCSHARES, INC.****Off-Balance Sheet Risk**

Through its operations, the Bank has made contractual commitments to extend credit in the ordinary course of its business activities. These commitments are legally binding agreements to lend money to the Bank's customers at predetermined interest rates for a specified period of time. At March 31, 2004 the Bank had issued commitments to extend credit of \$20,271,350 and standby letters of credit of \$202,660 through various types of commercial lending arrangements. Approximately \$16,461,451 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 March 31, 2004.

| | <u>Within One Month</u> | <u>After One Through Three Months</u> | <u>After Three Through Twelve Months</u> | <u>Within One Year</u> | <u>Greater Than One Year</u> | <u>Total</u> |
|-------------------------------------|---------------------------------|---|--|--------------------------------|--------------------------------------|------------------|
| <i>(Dollars in thousands)</i> | | | | | | |
| Unused commitments to extend credit | \$ 2,727 | \$ 1,222 | \$ 9,238 | \$ 13,187 | \$ 7,084 | \$ 20,271 |
| Standby letters of credit | | 58 | 145 | 203 | | 203 |
| Totals | \$ 2,727 | \$ 1,280 | \$ 9,383 | \$ 13,390 | \$ 7,084 | \$ 20,474 |

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

Item 3. Controls and Procedures

As of the end of the period covered by this report, our management, including our Chief Executive Officer and Chief Financial Officer, reviewed and evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiary) that is required to be included in our periodic filings with the Securities and Exchange Commission. There have been no significant changes in our internal controls or, to management's knowledge, in other factors that could significantly affect those internal controls subsequent to the date we carried out our evaluation, and there has been no corrective actions with respect to significant deficiencies or material weaknesses.

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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 2. Changes in Securities

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

The information required for limitations upon payment of dividends is incorporated herein by reference to the Company's annual report on Form 10-KSB, filed with the Securities and Exchange Commission for the year ended December 31, 2003.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Submission of Matters to a Vote of Securities

None.

Item 5. Other Information

None.

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(a) Exhibits

| <u>Exhibit Number</u> | <u>Exhibit</u> |
|------------------------------|--|
| 2.1 | Plan of Reorganization and Exchange between First Reliance Bancshares, Inc. and First Reliance Bank (incorporated by reference to the Registrant's current report on Form 8-K dated April 1, 2002). |
| 3.1 | Articles of Incorporation (incorporated by reference to the Registrant's current report on Form 8-K dated April 1, 2002). |
| 3.2 | Bylaws (incorporated by reference to the Registrant's current report on Form 8-K dated April 1, 2002). |
| 4.1 | See Articles of Incorporation at Exhibit 3.1 hereto and Bylaws at Exhibit 3.2 hereto. |
| 10.1(a) | Executive Employment Agreement dated August 21, 2001 - F. R. Saunders, Jr. (incorporated by reference to Exhibit 10.4 to the Registrant's quarterly report on Form 10-QSB for the quarter ended March 31, 2002). |
| 10.1(b) | Amendment 1 to Executive Employment Agreement dated June 1, 2002 - F. R. Saunders, Jr. (incorporated by reference to Exhibit 10.5(b) to the Registrant's quarterly report On Form 10-QSB for the quarter ended June 30, 2002). |
| 10.2(a) | Executive Employment Agreement dated August 21, 2001 - A. Dale Porter (incorporated by reference to Exhibit 10.5 to the Registrant's quarterly report on Form 10-QSB for the quarter ended March 31, 2002). |
| 10.2(b) | Amendment 1 to Executive Employment Agreement dated June 1, 2002 - A. Dale Porter (incorporated by reference to Exhibit 10.6(b) to the Registrant's quarterly report On Form 10-QSB for the quarter ended June 30, 2002). |
| 10.3(a) | Executive Employment Agreement dated August 21, 2001 - Paul C. Saunders (incorporated by reference to Exhibit 10.6 to the Registrant's quarterly report on Form 10-QSB for the quarter ended March 31, 2002). |
| 10.3(b) | Amendment 1 to Executive Employment Agreement dated June 1, 2002 - Paul C. Saunders (incorporated by reference to Exhibit 10.7(b) to the Registrant's quarterly report On Form 10-QSB for the quarter ended June 30, 2002). |
| 10.4(a) | 1999 First Reliance Bank Employee Stock Option Plan (incorporated by reference to Exhibit 10.1 to the Registrant's quarterly report on Form 10-QSB for the quarter ended March 31, 2002). |
| 10.4(b) | Amendment No. 1 to 1999 First Reliance Bank Employee Stock Option Plan (incorporated by reference to Exhibit 10.2 to the Registrant's quarterly report on Form 10-QSB for the quarter ended March 31, 2002). |
| 10.4(c) | Amendment No. 2 to 1999 First Reliance Bank Employee Stock Option Plan (incorporated by reference to Exhibit 10.3 to the Registrant's quarterly report on Form 10-QSB for the quarter ended June 30, 2002). |
| 10.5 | Employment Agreement dated September 27, 2002 - Jeffrey A. Paolucci (incorporated by reference to Exhibit 10.5 to the Registrant's quarterly report on Form 10-KSB for the year ended December 31, 2002). |
| 31.1 | Certification pursuant to Rule 13a-15 under the Securities Exchange Act of 1934, as amended. |
| 31.2 | Certification pursuant to Rule 13a-15 under the Securities Exchange Act of 1934, as amended. |
| 32.1 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

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FIRST RELIANCE BANCSHARES, INC.

Item 6. Exhibits and Reports on Form 8-K - *continued*

(b) Reports on Form 8-K. The following reports were filed on Form 8-K during the quarter ended March 31, 2004.

The Company filed a report on Form 8-K on January 10, 2004 to announce earnings for the year ended December 31, 2003.

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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: May 13, 2004

By: /s/ JEFFERY A. PAOLUCCI

Jeffery A. Paolucci
Senior Vice President and Chief Financial Officer

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