

FIRST RELIANCE BANCSHARES INC  
Form 10-Q  
August 11, 2011

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C.

(Mark One)

FORM 10-Q

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

For the Quarterly Period Ended June 30, 2011

OR

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

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

Commission File Number 000-49757

FIRST RELIANCE BANCSHARES, INC.  
(Exact name of small business issuer as specified in its charter)

South Carolina  
(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)

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

4,094,459 shares of common stock, par value \$0.01 per share, as of July 31, 2011

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.

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

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

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

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FIRST RELIANCE BANCSHARES, INC  
Condensed Consolidated Balance Sheets

|   | June 30,<br>2011<br>(Unaudited) | December 31,<br>2010<br>(Audited) |
|---|---------------------------------|-----------------------------------|
| <b>Assets</b>                                 |                                 |                                   |
| Cash and cash equivalents:                    |                                 |                                   |
| Cash and due from banks                       | \$2,292,964                     | \$ 1,806,512                      |
| Interest-bearing deposits with other banks    | 10,902,395                      | 23,863,781                        |
| Total cash and cash equivalents               | 13,195,359                      | 25,670,293                        |
| Time deposits in other banks                  | 100,000                         | 100,000                           |
| Securities available-for-sale                 | 101,164,899                     | 84,472,553                        |
| Nonmarketable equity securities               | 3,463,800                       | 4,357,300                         |
| Total investment securities                   | 104,628,699                     | 88,829,853                        |
| Loans held for sale                           | 735,115                         | 1,185,576                         |
| Loans receivable                              | 328,772,357                     | 354,327,969                       |
| Less allowance for loan losses                | (4,695,843 )                    | (6,271,045 )                      |
| Loans, net                                    | 324,076,514                     | 348,056,924                       |
| Premises, furniture and equipment, net        | 25,572,421                      | 25,922,343                        |
| Accrued interest receivable                   | 2,087,574                       | 2,417,134                         |
| Other real estate owned                       | 19,673,504                      | 14,669,051                        |
| Cash surrender value life insurance           | 12,028,595                      | 11,827,957                        |
| Other assets                                  | 10,090,092                      | 11,415,794                        |
| Total assets                                  | \$512,187,873                   | \$ 530,094,925                    |
| <b>Liabilities and Shareholders' Equity</b>   |                                 |                                   |
| <b>Liabilities</b>                            |                                 |                                   |
| <b>Deposits</b>                               |                                 |                                   |
| Noninterest-bearing transaction accounts      | \$48,749,077                    | \$41,166,965                      |
| Interest-bearing transaction accounts         | 36,100,230                      | 41,761,498                        |
| Savings                                       | 124,369,830                     | 108,890,398                       |
| Time deposits \$100,000 and over              | 120,252,386                     | 157,480,480                       |
| Other time deposits                           | 99,499,788                      | 105,951,124                       |
| Total deposits                                | 428,971,311                     | 455,250,465                       |
| Securities sold under agreement to repurchase | 260,252                         | 476,522                           |
| Advances from Federal Home Loan Bank          | 20,000,000                      | 13,000,000                        |
| Junior subordinated debentures                | 10,310,000                      | 10,310,000                        |
| Accrued interest payable                      | 274,409                         | 547,222                           |
| Other liabilities                             | 2,310,699                       | 1,918,872                         |
| Total liabilities                             | 462,126,671                     | 481,503,081                       |

## Shareholders' Equity

Preferred stock, no par value, authorized 10,000,000 shares:

|  |                |                |
|--|----------------|----------------|
| Series A cumulative perpetual preferred stock - 15,349 shares issued and outstanding   | \$ 14,827,194  | \$ 14,730,721  |
| Series B cumulative perpetual preferred stock - 767 shares issued and outstanding  | 811,270        | 819,455        |
| Series C cumulative mandatory convertible preferred stock - 2,293 shares issued and outstanding  | 2,293,000      | 2,293,000      |
| Common stock, \$0.01 par value; 20,000,000 shares authorized, 4,094,459 and 4,115,903 shares issued and outstanding at June 30, 2011 and December 31, 2010, respectively | 40,944         | 41,159         |
| Capital surplus  | 28,022,921     | 28,140,094     |
| Treasury stock, at cost, 13,245 and 12,632 shares at June 30, 2011 and December 31, 2010, respectively   | (172,672 )     | (168,864 )     |
| Nonvested restricted stock   | (477,919 )     | (679,264 )     |
| Retained earnings  | 3,951,876      | 4,002,469      |
| Accumulated other comprehensive income (loss)  | 764,588        | (586,926 )     |
| Total shareholders' equity   | 50,061,202     | 48,591,844     |
| Total liabilities and shareholders' equity   | \$ 512,187,873 | \$ 530,094,925 |

See notes to condensed consolidated financial statements

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

|  | Three Months Ended<br>June 30, |                     | Six Months Ended<br>June 30, |                     |
|--|--------------------------------|---------------------|------------------------------|---------------------|
|  | 2011                           | 2010                | 2011                         | 2010                |
| <b>Interest income:</b>  |                                |                     |                              |                     |
| Loans, including fees  | \$5,019,414                    | \$5,853,126         | \$10,089,688                 | \$12,066,213        |
| <b>Investment securities:</b>  |                                |                     |                              |                     |
| Taxable  | 367,080                        | 583,191             | 672,240                      | 1,193,184           |
| Nontaxable   | 483,120                        | 653,973             | 1,017,577                    | 1,306,871           |
| Other interest income  | 30,545                         | 26,599              | 54,608                       | 55,472              |
| <b>Total</b>   | <b>5,900,159</b>               | <b>7,116,889</b>    | <b>11,834,113</b>            | <b>14,621,740</b>   |
| <b>Interest expense:</b>   |                                |                     |                              |                     |
| Time Deposits over \$100,000   | 941,913                        | 1,508,020           | 1,997,746                    | 3,028,183           |
| Other deposits   | 678,998                        | 1,245,227           | 1,399,229                    | 2,598,035           |
| Other interest expense   | (15,821 )                      | 392,253             | 62,764                       | 781,052             |
| <b>Total</b>   | <b>1,605,090</b>               | <b>3,145,500</b>    | <b>3,459,739</b>             | <b>6,407,270</b>    |
| <b>Net interest income</b>   | <b>4,295,069</b>               | <b>3,971,389</b>    | <b>8,374,374</b>             | <b>8,214,470</b>    |
| Provision for loan losses  | 282,010                        | 1,879,810           | 523,124                      | 2,065,899           |
| <b>Net interest income after provision for loan losses</b>   | <b>4,013,059</b>               | <b>2,091,579</b>    | <b>7,851,250</b>             | <b>6,148,571</b>    |
| <b>Noninterest income:</b>   |                                |                     |                              |                     |
| Service charges on deposit accounts  | 447,228                        | 443,470             | 892,790                      | 911,690             |
| Gain on sales of mortgage loans  | 178,603                        | 170,420             | 301,648                      | 380,463             |
| Income from bank owned life insurance  | 100,176                        | 103,689             | 200,638                      | 208,347             |
| Other charges, commissions and fees  | 207,190                        | 171,011             | 399,243                      | 323,995             |
| Gain on sale of securities   | 535,581                        | -                   | 580,856                      | 1,602               |
| Other non-interest income  | 121,086                        | 70,222              | 221,382                      | 175,000             |
| <b>Total</b>   | <b>1,589,864</b>               | <b>958,812</b>      | <b>2,596,557</b>             | <b>2,001,097</b>    |
| <b>Noninterest expenses:</b>   |                                |                     |                              |                     |
| Salaries and employee benefits   | 2,183,814                      | 2,267,609           | 4,559,859                    | 4,663,675           |
| Occupancy expense  | 359,117                        | 378,381             | 736,313                      | 777,915             |
| Furniture and equipment expense  | 312,952                        | 288,131             | 627,622                      | 598,356             |
| Other operating expenses   | 2,451,228                      | 1,253,826           | 4,407,217                    | 2,783,376           |
| <b>Total</b>   | <b>5,307,111</b>               | <b>4,187,947</b>    | <b>10,331,011</b>            | <b>8,823,322</b>    |
| <b>Income (loss) before income taxes</b>   | <b>295,812</b>                 | <b>(1,137,556)</b>  | <b>116,796</b>               | <b>(673,654 )</b>   |
| <b>Income tax benefit</b>  | <b>(125,708 )</b>              | <b>(658,403 )</b>   | <b>(419,394 )</b>            | <b>(724,635 )</b>   |
| <b>Net income (loss)</b>   | <b>421,520</b>                 | <b>(479,153 )</b>   | <b>536,190</b>               | <b>50,981</b>       |
| <b>Preferred stock dividends</b>   | <b>249,247</b>                 | <b>250,227</b>      | <b>498,495</b>               | <b>454,801</b>      |
| Deemed dividends on preferred stock resulting from net accretion of discount and amortization of premium | 44,388                         | 44,388              | 88,288                       | 88,288              |
| <b>Net income (loss) available to common shareholders</b>  | <b>\$127,885</b>               | <b>\$(773,768 )</b> | <b>\$(50,593 )</b>           | <b>\$(492,108 )</b> |
| <b>Average common shares outstanding, basic</b>  | <b>4,104,808</b>               | <b>3,935,610</b>    | <b>4,107,626</b>             | <b>3,760,792</b>    |
| <b>Average common shares outstanding, diluted</b>  | <b>4,457,577</b>               | <b>3,935,610</b>    | <b>4,107,626</b>             | <b>3,760,792</b>    |

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|                                 |        |          |   |          |   |          |   |
|---------------------------------|--------|----------|---|----------|---|----------|---|
| Basic income (loss) per share   | \$0.03 | \$ (0.20 | ) | \$ (0.01 | ) | \$ (0.13 | ) |
| Diluted income (loss) per share | \$0.03 | \$ (0.20 | ) | \$ (0.01 | ) | \$ (0.13 | ) |

See notes to condensed consolidated financial statements

FIRST RELIANCE BANCSHARES, INC  
Condensed Consolidated Statements of Shareholders' Equity and Comprehensive Income  
For the Six Months Ended June 30, 2011 and 2010  
(Unaudited)

|  | Preferred<br>Stock | Common<br>Stock | Capital<br>Surplus | Treasury<br>Stock | Nonvested<br>Restricted<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total         |
|--|--------------------|-----------------|--------------------|-------------------|----------------------------------|----------------------|---|---------------|
| Balance<br>December 31,<br>2009  | \$ 15,372,136      | \$ 35,827       | \$ 26,181,576      | \$(163,936)       | \$(206,004)                      | \$ 5,269,463         | \$(1,265,235)   | \$ 45,223,827 |
| Issuance of<br>Series C  | 2,293,000          |                 |                    |                   |                                  |                      |   | 2,293,000     |
| Issuance of<br>common stock<br>net of issuance<br>cost of<br>\$329,390 |                    | 3,401           | 1,197,861          |                   |                                  |                      |   | 1,201,262     |
| Net income   |                    |                 |                    |                   |                                  | 50,981               |   | 50,981        |
| Other<br>comprehensive<br>gain, net of tax<br>expense of<br>\$953,641  |                    |                 |                    |                   |                                  |                      | 1,869,080   | 1,869,080     |
| Other<br>comprehensive<br>income                                       |                    |                 |                    |                   |                                  |                      |   | 1,920,061     |
| Preferred Stock<br>Dividend  |                    |                 |                    |                   |                                  | (441,422 )           |   | (441,422 )    |
| Accretion of<br>Series A<br>Preferred stock<br>discount                | 96,473             |                 |                    |                   |                                  | (96,473 )            |   | -             |
| Amortization<br>of Series B<br>Preferred stock<br>premium              | (8,185 )           |                 |                    |                   |                                  | 8,185                |   | -             |
|  |                    | 1,872           | 741,701            |                   | (650,856)                        |                      |   | 92,717        |



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|   |              |          |              |             |             |             |              |              |
|---|--------------|----------|--------------|-------------|-------------|-------------|--------------|--------------|
| Net Change in Restricted Stock                            |              |          |              |             |             |             |              |              |
| Purchase of treasury stock                                |              |          |              | (4,330 )    |             |             |              | (4,330 )     |
| Balance, June 30, 2010                                    | \$17,753,424 | \$41,100 | \$28,121,138 | \$(168,266) | \$(856,860) | \$4,790,734 | \$603,845    | \$50,285,115 |
| Balance December 31, 2010                                 | \$17,843,176 | \$41,159 | \$28,140,094 | \$(168,864) | \$(679,264) | \$4,002,469 | \$(586,926 ) | \$48,591,844 |
| Net income  |              |          |              |             |             | 536,190     |              | 536,190      |
| Other comprehensive gain, net of tax expense of \$696,234 |              |          |              |             |             |             | 1,351,514    | 1,351,514    |
| Other comprehensive income                                |              |          |              |             |             |             |              | 1,887,704    |
| Preferred Stock Dividend                                  |              |          |              |             |             | (498,495 )  |              | (498,495 )   |
| Accretion of Series A Preferred stock discount            | 96,473       |          |              |             |             | (96,473 )   |              | -            |
| Amortization of Series B Preferred stock premium          | (8,185 )     |          |              |             |             | 8,185       |              | -            |
| Issuance Common Stock                                     |              | 3        | 999          |             |             |             |              | 1,002        |
| Net Change in Restricted Stock                            |              | (218 )   | (118,172 )   |             | 201,345     |             |              | 82,955       |
| Purchase of treasury stock                                |              |          |              |             |             | (3,808 )    |              | (3,808 )     |
| Balance, June 30, 2011                                    | \$17,931,464 | \$40,944 | \$28,022,921 | \$(172,672) | \$(477,919) | \$3,951,876 | \$764,588    | \$50,061,202 |

See notes to condensed consolidated financial statements

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

|  | Six Months Ended<br>June 30, |              |
|--|------------------------------|--------------|
|  | 2011                         | 2010         |
| <b>Cash flows from operating activities:</b>   |                              |              |
| Net income   | \$536,190                    | \$50,981     |
| <b>Adjustments to reconcile net income to net cash Provided by operating activities:</b> |                              |              |
| Provision for loan losses  | 523,124                      | 2,065,899    |
| Depreciation and amortization expense  | 484,113                      | 492,979      |
| Gain on sale of available-for-sale securities  | (580,856 )                   | (1,602 )     |
| Loss (gain) on sale of other real estate owned   | 88,487                       | (482,681 )   |
| Write down of other real estate owned  | 718,255                      | 187,582      |
| Discount accretion and premium amortization  | 87,999                       | 139,438      |
| Disbursements for loans held-for-sale  | (10,018,022)                 | (15,693,549) |
| Proceeds from loans held-for-sale  | 10,482,500                   | 20,216,509   |
| Net decrease in valuation allowance for loans held-for-sale                              | (14,017 )                    | (1,617 )     |
| Decrease in interest receivable  | 329,560                      | 123,530      |
| Increase in cash surrender value of life insurance                                       | (200,638 )                   | (208,347 )   |
| Decrease in interest payable   | (327,361 )                   | (88,353 )    |
| Amortization of deferred compensation on restricted stock                                | 82,955                       | 92,717       |
| Increase (decrease) in other liabilities   | 391,826                      | (39,151 )    |
| Decrease in other assets   | 629,732                      | 1,832,748    |
| Net cash provided by operating activities  | 3,213,847                    | 8,687,083    |
| <b>Cash flows from investing activities:</b>   |                              |              |
| Increase in time deposits  | -                            | (1,555 )     |
| Net decrease in loans receivable   | 14,085,167                   | 19,165,193   |
| Purchases of securities available-for-sale   | (44,587,976)                 | (2,888,381 ) |
| Proceeds on sales of securities available-for-sale                                       | 27,898,732                   | 3,117,545    |
| Maturities of securities available-for-sale  | 2,537,503                    | 2,183,920    |
| Net decrease of nonmarketable equity securities  | 893,500                      | -            |
| Proceeds from sales of other real estate owned   | 3,560,925                    | 4,430,093    |
| Improvements to other real estate owned  | -                            | (149,116 )   |
| Purchases of premises and equipment  | (79,907 )                    | (162,835 )   |
| Net cash provided by investing activities  | 4,307,944                    | 25,694,864   |
| <b>Cash flows from financing activities:</b>   |                              |              |
| Net increase (decrease) in demand deposits, interest-bearing and savings accounts        | 17,400,276                   | (6,806,790 ) |
| Net decrease in certificates of deposit and other time deposits                          | (43,679,430)                 | (43,034,907) |
| Net decrease in securities sold under agreements to repurchase                           | (216,270 )                   | (52,695 )    |
| Increase (decrease) in advances from the Federal Home Loan Bank                          | 7,000,000                    | (8,000,000 ) |
| Net proceeds from issuance of preferred stock  | -                            | 2,293,000    |
| Net proceeds from issuance of common stock   | -                            | 1,201,262    |
| Issuance of common stock to employees  | 1,002                        | -            |
| Preferred stock dividends paid   | (498,495 )                   | (441,422 )   |
| Purchase of treasury stock   | (3,808 )                     | (4,330 )     |
| Net cash used by financing activities  | (19,996,725)                 | (54,845,882) |

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|  |               |               |
|--|---------------|---------------|
| Net decrease in cash and cash equivalents                | (12,474,934)  | (20,463,935)  |
| Cash and cash equivalents, beginning of period           | 25,670,293    | 53,298,486    |
| Cash and cash equivalents, end of period                 | \$ 13,195,359 | \$ 32,834,551 |
| Cash paid during the period for:                         |               |               |
| Income taxes   | \$-           | \$-           |
| Interest   | \$3,732,552   | \$6,370,837   |
| Supplemental noncash investing and financing activities: |               |               |
| Foreclosures on loans                                    | \$9,372,119   | \$7,300,030   |
| Net change in valuation allowance – available-for-sale   | \$1,351,514   | \$1,869,080   |

See notes to condensed consolidated financial statements

Note to Condensed Consolidated Financial Statements

Note 1 - Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with the requirements for interim financial statements and, accordingly, they are condensed and omit certain disclosures that would appear in audited annual consolidated financial statements. The consolidated financial statements as of June 30, 2011 and for the interim periods ended June 30, 2011 and 2010 are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation. The consolidated financial information as of December 31, 2010 has been derived from the audited consolidated financial statements as of that date. For further information, refer to the consolidated financial statements and the notes included in First Reliance Bancshares, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2010.

Note 2 - 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 July 2010, the Receivables topic of the Accounting Standards Codification ("ASC") was amended by Accounting Standards Update ("ASU") 2010-20 to require expanded disclosures related to a company's allowance for credit losses and the credit quality of its financing receivables. The amendments require the allowance disclosures to be provided on a disaggregated basis. The Company is required to include these disclosures in its interim and annual financial statements, and these disclosures are provided as part of Note 6—Loans Receivable and Allowance for Loan Losses

Disclosures about Troubled Debt Restructurings ("TDRs") required by ASU 2010-20 were deferred by the Financial Accounting Standards Board ("FASB") in ASU 2011-01 issued in January 2011. In April 2011, the FASB issued ASU 2011-02 to assist creditors with their determination of when a restructuring is a TDR. The determination is based on whether the restructuring constitutes a concession and whether the debtor is experiencing financial difficulties as both events must be present.

Disclosures related to TDRs under ASU 2010-20 will be effective for reporting periods beginning after June 15, 2011.

In April 2011, the criteria used to determine effective control of transferred assets in the Transfers and Servicing topic of the ASC was amended by ASU 2011-03. The requirement for the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms and the collateral maintenance implementation guidance related to that criterion were removed from the assessment of effective control. The other criteria to assess effective control were not changed. The amendments are effective for the Company beginning January 1, 2012 but are not expected to have a material effect on the financial statements.

ASU 2011-04 was issued in May 2011 to amend the Fair Value Measurement topic of the ASC by clarifying the application of existing fair value measurement and disclosure requirements and by changing particular principles or requirements for measuring fair value or for disclosing information about fair value measurements. The amendments will be effective for the Company beginning January 1, 2012 but are not expected to have a material effect on the financial statements.

The Comprehensive Income topic of the ASC was amended in June 2011. The amendment eliminates the option to present other comprehensive income as a part of the statement of changes in stockholders' equity. The amendment requires consecutive presentation of the statement of net income and other comprehensive income and requires an entity to present reclassification adjustments from other comprehensive income to net income on the face of the

financial statements. The amendments will be applicable to the Company on January 1, 2012 and will be applied retrospectively.

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

Note 3 - Reclassifications

Certain captions and amounts in the financial statements in the Company's Form 10-Q for the quarter ended June 30, 2010 were reclassified to conform to the June 30, 2011 presentation.

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## Note 4 - Comprehensive Income

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

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

|   | Pre-tax<br>Amount | Tax<br>(Expense)<br>Benefit | Net-of-tax<br>Amount |
|---|-------------------|-----------------------------|----------------------|
| <b>For the Three Months Ended June 30, 2011:</b>    |                   |                             |                      |
| Unrealized gains on securities available-for-sale   | \$2,344,038       | \$(796,973 )                | \$1,547,065          |
| Reclassification adjustment for gains in net income | 535,581           | (182,098 )                  | 353,483              |
|   | \$1,808,457       | \$(614,875 )                | \$1,193,582          |
| <b>For the Three Months Ended June 30, 2010:</b>    |                   |                             |                      |
| Unrealized gains on securities available-for-sale   | \$1,955,376       | \$(658,744 )                | \$1,296,632          |
| Reclassification adjustment for gains in net income | -                 | -                           | -                    |
|   | \$1,955,376       | \$(658,744 )                | \$1,296,632          |
|   | Pre-tax<br>Amount | Tax<br>(Expense)<br>Benefit | Net-of-tax<br>Amount |
| <b>For the Six Months Ended June 30, 2011:</b>      |                   |                             |                      |
| Unrealized gains on securities available-for-sale   | \$2,628,604       | \$(893,726 )                | \$1,734,878          |
| Reclassification adjustment for gains in net income | 580,856           | (197,492 )                  | 383,364              |
|   | \$2,047,748       | \$(696,234 )                | \$1,351,514          |
| <b>For the Six Months Ended June 30, 2010:</b>      |                   |                             |                      |
| Unrealized gains on securities available-for-sale   | \$2,824,323       | \$(954,186 )                | \$1,870,137          |
| Reclassification adjustment for gains in net income | 1,602             | (545 )                      | 1,057                |
|   | \$2,822,721       | \$(953,641 )                | \$1,869,080          |

## Note 5 - Investment Securities

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

|                            | Amortized<br>Cost | Gross Unrealized<br>Gains | Gross Unrealized<br>Losses | Estimated<br>Fair Value |
|----------------------------|-------------------|---------------------------|----------------------------|-------------------------|
| <b>June 30, 2011</b>       |                   |                           |                            |                         |
| U.S. Government agencies   | \$ 2,898,456      | \$ 147,150                | \$ -                       | \$ 3,045,606            |
| Mortgage-backed securities | 64,944,510        | 985,392                   | 33,553                     | 65,896,349              |
| Municipals                 | 31,972,685        | 511,533                   | 274,024                    | 32,210,194              |
| Other                      | 200,000           | -                         | 187,250                    | 12,750                  |
| Total                      | \$ 100,015,651    | \$ 1,644,075              | \$ 494,827                 | \$ 101,164,899          |
| <b>December 31, 2010</b>   |                   |                           |                            |                         |

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|                            |               |            |              |               |
|----------------------------|---------------|------------|--------------|---------------|
| U.S. Government agencies   | \$ 5,031      | \$ 147     | \$ -         | \$ 5,178      |
| Mortgage-backed securities | 35,361,686    | 408,027    | -            | 35,769,713    |
| Municipals                 | 49,804,336    | 186,999    | 1,334,173    | 48,657,162    |
| Other                      | 200,000       | -          | 159,500      | 40,500        |
| Total                      | \$ 85,371,053 | \$ 595,173 | \$ 1,493,673 | \$ 84,472,553 |

The following is a summary of maturities of securities available-for-sale as of June 30, 2011. The amortized cost and estimated fair values are based on the contractual maturity dates. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without penalty.



|   | Securities<br>Available-For-Sale |                         |
|---|----------------------------------|-------------------------|
|   | Amortized<br>Cost                | Estimated<br>Fair Value |
| Due within one year                       | \$ 122,531                       | \$ 128,604              |
| Due after one year but within five years  | 7,103,095                        | 7,157,379               |
| Due after five years but within ten years | 11,100,575                       | 11,085,325              |
| Due after ten years                       | 16,544,940                       | 16,884,492              |
|   | 34,871,141                       | 35,255,800              |
| Mortgage-backed securities                | 64,944,510                       | 65,896,349              |
| Other                                     | 200,000                          | 12,750                  |
| Total                                     | \$ 100,015,651                   | \$ 101,164,899          |

The following table shows gross unrealized losses and fair value, aggregated by investment category, and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2011 and December 31, 2010.

|                                     | June 30, 2011 |                      | December 31, 2010 |                      |
|-------------------------------------|---------------|----------------------|-------------------|----------------------|
|                                     | Fair<br>Value | Unrealized<br>Losses | Fair<br>Value     | Unrealized<br>Losses |
| <b>Less Than 12 Months</b>          |               |                      |                   |                      |
| Mortgage-backed securities          | \$4,975,581   | \$33,553             | \$-               | \$-                  |
| Municipals                          | 5,290,765     | 93,566               | 30,472,741        | 1,047,688            |
|                                     | 10,266,346    | 127,119              | 30,472,741        | 1,047,688            |
| <b>12 Months or More</b>            |               |                      |                   |                      |
| Municipals                          | 2,302,678     | 180,458              | 2,200,477         | 286,485              |
| Other                               | 12,750        | 187,250              | 40,500            | 159,500              |
|                                     | 2,315,428     | 367,708              | 2,240,977         | 445,985              |
| Total securities available-for-sale | \$ 12,581,774 | \$ 494,827           | \$ 32,713,718     | \$ 1,493,673         |

At June 30, 2011, securities classified as available-for-sale were recorded at fair market value. Approximately 74.31% of the unrealized losses, or five individual securities, consisted of securities in a continuous loss position for twelve months or more. The Company does not intend to sell these securities in the near future and it is more likely than not that the Company will not be required to sell these securities before recovery of their amortized cost. The Company believes, based on industry analyst reports and credit ratings, that the deterioration in value is attributable to changes in market interest rates and is not in the credit quality of the issuer and therefore, these losses are not considered other-than-temporary.

During the first six months of 2011 and 2010, proceeds from the sale of available-for-sale securities were \$27,898,732 and \$3,117,545, respectively. Net gains on available-for-sale securities totaled \$580,856 and \$1,602 for the first six months of 2011 and 2010, respectively.

#### Note 6 – Loans Receivable and Allowance for Loan Losses

Major classifications of loans receivable are summarized as follows:

| June 30,<br>2011 | December 31,<br>2010 |
|------------------|----------------------|
|------------------|----------------------|

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|                                |                |                |
|--------------------------------|----------------|----------------|
| Mortgage loans on real estate: |                |                |
| Construction                   | \$ 50,893,002  | \$ 62,635,354  |
| Residential 1-4 family         | 48,429,244     | \$ 50,085,085  |
| Multifamily                    | 4,893,050      | 9,337,285      |
| Second mortgages               | 8,043,146      | 4,782,583      |
| Equity lines of credit         | 26,025,204     | 27,989,649     |
| Commercial                     | 143,689,916    | 152,178,318    |
|                                | 281,973,562    | 307,008,274    |
| Commercial and industrial      | 38,579,950     | 40,856,292     |
| Consumer                       | 7,815,669      | 6,057,089      |
| Other                          | 403,176        | 406,314        |
| Total gross loans              | \$ 328,772,357 | \$ 354,327,969 |

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The Company has pledged certain loans as collateral to secure its borrowings from the Federal Home Loan Bank. The total of loans pledged was \$40,275,700 and \$44,940,440 at June 30, 2011 and December 31, 2010, respectively.

A summary of the allowance for loan losses for the six months ended June 30, 2011 and year ended December 31, 2010 is as follows:

|  | June 30,<br>2011 | December 31,<br>2010 |
|--|------------------|----------------------|
| Beginning balance                          | \$6,271,045      | \$ 9,800,746         |
| Provision charged to operations            | 523,124          | 3,541,650            |
| Recoveries on loans previously charged-off | 418,371          | 3,323,380            |
| Loans charged-off                          | (2,516,697)      | (10,394,731)         |
| Ending balance                             | \$4,695,843      | \$ 6,271,045         |

The following is an analysis of the allowance for loan losses by class of loans for the six months ended June 30, 2011 and the year ended December 31, 2010.

June 30, 2011

| (Dollars in Thousands) | Real Estate Loans |              |             |                     | Total<br>Real<br>Estate<br>Loans | Commercial | Consumer<br>and<br>Other |
|------------------------|-------------------|--------------|-------------|---------------------|----------------------------------|------------|--------------------------|
|                        | Total             | Construction | Residential | Non-<br>Residential |                                  |            |                          |
| Beginning balance      | \$ 6,271          | \$ 2,548     | \$ 1,730    | \$ 947              | \$ 5,225                         | \$ 998     | \$ 48                    |
| Provisions             | 523               | (982 )       | 1,212       | 75                  | 305                              | 212        | 6                        |
| Recoveries             | 419               | 253          | 58          | 70                  | 381                              | 38         | -                        |
| Charge-offs            | (2,517 )          | (1,035 )     | (977 )      | (75 )               | (2,087 )                         | (415 )     | (15 )                    |
| Ending balance         | \$ 4,696          | \$ 784       | \$ 2,023    | \$ 1,017            | \$ 3,824                         | \$ 833     | \$ 39                    |

December 31, 2010

| (Dollars in Thousands) | Real Estate Loans |              |             |                     | Total<br>Real<br>Estate<br>Loans | Commercial | Consumer<br>and<br>Other |
|------------------------|-------------------|--------------|-------------|---------------------|----------------------------------|------------|--------------------------|
|                        | Total             | Construction | Residential | Non-<br>Residential |                                  |            |                          |
| Beginning balance      | \$ 9,801          | \$ 4,192     | \$ 2,773    | \$ 1,271            | \$ 8,236                         | \$ 1,520   | \$ 45                    |
| Provisions             | 3,542             | 1,475        | 1,172       | 432                 | 3,079                            | 509        | (46 )                    |
| Recoveries             | 3,323             | 1,311        | 286         | 1,123               | 2,720                            | 438        | 165                      |
| Charge-offs            | (10,395)          | (4,430 )     | (2,501 )    | (1,879 )            | (8,810 )                         | (1,469 )   | (116 )                   |
| Ending balance         | \$ 6,271          | \$ 2,548     | \$ 1,730    | \$ 947              | \$ 5,225                         | \$ 998     | \$ 48                    |

The following is a summary of loans evaluated for impairment individually and collectively, by class, for the six months ended June 30, 2011 and the year ended December 31, 2010.

June 30, 2011

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

|                           |          |        |          |          |          |        | and<br>Other |
|---------------------------|----------|--------|----------|----------|----------|--------|--------------|
| Allowance                 |          |        |          |          |          |        |              |
| Evaluated for impairment  |          |        |          |          |          |        |              |
| Individually              | \$ 174   | \$ 107 | \$ -     | \$ 67    | \$ 174   | \$ -   | \$ -         |
| Collectively              | 4,522    | 677    | 2,023    | 950      | 3,650    | 833    | 39           |
| Allowance for loan losses | \$ 4,696 | \$ 784 | \$ 2,023 | \$ 1,017 | \$ 3,824 | \$ 833 | \$ 39        |

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| (Dollars in Thousands)   | Real Estate Loans |              |             |                 | Total Real Estate Loans | Commercial | Consumer and Other |
|--------------------------|-------------------|--------------|-------------|-----------------|-------------------------|------------|--------------------|
|                          | Total             | Construction | Residential | Non-Residential |                         |            |                    |
| <b>Total Loans</b>       |                   |              |             |                 |                         |            |                    |
| Evaluated for impairment |                   |              |             |                 |                         |            |                    |
| Individually             | \$ 28,402         | \$ 12,401    | \$ 3,824    | \$ 11,066       | \$ 27,291               | \$ 1,077   | \$ 34              |
| Collectively             | 300,370           | 38,492       | 83,567      | 132,624         | 254,683                 | 37,503     | 8,184              |
| Loans receivable         | \$ 328,772        | \$ 50,893    | \$ 87,391   | \$ 143,690      | \$ 281,974              | \$ 38,580  | \$ 8,218           |

December 31,  
2010

| (Dollars in Thousands)    | Real Estate Loans |              |             |                 | Total Real Estate Loans | Commercial | Consumer and Other |
|---------------------------|-------------------|--------------|-------------|-----------------|-------------------------|------------|--------------------|
|                           | Total             | Construction | Residential | Non-Residential |                         |            |                    |
| <b>Allowance</b>          |                   |              |             |                 |                         |            |                    |
| Evaluated for impairment  |                   |              |             |                 |                         |            |                    |
| Individually              | \$ 560            | \$ 508       | \$ 41       | \$ -            | \$ 549                  | \$ 11      | \$ -               |
| Collectively              | 5,711             | 2,040        | 1,689       | 947             | 4,676                   | 987        | 48                 |
| Allowance for loan losses | \$ 6,271          | \$ 2,548     | \$ 1,730    | \$ 947          | \$ 5,225                | \$ 998     | \$ 48              |

|                          |            |           |           |            |            |           |          |
|--------------------------|------------|-----------|-----------|------------|------------|-----------|----------|
| <b>Total Loans</b>       |            |           |           |            |            |           |          |
| Evaluated for impairment |            |           |           |            |            |           |          |
| Individually             | \$ 19,302  | \$ 15,558 | \$ 1,903  | \$ 1,541   | \$ 19,002  | \$ 300    | \$ -     |
| Collectively             | 335,026    | 47,077    | 90,292    | 150,637    | 288,006    | 40,557    | 6,463    |
| Loans receivable         | \$ 354,328 | \$ 62,635 | \$ 92,195 | \$ 152,178 | \$ 307,008 | \$ 40,857 | \$ 6,463 |

The Company identifies impaired loans through its normal internal loan review process. Loans on the Company's problem loan watch list are considered potentially impaired loans. These loans are evaluated in determining whether all outstanding principal and interest are expected to be collected. Loans are not considered impaired if a minimal delay occurs and all amounts due including accrued interest at the contractual interest rate for the period of delay are expected to be collected.

The following summarizes the Company's impaired loans as of June 30, 2011.

| (Dollars in Thousands)                     | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment |
|--|---------------------|--------------------------|-------------------|-----------------------------|
| <b>With no related allowance recorded:</b> |                     |                          |                   |                             |
| Real estate                                |                     |                          |                   |                             |
| Construction                               | \$11,486            | \$13,488                 | \$-               | \$8,431                     |
| Residential                                | 3,775               | 4,238                    | -                 | 3,027                       |
| Nonresidential                             | 10,637              | 10,637                   | -                 | 5,877                       |
| Total real estate loans                    | 25,898              | 28,363                   | -                 | 17,335                      |

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|                    |        |        |   |        |
|--------------------|--------|--------|---|--------|
| Commercial         | 1,077  | 1,207  | - | 666    |
| Consumer and other | 34     | 34     | - | 21     |
|                    | 27,009 | 29,604 | - | 18,022 |

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| (Dollars in Thousands)             | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment |
|------------------------------------|---------------------|--------------------------|-------------------|-----------------------------|
| <b>With an allowance recorded:</b> |                     |                          |                   |                             |
| Real estate                        |                     |                          |                   |                             |
| Construction                       | \$915               | \$915                    | \$107             | \$6,464                     |
| Residential                        | 49                  | 49                       | -                 | 523                         |
| Nonresidential                     | 429                 | 429                      | 67                | 285                         |
| Total real estate loans            | 1,393               | 1,393                    | 174               | 7,272                       |
| Commercial                         | -                   | -                        | -                 | 125                         |
| Consumer and other                 | -                   | -                        | -                 | -                           |
|                                    | 1,393               | 1,393                    | 174               | 7,397                       |
| <b>Total</b>                       |                     |                          |                   |                             |
| Real estate                        |                     |                          |                   |                             |
| Construction                       | \$12,401            | \$14,403                 | \$107             | \$14,895                    |
| Residential                        | 3,824               | 4,287                    | -                 | 3,550                       |
| Nonresidential                     | 11,066              | 11,066                   | 67                | 6,162                       |
| Total real estate loans            | 27,291              | 29,756                   | 174               | 24,607                      |
| Commercial                         | 1,077               | 1,207                    | -                 | 791                         |
| Consumer and other                 | 34                  | 34                       | -                 | 21                          |
| Total                              | \$28,402            | \$30,997                 | \$174             | \$25,419                    |

The following summarizes the Company's impaired loans as of December 31, 2010.

| (Dollars in Thousands)                     | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment |
|--|---------------------|--------------------------|-------------------|-----------------------------|
| <b>With no related allowance recorded:</b> |                     |                          |                   |                             |
| Real estate                                |                     |                          |                   |                             |
| Construction                               | \$6,937             | \$8,115                  | \$-               | \$7,823                     |
| Residential                                | 613                 | 962                      | -                 | 1,139                       |
| Nonresidential                             | 1,541               | 1,541                    | -                 | 2,723                       |
| Total real estate loans                    | 9,091               | 10,618                   | -                 | 11,685                      |
| Commercial                                 | 80                  | 145                      | -                 | 152                         |
| Consumer and other                         | -                   | -                        | -                 | -                           |
|  | 9,171               | 10,763                   | -                 | 11,837                      |
| <b>With an allowance recorded:</b>         |                     |                          |                   |                             |
| Real estate                                |                     |                          |                   |                             |
| Construction                               | \$8,621             | \$10,416                 | \$507             | \$10,265                    |
| Residential                                | 1,290               | 1,687                    | 42                | 1,666                       |
| Nonresidential                             | -                   | -                        | -                 | -                           |
| Total real estate loans                    | 9,911               | 12,103                   | 549               | 11,931                      |
| Commercial                                 | 220                 | 285                      | 11                | 290                         |
| Consumer and other                         | -                   | -                        | -                 | -                           |
|  | 10,131              | 12,388                   | 560               | 12,221                      |
| <b>Total</b>                               |                     |                          |                   |                             |

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|                         |          |          |       |          |
|-------------------------|----------|----------|-------|----------|
| Real estate             |          |          |       |          |
| Construction            | \$15,558 | \$18,531 | \$507 | \$18,088 |
| Residential             | 1,903    | 2,649    | 42    | 2,805    |
| Nonresidential          | 1,541    | 1,541    | -     | 2,723    |
| Total real estate loans | 19,002   | 22,721   | 549   | 23,616   |
| Commercial              | 300      | 430      | 11    | 442      |
| Consumer and other      | -        | -        | -     | -        |
| Total                   | \$19,302 | \$23,151 | \$560 | \$24,058 |

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Interest income on impaired loans other than nonaccrual loans is recognized on an accrual basis. Interest income on nonaccrual loans is recognized only as collected. For the six months ended June 30, 2011, interest income recognized on nonaccrual loans was \$127,573. If the nonaccrual loans had been accruing interest at their original contracted rates, related income would have been \$605,280 for the six months ended June 30, 2011.

A summary of current, past due and nonaccrual loans as of June 30, 2011 was as follows:

| (Dollars in Thousands)  | Past Due<br>30-89<br>Days | Past Due Over 90 days<br>and<br>Accruing | Non-<br>Accruing | Total<br>Past Due | Current   | Total<br>Loans |
|-------------------------|---------------------------|--|------------------|-------------------|-----------|----------------|
| Real estate             |                           |  |                  |                   |           |                |
| Construction            | \$826                     | \$1,830                                  | \$9,528          | \$12,184          | \$38,709  | \$50,893       |
| Residential             | 1,583                     | 38                                       | 3,445            | 5,066             | 82,325    | 87,391         |
| Nonresidential          | 2,266                     | 2,741                                    | 6,496            | 11,503            | 132,187   | 143,690        |
| Total real estate loans | 4,675                     | 4,609                                    | 19,469           | 28,753            | 253,221   | 281,974        |
| Commercial              | 1,351                     | 5  | 739              | 2,095             | 36,485    | 38,580         |
| Consumer and other      | 10                        | 1  | 9                | 20                | 8,198     | 8,218          |
| Totals                  | \$6,036                   | \$4,615                                  | \$20,217         | \$30,868          | \$297,904 | \$328,772      |

A summary of current, past due and nonaccrual loans as of December 31, 2010 was as follows:

| (Dollars in Thousands)  | Past Due<br>30-89<br>Days | Past Due Over 90 days<br>Accruing | Non-<br>Accruing | Total<br>Past Due | Current   | Total<br>Loans |
|-------------------------|---------------------------|-----------------------------------|------------------|-------------------|-----------|----------------|
| Real estate             |                           |                                   |                  |                   |           |                |
| Construction            | \$1,896                   | \$1,546                           | \$14,796         | \$18,238          | \$44,397  | \$62,635       |
| Residential             | 1,102                     | -                                 | 3,310            | 4,412             | 87,783    | 92,195         |
| Nonresidential          | 5,993                     | 335                               | 1,001            | 7,329             | 144,849   | 152,178        |
| Total real estate loans | 8,991                     | 1,881                             | 19,107           | 29,979            | 277,029   | 307,008        |
| Commercial              | 776                       | 29                                | 753              | 1,558             | 39,299    | 40,857         |
| Consumer and other      | 49                        | -                                 | 6                | 55                | 6,408     | 6,463          |
| Totals                  | \$9,816                   | \$1,910                           | \$19,866         | \$31,592          | \$322,736 | \$354,328      |

At June 30, 2011 and December 31, 2010 loans past due 90 days and still accruing interest totaled \$4,614,678 and \$1,910,413, respectively.

Loans totaling \$20,217,438 and \$19,866,061 were in nonaccrual status at June 30, 2011 and December 31, 2010, respectively.

Restructured loans (loans, still accruing interest, which have been renegotiated at below-market interest rates or for which other concessions have been granted) were \$2,827,504 and \$2,183,635 at June 30, 2011 and December 31, 2010, respectively. At June 30, 2011, all restructured loans were performing as agreed.

#### Credit Indicators

Loans are categorized into risk categories based on relevant information about the ability of borrowers to service their debt, such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The following definitions are utilized for risk ratings, which are consistent with the definitions used in supervisory guidance:

Special Mention - Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

Substandard - Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful - Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

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Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans.

As of June 30, 2011, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

| (Dollars in Thousands) | Real Estate Loans |              |             |                 | Total Real Estate Loans | Commercial | Consumer and Other |
|------------------------|-------------------|--------------|-------------|-----------------|-------------------------|------------|--------------------|
|                        | Total             | Construction | Residential | Non-Residential |                         |            |                    |
| Pass                   | \$249,533         | \$27,849     | \$73,244    | \$106,157       | \$207,250               | \$34,224   | \$8,059            |
| Special mention        | 39,169            | 10,017       | 6,573       | 20,898          | 37,488                  | 1,603      | 78                 |
| Substandard            | 40,070            | 13,027       | 7,574       | 16,635          | 37,236                  | 2,753      | 81                 |
| Doubtful               | -                 | -            | -           | -               | -                       | -          | -                  |
| Totals                 | \$328,772         | \$50,893     | \$87,391    | \$143,690       | \$281,974               | \$38,580   | \$8,218            |

As of December 31, 2010, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

| (Dollars in Thousands) | Real Estate Loans |              |             |                 | Total Real Estate Loans | Commercial | Consumer and Other |
|------------------------|-------------------|--------------|-------------|-----------------|-------------------------|------------|--------------------|
|                        | Total             | Construction | Residential | Non-Residential |                         |            |                    |
| Pass                   | \$270,154         | \$31,067     | \$76,299    | \$120,429       | \$227,795               | \$36,233   | \$6,126            |
| Special mention        | 43,386            | 12,743       | 7,481       | 20,822          | 41,046                  | 2,149      | 191                |
| Substandard            | 40,788            | 18,825       | 8,415       | 10,927          | 38,167                  | 2,475      | 146                |
| Doubtful               | -                 | -            | -           | -               | -                       | -          | -                  |
| Totals                 | \$354,328         | \$62,635     | \$92,195    | \$152,178       | \$307,008               | \$40,857   | \$6,463            |

The Company enters into financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments consist of commitments to extend credit and standby letters of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. A commitment involves, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The Company's exposure to credit loss in the event of nonperformance by the other parties to the instrument is represented by the contractual notional amount of the instrument. Since certain commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company uses the same credit policies in making commitments to extend credit as it does for on-balance-sheet instruments. Letters of credit are conditional commitments issued to guarantee a customer's performance to a third party and have essentially the same credit risk as other lending facilities.

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

The following table summarizes the Company's off-balance sheet financial instruments as of June 30, 2011 and December 31, 2010 whose contract amounts represent credit risk:

June 30,      December 31,

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|                              | 2011         | 2010          |
|------------------------------|--------------|---------------|
| Commitments to extend credit | \$31,550,897 | \$ 32,932,922 |
| Standby letters of credit    | 2,165,497    | 2,102,497     |

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## Note 7 – Other Real Estate Owned

Transactions in other real estate owned for the six months ended June 30, 2011 and year ended December 31, 2010 are summarized below:

|                                 | June 30,<br>2011 | December 31,<br>2010 |
|---------------------------------|------------------|----------------------|
| Beginning balance               | \$ 14,669,051    | \$ 8,954,214         |
| Additions                       | 9,372,119        | 12,010,459           |
| Improvements made to properties | -                | 180,475              |
| Sales                           | (3,649,411 )     | (6,273,435 )         |
| Write downs                     | (718,255 )       | (202,662 )           |
| Ending balance                  | \$ 19,673,504    | \$ 14,669,051        |

The Company recognized a net loss of \$88,487 and a net gain of \$482,681 on the sale of other real estate owned for the six months ended June 30, 2011 and 2010, respectively.

Other real estate owned expense for the six months ended June 30, 2011 and 2010 was \$1,532,618 and \$394,663, respectively, which includes gains and losses on sales.

## Note 8 – Shareholders' Equity

Common Stock – The following is a summary of the changes in common shares outstanding for the six months ended June 30, 2011 and 2010.

|  | Six Months Ended<br>June 30, |           |
|--|------------------------------|-----------|
|  | 2011                         | 2010      |
| Common shares outstanding at beginning of the period | 4,115,903                    | 3,582,691 |
| Issuance of common stock                             | 334                          | 340,145   |
| Issuance of non-vested restricted shares             | 20,000                       | 187,765   |
| Forfeiture of restricted shares                      | (41,778 )                    | (633 )    |
| Common shares outstanding at end of the period       | 4,094,459                    | 4,109,968 |

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

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

The following is a summary of the net income (loss) per common share calculations for the three months and six months ended June 30, 2011 and 2010.

|  | Three Months Ended<br>June 30, |              | Six Months Ended<br>June 30, |          |
|--|--------------------------------|--------------|------------------------------|----------|
|  | 2011                           | 2010         | 2011                         | 2010     |
| Net income (loss) available to common shareholders |                                |              |                              |          |
| Net income (loss)                                  | \$421,520                      | \$(479,153 ) | \$536,190                    | \$50,981 |
| Preferred stock dividends                          | 249,247                        | 250,227      | 498,495                      | 454,801  |

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|  |           |              |             |              |
|--|-----------|--------------|-------------|--------------|
| Deemed dividends on preferred stock resulting from net accretion of discount and amortization of premium | 44,388    | 44,388       | 88,288      | 88,288       |
| Net income (loss) available to common shareholders   | \$127,885 | \$(773,768 ) | \$(50,593 ) | \$(492,108 ) |
| Basic net income (loss) per common share:  |           |              |             |              |
| Net income (loss) available to common shareholders   | \$127,885 | \$(773,768 ) | \$(50,593 ) | \$(492,108 ) |
| Average common shares outstanding - basic  | 4,104,808 | 3,935,610    | 4,107,626   | 3,760,792    |
| Basic net income (loss) per share  | \$0.03    | \$(0.20 )    | \$(0.01 )   | \$(0.13 )    |

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|  | Three Months Ended<br>June 30, |              | Six Months Ended<br>June 30, |              |
|--|--------------------------------|--------------|------------------------------|--------------|
|  | 2011                           | 2010         | 2011                         | 2010         |
| <b>Diluted net income (loss) per common share:</b> |                                |              |                              |              |
| Net income (loss) available to common shareholders | \$127,885                      | \$(773,768 ) | \$(50,593 )                  | \$(492,108 ) |
| Average common shares outstanding - basic          | 4,104,808                      | 3,935,610    | 4,107,626                    | 3,760,792    |
| Dilutive potential common shares                   | 352,769                        | -            | -                            | -            |
| Average common shares outstanding - diluted        | 4,457,577                      | 3,935,610    | 4,107,626                    | 3,760,792    |
| Diluted income (loss) per share                    | \$0.03                         | \$(0.20 )    | \$(0.01 )                    | \$(0.13 )    |

#### Note 10 - Equity Incentive Plan

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

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

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

During the six months ended June 30, 2011 and 2010 the Company issued 20,000 and 187,765 shares, respectively, of restricted stock pursuant to the 2006 Equity Incentive Plan. The shares issued in 2011 and 2010 cliff vest in three years and are fully vested in 2013 and 2012, respectively, subject to meeting the performance criteria of the Plan. The weighted-average fair value of restricted stock issued during the six months ended June 30, 2011 and 2010 was \$2.20 and \$4.00 per share, respectively. Compensation cost associated with the issuance for 2011 and 2010 was \$44,000 and \$751,091, respectively, to be amortized over three years. During the first six months of 2011 and 2010, 41,778 and 633 shares were forfeited having a weighted average price of \$3.39 and \$11.88, respectively. Deferred compensation expense of \$82,955 and \$92,717, relating to restricted stock, was amortized to income during the six months ended June 30, 2011 and 2010, respectively.

The 2006 Equity Incentive Plan allows for the issuance of Stock Appreciation Rights ("SARs"). The SARs entitle the participant to receive the excess of (1) the market value of a specified or determinable number of shares of the stock at the exercise date over the fair value at grant date or (2) a specified or determinable price which may not in any event be less than the fair market value of the stock at the time of the award. Upon exercise, the Company can elect to settle the awards using either Company stock or cash. The shares start vesting after five years and vest at 20% per year until fully vested. Compensation cost for SARs is amortized to compensation expense over the vesting period.

The SARs compensation expense for the six months ended June 30, 2011 and 2010 was \$26,895 and \$36,917, respectively.



A summary of the status of the Company's SARs as of June 30, 2011 and 2010 and changes during the period then ended is presented below.

|                                  | June 30, |                                 |                                  |          |
|----------------------------------|----------|---------------------------------|----------------------------------|----------|
|                                  | 2011     | 2011                            | 2010                             | 2010     |
|                                  | Shares   | Weighted-Average Exercise Price | Weighted-Average Exercise Shares | Price    |
| Outstanding at beginning of year | 84,334   | \$ 14.95                        | 89,293                           | \$ 14.95 |
| Forfeited                        | -        | -                               | (794 )                           | 15.00    |
| Outstanding at end of period     | 84,334   | \$ 14.95                        | 88,499                           | \$ 14.95 |

#### Note 11 – Fair Value Measurements

The following methods and assumptions were used to estimate the fair value of significant financial instruments:

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

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

Securities Available-for-Sale - The fair values of securities available-for-sale equal the carrying amounts, which are the quoted market prices. If quoted market prices are not available, fair values are based on quoted market prices of comparable securities.

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

Loans Held-for-Sale - The carrying amount of loans held for sale is a reasonable estimate of fair value.

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

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

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

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

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

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

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

The carrying values and estimated fair values of the Company's financial instruments at June 30, 2011 and December 31, 2010 were as follows:

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|  | June 30, 2011   |                      | December 31, 2010 |                      |
|--|-----------------|----------------------|-------------------|----------------------|
|  | Carrying Amount | Estimated Fair Value | Carrying Amount   | Estimated Fair Value |
| <b>Financial Assets:</b>   |                 |                      |                   |                      |
| Cash and due from banks  | \$2,292,964     | \$ 2,292,964         | \$ 1,806,512      | \$ 1,806,512         |
| Interest-bearing deposits with other banks                         | 10,902,395      | 10,902,395           | 23,863,781        | 23,863,781           |
| Time deposits in other banks                                       | 100,000         | 100,000              | 100,000           | 100,000              |
| Securities available-for-sale                                      | 101,164,899     | 101,164,899          | 84,472,553        | 84,472,553           |
| Nonmarketable equity securities                                    | 3,463,800       | 3,463,800            | 4,357,300         | 4,357,300            |
| Loans, including loans held for sale                               | 329,507,472     | 332,902,000          | 355,513,545       | 356,465,000          |
| Accrued interest receivable  | 2,087,574       | 2,087,574            | 2,417,134         | 2,417,134            |
| <b>Financial Liabilities:</b>                                      |                 |                      |                   |                      |
| Demand deposit, interest-bearing transaction, and savings accounts | \$209,219,137   | \$ 209,219,137       | \$ 191,818,861    | \$ 191,818,861       |
| Certificates of deposit  | 219,752,174     | 225,573,000          | 263,431,604       | 266,448,000          |
| Securities sold under agreements to repurchase                     | 260,252         | 260,252              | 476,522           | 476,522              |
| Advances from Federal Home Loan Bank                               | 20,000,000      | 20,075,385           | 13,000,000        | 13,049,000           |
| Junior subordinated debentures                                     | 10,310,000      | 10,310,000           | 10,310,000        | 10,310,000           |
| Accrued interest payable   | 274,409         | 274,409              | 547,222           | 547,222              |
|  | Notional Amount |                      | Notional Amount   |                      |
| <b>Off-Balance Sheet Financial Instruments:</b>                    |                 |                      |                   |                      |
| Commitments to extend credit                                       | \$31,550,897    |                      | \$32,932,922      |                      |
| Standby letters of credit  | 2,165,497       |                      | 2,102,497         |                      |

Generally accepted accounting principles (GAAP) provide a framework for measuring and disclosing fair value that requires disclosures about the fair value of assets and liabilities recognized in the balance sheet, whether the measurements are made on a recurring basis (for example, available-for-sale investment securities) or on a nonrecurring basis (for example, impaired loans).

Fair value is defined as the exchange in price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. GAAP also establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The Company utilizes fair value measurements to record fair value adjustments to certain assets and to determine fair value disclosures. Securities available-for-sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as loans held for sale, loans held for investment and certain other assets. These nonrecurring fair value adjustments typically involve application of the lower of cost or market accounting or the writing down of individual assets.

#### Fair Value Hierarchy

The Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine the fair value. These levels are:

Level 1 -Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2 -Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 -Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include the use of option pricing models, discounted cash flow models and similar techniques.

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

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

Loans - The Company does not record loans at fair value on a recurring basis, however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan are considered impaired. Once a loan is identified as individually impaired, management measures the impairment. The fair value of impaired loans is estimated using one of several valuation methods, including the collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring a specific allowance represent loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. At June 30, 2011 and December 31, 2010, substantially all of the impaired loans were evaluated based upon the fair value of the collateral. Impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the loan as nonrecurring Level 3.

Other Real Estate Owned - Foreclosed assets are adjusted to fair value upon transfer of the loans to other real estate owned. Real estate acquired in settlement of loans is recorded initially at estimated fair value of the property less estimated selling costs at the date of foreclosure. The initial recorded value may be subsequently reduced by additional allowances, which are charges to earnings if the estimated fair value of the property less estimated selling costs declines below the initial recorded value. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the foreclosed asset as nonrecurring Level 3.

The tables below present the balances of assets and liabilities measured at fair value on a recurring basis by level within the hierarchy at June 30, 2011 and December 31, 2010.

|                                  | Total         | Level 1 | Level 2       | Level 3 |
|----------------------------------|---------------|---------|---------------|---------|
| <b>June 30, 2011</b>             |               |         |               |         |
| Available for-sale-securities:   |               |         |               |         |
| U.S. Government agencies         | \$3,045,606   | \$-     | \$3,045,606   | \$-     |
| Mortgage-backed securities       | 65,896,349    | -       | 65,896,349    | -       |
| Municipals                       | 32,210,194    | -       | 32,210,194    | -       |
| Other                            | 12,750        | -       | 12,750        | -       |
|                                  | 101,164,899   | -       | 101,164,899   | -       |
| Mortgage loans held for sale (1) | 735,115       | -       | 735,115       | -       |
|                                  | \$101,900,014 | \$-     | \$101,900,014 | \$-     |
| <b>December 31, 2010</b>         |               |         |               |         |

Available for-sale-securities:

|                                  |              |     |              |     |
|----------------------------------|--------------|-----|--------------|-----|
| U.S. Government agencies         | \$5,178      | \$- | \$5,178      | \$- |
| Mortgage-backed securities       | 35,769,713   | -   | 35,769,713   | -   |
| Municipals                       | 48,657,162   | -   | 48,657,162   | -   |
| Other                            | 40,500       | -   | 40,500       | -   |
|                                  | 84,472,553   | -   | 84,472,553   | -   |
| Mortgage loans held for sale (1) | 1,185,576    | -   | 1,185,576    | -   |
|                                  | \$85,658,129 | \$- | \$85,658,129 | \$- |

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

There were no liabilities measured at fair value on a recurring basis at June 30, 2011 and December 31, 2010.

Certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The following table presents the assets and liabilities measured at fair value on a nonrecurring basis at June 30, 2011 and December 31, 2010, aggregated by level in the fair value hierarchy within which those measurements fall.

|                            | Total        | Level 1 | Level 2      | Level 3 |
|----------------------------|--------------|---------|--------------|---------|
| <b>June 30, 2011</b>       |              |         |              |         |
| Impaired loans receivable  | \$28,228,471 | \$-     | \$28,228,471 | \$-     |
| Other real estate owned    | 19,673,504   | -       | 19,673,504   | -       |
| Total assets at fair value | \$47,901,975 | \$-     | \$47,901,975 | \$-     |
| <b>December 31, 2010</b>   |              |         |              |         |
| Impaired loans receivable  | \$18,742,006 | \$-     | \$18,742,006 | \$-     |
| Other real estate owned    | 14,669,051   | -       | 14,669,051   | -       |
| Total assets at fair value | \$33,411,057 | \$-     | \$33,411,057 | \$-     |

There were no liabilities measured at fair value on a nonrecurring basis at June 30, 2011 and December 31, 2010.

Impaired loans which are measured for impairment using the fair value of collateral for collateral dependent loans, had a carrying value of \$28,402,226 at June 30, 2011 with a valuation allowance of \$173,755. Impaired loans had a carrying value of \$19,301,570 at December 31, 2010 with a valuation allowance of \$559,564.

Other real estate owned, which is measured at the lower of carrying amount or fair value less costs to sell, had a net carrying value of \$19,673,504 and \$14,669,051 at June 30, 2011 and December 31, 2010, respectively. Write downs of other real estate owned for the six months ended June 30, 2011 and for the year ended December 31, 2010 were \$718,255 and \$202,662, respectively.

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

#### Note 12 - Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Unrecognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through the date the financial statements were issued and no subsequent events have occurred that require accrual or disclosure.

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

### Cautionary Note Regarding Forward-Looking Statements

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

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

- deterioration in the financial condition of borrowers resulting in significant increases in loan losses and provisions for those losses;
- changes in loan underwriting, credit review or loss reserve policies associated with economic conditions, examination conclusions, or regulatory developments;
  - the failure of assumptions underlying the establishment of reserves for possible loan losses;
- changes in political and economic conditions, including the political and economic effects of the current economic downturn and other major developments, including the ongoing war on terrorism and political unrest in the Middle East;
- changes in financial market conditions, either internationally, nationally or locally in areas in which the Company conducts its operations, including, without limitation, reduced rates of business formation and growth, commercial and residential real estate development, and real estate prices;
- the Company's ability to comply with any requirements imposed on it or the Bank by their respective regulators, and the potential negative consequences that may result;
- fluctuations in markets for equity, fixed-income, commercial paper and other securities, which could affect availability, market liquidity levels, and pricing;
  - governmental monetary and fiscal policies, as well as legislative and regulatory changes;
- the Company's participation or lack of participation in governmental programs implemented under the Emergency Economic Stabilization Act (the "EESA") and the American Recovery and Reinvestment Act (the "ARRA"), including, without limitation, the CPP administered under the Troubled Asset Relief Program, and the Temporary Liquidity



Guarantee Program (the “TLGP”) and the impact of such programs and related regulations on the Company and on international, national, and local economic and financial markets and conditions;

- the Company’s lack of participation in a “stress test” under the Federal Reserve’s Supervisory Capital Assessment Program; the diagnostic and stress testing we conducted differs from that administered under the Supervisory Capital Assessment Program, and the results of our test may be inaccurate; and
- the impact of the EESA and the ARRA and related rules and regulations on the business operations and competitiveness of the Company and other participating American financial institutions, including the impact of the executive compensation limits of these acts, which may impact the ability of the Company to retain and recruit executives and other personnel necessary for their businesses and competitiveness.

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

## Overview

The following discussion describes our results of operation for the quarter and six months ended June 30, 2011 as compared to the quarter and six months ended June 30, 2010 and also analyzes our financial condition as of June 30, 2011 as compared to December 31, 2010.

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

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 our non-interest expense.

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

## Critical Accounting Policies

We have adopted various accounting policies, which govern the application of accounting principles generally accepted in the United States in the preparation of our financial statements. Our significant accounting policies are described in the notes to the consolidated financial statements at December 31, 2010 as filed on our annual report on Form 10-K. 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

Following an examination of the Bank by the Federal Deposit Insurance Corporation (the "FDIC") during the first quarter of 2010, the Bank's Board of Directors agreed to enter into a Memorandum of Understanding (the "Bank MOU")

with the FDIC and South Carolina Commissioner of Banks (“SC State Board”) that became effective August 19, 2010. Among other things, the Bank MOU provides for the Bank to (i) review and formulate objectives relative to liquidity and growth, including a reduction in reliance on volatile liabilities, (ii) formulate plans for the reduction and improvement in adversely classified assets, (iii) maintain a Tier 1 leverage capital ratio of 8% and continue to be “well capitalized” for regulatory purposes, (iv) continue to maintain an adequate allowance for loan and lease losses, (v) not pay any dividend to the Bank’s parent holding company without the approval of the regulators, (vi) review officer performance and consider additional staffing needs, and (vii) provide progress reports and submit various other information to the regulators.

In addition, on the basis of the same examination by the FDIC and the SC State Board, the Federal Reserve Bank of Richmond (the “Federal Reserve Bank”) requested that the Company enter into a separate Memorandum of Understanding, which the Company entered into in December 2010 (the “Company MOU”). While this agreement provides for many of the same measures suggested by the Memorandum already in place for the Bank, the Company MOU requires that the Company seek pre-approval from the Federal Reserve Bank prior to the declaration or payment of dividends or other interest payments relating to its securities. As a result, until the Company is no longer subject to the Company MOU, it will be required to seek regulatory approval prior to paying scheduled dividends on its preferred stock and trust preferred securities, including the Series A Preferred Stock and Series B Preferred Stock issued to the Treasury as part of our participation in the TARP CPP, as well as the Series C Preferred Stock issued as part of a private offering completed in 2010. This provision will also apply to the Company’s common stock, although, to date, the Company has not elected to pay a cash dividend on its shares of common stock. The Federal Reserve Bank approved the scheduled payment of dividends on the Company’s preferred stock and interest payments on the Company’s trust preferred securities for the first and second quarter of 2011. However, no assurance can be given as to the ability of the Company to obtain approval from the Federal Reserve Bank to declare and pay such dividends and interest in future quarters while the Company MOU remains in effect.

In response to these Regulatory Matters, the Bank and the Company have taken various actions over the past year designed to improve our lending procedures, nonperforming assets, liquidity and capital position and other conditions related to our operations, which are more fully described in turn as part of this discussion. We believe that the successful completion of these initiatives will result in full compliance with our regulatory obligations with the FDIC, the SC State Board and the Federal Reserve and position us well for stability and growth over the long term.

#### Effect of Economic Trends

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

#### Results of Operations

For the second quarter of 2011 our net income available to common shareholders was \$127,885 compared to a net loss available to common shareholders of \$773,768 for the second quarter of 2010. This resulted in basic and diluted income per share of \$0.03 for 2011, compared to basic and diluted loss per share of \$0.20 for 2010. The \$901,653 improvement in our 2011 quarterly net income is primarily attributable to the reduction in our provision for loan losses and net gain on the sale of securities. As compared to the second quarter of 2010, our provision for loan losses declined \$1,597,800 in the second quarter of 2011. Also during the second quarter of 2011, we earned a net gain on the sale of securities of \$535,581. However, our earnings for the second quarter of 2011 compared to 2010 were negatively impacted by the \$952,457 increase in our expenses related to our properties acquired through foreclosures.

For the six months ended June 30, 2011 and 2010, we incurred a net loss available to common shareholders of \$50,593 and \$492,108, respectively. This resulted in basic and diluted loss per share of \$0.01 and \$0.13 for 2011 and 2010, respectively. The \$441,515 improvement in our earnings for the six months ended June 30, 2011 compared to the comparable 2010 period is primarily attributable to the reduction in our provision for loan losses and net gain on the sale of securities. As compared to the first six months of 2010, our provision for loan losses declined \$1,542,775 in the first six months of 2011. Also during the first six months of 2011, we earned a net gain on the sale of securities of \$580,856. However, our earnings for the first six months of 2011 compared to 2010 were negatively impacted by the \$1,137,955 increase in our expenses related to our properties acquired through foreclosures.

#### Income Statement Review

##### Net Interest Income

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

Net interest income increased \$323,680 or 8.15%, to \$4,295,069 for the quarter ended June 30, 2011, from \$3,971,389 for the comparable period of 2010. Our net interest income for the six months ended June 30, 2011 and 2010 was \$8,374,374 and \$8,214,470, respectively. This represents an increase of \$159,904 or 1.95%. The improvement in our net interest income for both periods is due primarily to the fact that our average interest earning assets decreased less than our interest-bearing liabilities during both the three and six months ended June 30, 2011, as compared to the comparable 2010 periods. See "Rate/Volume Analysis" below for a more detailed discussion.



For the second quarter of 2011, average-earning assets totaled \$458,992,658 with an annualized average yield of 5.16% compared to \$543,619,700, and 5.25%, respectively, for the second quarter of 2010. Average interest-bearing liabilities totaled \$421,468,754 with an annualized average cost of 1.53% for second quarter of 2011 compared to \$506,075,351 and 2.49%, respectively, for the second quarter of 2010.

Average earning assets for the six months ended June 30, 2011 and 2010 were \$461,107,118 and \$554,734,316, respectively, with an annualized average yield of 5.18% and 5.32% respectively. Average interest-bearing liabilities totaled \$425,955,102 and \$516,850,506 with an annualized average cost of 1.64% and 2.50% for the six months ended June 30, 2011 and 2010, respectively.

Our net interest margin and net interest spread were 3.75% and 3.63%, respectively, for the second quarter of 2011 compared to 2.93% and 2.76%, respectively, for the second quarter of 2010. For the six months ended June 30, 2011, our net interest margin and net interest spread were 3.66% and 3.54%, respectively compared to 2.99% and 2.82%, respectively for the comparable period of 2010.

Because loans often provide a higher yield than other types of earning assets, one of our goals is to maintain our loan portfolio as the largest component of total earning assets. Loans comprised 73.59% and 74.31% of average earning assets for the three and six months ending June 30, 2011, respectively compared to 70.61% and 70.93%, respectively for the comparable period of 2010.

Loan interest income for the three and six months ended June 30, 2011 was \$5,019,414 and \$10,089,688, respectively compared to \$5,853,126 and \$12,066,213, respectively for the comparable periods of 2010. The annualized average yield on loans was 5.96% and 5.94%, respectively, for the three and six months ended June 30, 2011 compared 6.12% and 6.18%, respectively for the comparable 2010 periods. For the three and six months ended June 30, 2011, compared to the three and six months ended June 30, 2010, the average balances of our loans decreased \$46,110,827, or 12.01% and \$50,870,775, or 12.93%, respectively. Our loan interest income for the three and six months ended June 30, 2011, continued to be negatively impacted by the lower loan demand, which has also reduced our loan pricing, and the high volume of our nonperforming loans.

Available-for-sale investment securities averaged \$85,044,770, or 18.53% of average earning assets, for the second quarter of 2011 compared to \$121,769,526, or 22.40% of average earning assets for the second quarter of 2010. Available-for-sale investment securities averaged \$83,926,325 and 18.20% of average earning assets for the six months ended June 30, 2011 compared to \$121,716,010 and 21.94% for the six months ended June 30, 2010. Interest earned on available-for-sale securities amounted to \$850,200 and \$1,689,817 for the three and six months ended June 30, 2011, respectively, compared to \$1,237,164 and \$2,500,055 respectively, for the same periods last year. With the relatively low yield available on our securities portfolio, we chose to instead reduce our securities position proportionally with a reduction in higher cost deposits as part of our effort to reduce interest expense. The annualized average yield on available-for-sale investment securities was 4.01% and 4.08% for the second quarter of 2011 and 2010, respectively. The annualized average yield on available-for-sale investment securities was 4.06% and 4.14% for the six months ended June 30, 2011 and 2010, respectively.

Our average interest-bearing deposits were \$391,255,203 and \$468,900,623 for the second quarter of 2011 and 2010, respectively. This represented a decrease of \$77,645,420, or 16.56%. Our average interest-bearing deposits were \$396,241,599 and \$478,836,381 for the six months ended June 30, 2011 and 2010, respectively. This represented a decrease of \$82,594,782, or 17.25%. Total interest paid on deposits for the three and six months ended June 30, 2011 was \$1,620,911 and \$3,396,975, respectively, compared to \$2,753,247 and \$5,626,218 for the same periods of 2010. The annualized average cost of deposits was 1.66% and 2.36% for the three months ended June 30, 2011 and 2010, respectively. The annualized average cost of deposits was 1.73% and 2.37% for the six months ended June 30, 2011 and 2010, respectively. As our loan demand declined, we concurrently lowered our rates paid for deposits,

especially for time deposits, which is the primary reason why our average time deposits were 28.86% and 28.00% lower during the three and six months ended June 30, 2011 than during the comparable 2010 periods.

The average balance of other interest-bearing liabilities was \$30,213,551 and \$37,174,728 for the three months ending June 30, 2011 and 2010, respectively. This represented a decrease of \$6,961,177 and 18.73%. For the six months ending June 30, 2011 and 2010 the average balance of other interest bearing liabilities was \$29,713,503 and \$38,014,125, respectively. This represented a decrease of \$8,300,622, or 21.84%. The decrease in both periods is mainly attributable to the decrease in our average borrowings from the Federal Home Loan Bank. With the weakness in loan demand we experienced during the past year, we became less reliant on borrowings from the Federal Home Loan Bank to meet our funding needs. We have instead shifted our focus to building locally-sourced core deposits in order to provide a lower-cost source of liquidity.

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

Three Months Ended June 30,

| (Dollars in thousands)                      | Average Balances, Income and Expenses, and Rates |                |            |                 |                |            |                 |                |            |
|---|--|----------------|------------|-----------------|----------------|------------|-----------------|----------------|------------|
|   | 2011   |                |            | 2010            |                |            | 2009            |                |            |
|   | Average Balance                                  | Income/Expense | Yield/Rate | Average Balance | Income/Expense | Yield/Rate | Average Balance | Income/Expense | Yield/Rate |
| <b>Assets</b>                               |  |                |            |                 |                |            |                 |                |            |
| Earning assets:                             |  |                |            |                 |                |            |                 |                |            |
| Loans (1)                                   | \$ 337,755                                       | \$ 5,019       | 5.96 %     | \$ 383,866      | \$ 5,853       | 6.12 %     | \$ 479,368      | \$ 6,870       | 5.75 %     |
| Securities, taxable                         | 40,157   | 367            | 3.67       | 60,929          | 583            | 3.84       | 41,464          | 472            | 4.56       |
| Securities, nontaxable                      | 44,888   | 483            | 4.32       | 60,841          | 654            | 4.31       | 37,326          | 432            | 4.65       |
| Other earning assets                        | 36,193   | 31             | 0.34       | 37,984          | 27             | 0.28       | 62,337          | 28             | 0.18       |
| Total earning assets                        | 458,993  | 5,900          | 5.16       | 543,620         | 7,117          | 5.25       | 620,495         | 7,802          | 5.04       |
| Non-earning assets:                         | 61,643   |                |            | 59,094          |                |            | 40,293          |                |            |
| Total assets                                | \$ 520,636                                       |                |            | \$ 602,714      |                |            | \$ 660,788      |                |            |
| <b>Liabilities and Shareholders' Equity</b> |  |                |            |                 |                |            |                 |                |            |
| Interest-bearing deposits:                  |  |                |            |                 |                |            |                 |                |            |
| Transaction accounts                        | \$ 36,423  | \$ 44          | 0.48       | \$ 37,260       | \$ 45          | 0.48 %     | \$ 37,750       | \$ 54          | 0.57 %     |
| Savings and money market accounts           | 123,829  | 259            | 0.84       | 106,910         | 343            | 1.29       | 97,474          | 481            | 1.98       |
| Time deposits                               | 231,003  | 1,318          | 2.29       | 324,730         | 2,365          | 2.93       | 349,664         | 2,740          | 3.14       |
| Total interest-bearing deposits             | 391,255  | 1,621          | 1.66       | 468,900         | 2,753          | 2.36       | 484,888         | 3,275          | 2.71       |
| Other interest-bearing liabilities:         |  |                |            |                 |                |            |                 |                |            |
| Federal Home Loan Bank bank borrowing       | 19,660   | 69             | 1.41       | 26,077          | 238            | 3.66       | 64,785          | 569            | 3.52       |
| Junior subordinated debentures              | 10,310   | (85 )          | (3.31 )    | 10,310          | 155            | 6.01       | 10,310          | 154            | 6.01       |
| Other                                       | 244  | -              | 0.00       | 788             | -              | 0.00       | 1,260           | -              | 0.00       |
| Total other interest-bearing liabilities    | 30,214   | (16 )          | (0.21 )    | 37,175          | 393            | 4.23       | 76,355          | 723            | 3.79       |
| Total interest-bearing liabilities          | 421,469  | 1,605          | 1.53       | 506,075         | 3,146          | 2.49       | 561,243         | 3,998          | 2.86       |
| Noninterest-bearing deposits                |  |                |            |                 |                |            |                 |                |            |
| Other liabilities                           | 49,374   |                |            | 44,076          |                |            | 44,433          |                |            |
| Shareholders' equity                        | 2,588  |                |            | 5,154           |                |            | 2,580           |                |            |
|   | 47,205   |                |            | 47,409          |                |            | 52,532          |                |            |
|   | \$ 520,636                                       |                |            | \$ 602,714      |                |            | \$ 660,788      |                |            |



Total liabilities and equity

Net interest income/interest spread

|          |        |          |        |          |        |
|----------|--------|----------|--------|----------|--------|
| \$ 4,295 | 3.63 % | \$ 3,971 | 2.76 % | \$ 3,804 | 2.18 % |
|----------|--------|----------|--------|----------|--------|

Net yield on earning assets

|        |        |        |
|--------|--------|--------|
| 3.75 % | 2.93 % | 2.46 % |
|--------|--------|--------|

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

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Six Months Ended June 30,

| (Dollars in thousands)                      | Average Balances, Income and Expenses, and Rates |                |            |                 |                |            |                 |                |            |
|---|--|----------------|------------|-----------------|----------------|------------|-----------------|----------------|------------|
|   | 2011   |                |            | 2010            |                |            | 2009            |                |            |
|   | Average Balance                                  | Income/Expense | Yield/Rate | Average Balance | Income/Expense | Yield/Rate | Average Balance | Income/Expense | Yield/Rate |
| <b>Assets</b>                               |  |                |            |                 |                |            |                 |                |            |
| Earning assets:                             |  |                |            |                 |                |            |                 |                |            |
| Loans (1)                                   | \$ 342,626                                       | \$ 10,090      | 5.94 %     | \$ 393,496      | \$ 12,066      | 6.18 %     | \$ 483,600      | \$ 13,838      | 5.77 %     |
| Securities, taxable                         | 37,504   | 672            | 3.61       | 61,031          | 1,193          | 3.94       | 44,006          | 1,003          | 4.60       |
| Securities, nontaxable                      | 46,422   | 1,017          | 4.42       | 60,685          | 1,307          | 4.34       | 33,219          | 746            | 4.53       |
| Other earning assets                        | 34,555   | 55             | 0.32       | 39,522          | 55             | 0.28       | 43,430          | 38             | 0.17       |
| Total earning assets                        | 461,107  | 11,834         | 5.18       | 554,734         | 14,621         | 5.32       | 604,255         | 15,625         | 5.21       |
| Non earning assets:                         | 62,401   |                |            | 56,346          |                |            | 39,472          |                |            |
| Total assets                                | \$ 523,508                                       |                |            | \$ 611,080      |                |            | \$ 643,727      |                |            |
| <b>Liabilities and Shareholders' Equity</b> |  |                |            |                 |                |            |                 |                |            |
| Interest-bearing deposits:                  |  |                |            |                 |                |            |                 |                |            |
| Transaction accounts                        | \$ 37,381  | \$ 96          | 0.52 %     | \$ 39,295       | \$ 88          | 0.45 %     | \$ 35,929       | \$ 103         | 0.58 %     |
| Savings and money market accounts           | 117,294  | 472            | 0.81       | 104,040         | 680            | 1.32       | 98,329          | 851            | 1.74       |
| Time deposits                               | 241,567  | 2,829          | 2.36       | 335,501         | 4,858          | 2.92       | 324,662         | 5,206          | 3.23       |
| Total interest-bearing deposits             | 396,242  | 3,397          | 1.73       | 478,836         | 5,626          | 2.37       | 458,920         | 6,160          | 2.71       |
| Other interest-bearing liabilities:         |  |                |            |                 |                |            |                 |                |            |
| Federal Home Loan Bank bank borrowing       |  |                |            |                 |                |            |                 |                |            |
|   | 19,094   | 137            | 1.44       | 26,924          | 474            | 3.55       | 73,368          | 1,234          | 3.39       |
| Junior subordinated debentures              | 10,310   | (74 )          | (1.45)     | 10,310          | 307            | 6.01       | 10,310          | 307            | 6.00       |
| Other                                       | 309  | -              | 0.00       | 780             | -              | 0.00       | 6,508           | 36             | 1.12       |
| Total other interest-bearing liabilities    | 29,713   | 63             | 0.43       | 38,014          | 781            | 4.14       | 90,186          | 1,577          | 3.53       |
| Total interest-bearing liabilities          | 425,955  | 3,460          | 1.64       | 516,850         | 6,407          | 2.50       | 549,106         | 7,737          | 2.84       |
| Noninterest-bearing deposits                |  |                |            |                 |                |            |                 |                |            |
|   | 47,254   |                |            | 43,724          |                |            | 45,996          |                |            |
| Other liabilities                           | 2,531  |                |            | 3,983           |                |            | 2,373           |                |            |
| Shareholders' equity                        | 47,768   |                |            | 46,523          |                |            | 46,252          |                |            |
|   | \$ 523,508                                       |                |            | \$ 611,080      |                |            | \$ 643,727      |                |            |

Total liabilities and equity

Net interest income/interest spread

|          |        |          |        |          |        |
|----------|--------|----------|--------|----------|--------|
| \$ 8,374 | 3.54 % | \$ 8,214 | 2.82 % | \$ 7,888 | 2.37 % |
|----------|--------|----------|--------|----------|--------|

Net yield on earning assets

|        |        |        |
|--------|--------|--------|
| 3.66 % | 2.99 % | 2.63 % |
|--------|--------|--------|

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

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

Three Months Ended June 30,

| (Dollars in thousands)                       | 2011 Compared to 2010         |           |           | 2010 Compared to 2009         |        |             |
|--|-------------------------------|-----------|-----------|-------------------------------|--------|-------------|
|  | Due to increase (decrease) in |           |           | Due to increase (decrease) in |        |             |
|  | Volume                        | Rate      | Total     | Volume                        | Rate   | Total       |
| <b>Interest income:</b>                      |                               |           |           |                               |        |             |
| Loan   | \$ (685 )                     | \$ (149 ) | \$ (834 ) | \$ (1,437 )                   | \$ 420 | \$ (1,017 ) |
| Securities, taxable                          | (191 )                        | (25 )     | (216 )    | 194                           | (83 )  | 111         |
| Securities, tax exempt                       | (173 )                        | 2         | (171 )    | 256                           | (34 )  | 222         |
| Other earning assets                         | -                             | 4         | 4         | (13 )                         | 12     | (1 )        |
| Total interest income                        | (1,049 )                      | (168 )    | (1,217 )  | (1,000 )                      | 315    | (685 )      |
| <b>Interest expense:</b>                     |                               |           |           |                               |        |             |
| <b>Interest-bearing deposits</b>             |                               |           |           |                               |        |             |
| <b>Interest-bearing transaction accounts</b> |                               |           |           |                               |        |             |
|  | (1 )                          | -         | (1 )      | (1 )                          | (8 )   | (9 )        |
| <b>Savings and money market accounts</b>     |                               |           |           |                               |        |             |
|  | 48                            | (132 )    | (84 )     | 43                            | (181 ) | (138 )      |
| Time deposits                                | (599 )                        | (448 )    | (1,047 )  | (189 )                        | (186 ) | (375 )      |
| Total interest-bearing deposits              | (552 )                        | (580 )    | (1,132 )  | (147 )                        | (375 ) | (522 )      |
| <b>Other interest-bearing liabilities</b>    |                               |           |           |                               |        |             |
| <b>Federal Home Loan Bank borrowings</b>     |                               |           |           |                               |        |             |
|  | (49 )                         | (120 )    | (169 )    | (353 )                        | 22     | (331 )      |
| Junior subordinated debentures               | -                             | (240 )    | (240 )    | 1                             | -      | 1           |
| Total other interest-bearing liabilities     | (49 )                         | (360 )    | (409 )    | (352 )                        | 22     | (330 )      |
| Total interest expense                       | (601 )                        | (940 )    | (1,541 )  | (499 )                        | (353 ) | (852 )      |
| Net interest income                          | \$ (448 )                     | \$ 772    | \$ 324    | \$ (501 )                     | \$ 668 | \$ 167      |

Six Months Ended June 30,

| (Dollars in thousands)           | 2011 Compared to 2010         |           |             | 2010 Compared to 2009         |        |             |
|----------------------------------|-------------------------------|-----------|-------------|-------------------------------|--------|-------------|
|                                  | Due to increase (decrease) in |           |             | Due to increase (decrease) in |        |             |
|                                  | Volume                        | Rate      | Total       | Volume                        | Rate   | Total       |
| <b>Interest income:</b>          |                               |           |             |                               |        |             |
| Loans                            | \$ (1,519 )                   | \$ (457 ) | \$ (1,976 ) | \$ (2,706 )                   | \$ 934 | \$ (1,772 ) |
| Securities, taxable              | (428 )                        | (93 )     | (521 )      | 349                           | (159 ) | 190         |
| Securities, tax exempt           | (314 )                        | 24        | (290 )      | 592                           | (31 )  | 561         |
| Other earning assets             | (7 )                          | 7         | -           | (3 )                          | 20     | 17          |
| Total interest income            | (2,268 )                      | (519 )    | (2,787 )    | (1,768 )                      | 764    | (1,004 )    |
| <b>Interest expense:</b>         |                               |           |             |                               |        |             |
| <b>Interest-bearing deposits</b> |                               |           |             |                               |        |             |
|                                  | (4 )                          | 12        | 8           | 9                             | (24 )  | (15 )       |

Interest-bearing transaction  
accounts

|                                      |          |          |          |     |        |        |
|--------------------------------------|----------|----------|----------|-----|--------|--------|
| Savings and money market<br>accounts | 79       | (287 )   | (208 )   | 46  | (217 ) | (171 ) |
| Time deposits                        | (1,204 ) | (825 )   | (2,029 ) | 168 | (516 ) | (348 ) |
| Total interest-bearing deposits      | (1,129 ) | (1,100 ) | (2,229 ) | 223 | (757 ) | (534 ) |

## Other interest-bearing liabilities

|   |             |          |          |             |          |          |
|---|-------------|----------|----------|-------------|----------|----------|
| Federal Home Loan Bank<br>borrowings        | (111 )      | (226 )   | (337 )   | (816 )      | 56       | (760 )   |
| Junior subordinated debentures              | -           | (381 )   | (381 )   | -           | -        | -        |
| Other                                       | -           | -        | -        | (17 )       | (19 )    | (36 )    |
| Total other interest-bearing<br>liabilities | (111 )      | (607 )   | (718 )   | (833 )      | 37       | (796 )   |
| Total interest expense                      | (1,240 )    | (1,707 ) | (2,947 ) | (610 )      | (720 )   | (1,330 ) |
| Net interest income                         | \$ (1,028 ) | \$ 1,188 | \$ 160   | \$ (1,158 ) | \$ 1,484 | \$ 326   |

### Provision and Allowance for Loan Losses

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

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

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

More specifically, in determining our allowance for loan losses, we regularly review loans for specific and impaired reserves based on the appropriate impairment assessment methodology. Pooled reserves are determined using historical loss trends measured over a four quarter average applied to risk rated loans grouped by Federal Financial Examination Council ("FFIEC") call code and segmented by impairment status. The pooled reserves are calculated by applying the appropriate historical loss ratio to the loan categories. Impaired loans greater than a minimum threshold established by management are excluded from this analysis. The sum of all such amounts determines our pooled reserves. Earlier this year, the Company undertook a thorough statistical review of our recognized loss history during the 2010 calendar year. This analysis revealed that over 80% of our losses were concentrated in the coastal markets. Management elected to reduce the Bank's portfolio exposure to the coastal markets due to this and other factors. As a result, we determined that it would be appropriate to modify our loss history calculation to segment our losses by geography. We now calculate a loss factor for each geographic region, then weight the overall loss factor by the geographic weight remaining in the overall portfolio. Over time, we expect these changes to our loan loss allowance methodology to have a material impact on our required allowance level as we continue to reduce our exposure to certain markets. We have also shortened the period over which we review historical losses from eight quarters to four in response to industry trends and conditions; the shorter loss history window is more in line with our peer group and tracks more closely the unusual market volatility of the past several years, making the provision estimate more responsive to current economic conditions. This analysis is updated each quarter end for the prior four quarters; the current model assess losses through the first quarter of 2011.

As we mentioned above, we track our portfolio and analyze loans grouped by FFIEC call code categories. The first step in this process is to risk grade each and every loan in the portfolio based on one common set of parameters. These parameters include items like debt-to-worth ratio, liquidity of the borrower, net worth, experience in a particular field

and other factors such as underwriting exceptions. Weight is also given to the relative strength of any guarantors on the loan.

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

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

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

As of June 30, 2011 and 2010, the allowance for loan losses was \$4,695,843 and \$7,048,764, respectively, a decrease of \$2,352,921, or 33.38%, from the 2010 allowance. However, as a percentage of total loans, the allowance for loan losses was 1.43% and 1.88% at June 30, 2011 and 2010, respectively. The decrease in the allowance for loan losses is due primarily to the significant reduction in our actual net loan losses for the four quarters ended June 30, 2011, as compared to the four quarters ended June 30, 2010. Our net loan losses declined due to both lower amounts of loans charged off and to the much higher recovery of loans previously charged off than historically experienced. In computing the allowance for loan losses for June 30, 2011, the historical net loan loss amounts included in the calculation dropped more than 30%. A large portion of this reduction was related to losses calculated for the construction and development loan portfolio; we are finding that this portfolio has not only declined dramatically in terms of absolute exposure but losses in this portfolio appear to have moderated as well. These changes in the risk profile of our loan portfolio have resulted in a reduction in the amount of reserves required as part of the Bank's allowance. We currently expect the majority of future losses to come through other loan categories, depending on regional and national economic developments. See "Activity in the Allowance for Loan Losses" below for additional information regarding our asset quality and loan portfolio.

For the second quarter of 2011 and 2010, the provision for loan losses was \$282,010 and \$1,879,810, respectively, a decrease of \$1,597,800 or 85.00%. The provision for loan losses was \$523,124 and \$2,065,899 for the six months ended June 30, 2011 and 2010, respectively. This represents a decrease of \$1,542,775, or 74.68%. The decrease in the provision for loan losses for both periods is primarily attributable to the stabilization of the credit quality relative to our experience of the last several years. We have found that the rate of deterioration and the rate of disposition have entered into equilibrium in recent months. We are resolving problem assets through charge-off, collateral disposition, and workout / recovery at roughly the same pace that other assets are deteriorating. For example, our classified assets balance measured in the second quarter of 2011 increased only slightly compared to the first quarter of 2011, whereas in 2009, it doubled. Historically, the rate of deterioration was much higher than the rate of disposition, leading to the dramatic historical increase in problem assets. Obviously, we do not expect this trend to continue indefinitely, and believe the outcome will be determined by regional and national economic conditions. Should economic conditions remain relatively stable or begin to improve, we are optimistic the rate of disposition will begin to exceed the rate of deterioration. If economic conditions deteriorate, however, then this will have a negative effect on our loan portfolio and will require additional adjustments to our reserves and provision, and would have a negative impact on our operating results.



The provision expense estimate is the result of a robust statistical model that is based on historical credit losses and geographic segmentation analysis, as well as a thorough individual analysis of large impaired credits. It is, however, subject to a great degree of volatility and is sensitive to current quarter loss experience and real estate collateral values in the marketplace. While we expect our current period loss experience to be lower than that realized historically, there can be no assurance that this will occur. In particular, if regional or national economic conditions do not improve, or decline in the coming months, then the provision expense will stabilize or rise in proportion with the risk profile of our loan portfolio in a future quarter. We are closely monitoring recent economic developments and their impact on the portfolio and, more generally, our market area.

We believe the allowance for loan losses at June 30, 2011, is adequate to meet potential loan losses inherent in the loan portfolio, and, as described earlier, to maintain the flexibility to adjust the allowance should our local economy and loan portfolio either improve or decline in the future.

#### Noninterest Income

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

|   | Three Months Ended<br>June 30, |                  | Six Months Ended<br>June 30, |                    |
|---|--------------------------------|------------------|------------------------------|--------------------|
|   | 2011                           | 2010             | 2011                         | 2010               |
| Service charges on deposit accounts           | \$447,228                      | \$443,470        | \$892,790                    | \$911,690          |
| Gain on sale of mortgage loans                | 178,603                        | 170,420          | 301,648                      | 380,463            |
| Gain on sale of securities available-for-sale | 535,581                        | -                | 580,856                      | 1,602              |
| Other income                                  | 428,452                        | 344,922          | 821,263                      | 707,342            |
| <b>Total noninterest income</b>               | <b>\$1,589,864</b>             | <b>\$958,812</b> | <b>\$2,596,557</b>           | <b>\$2,001,097</b> |

Noninterest income increased \$631,052, or 65.82%, to \$1,589,864 for the second quarter of 2011 from \$958,812 for the second quarter of 2010. Noninterest income increased \$595,460, or 29.76%, to \$2,596,557 for the first half of 2011 from \$2,001,097 for the first half of 2010. Due to the weak demand for mortgage loans and the bottoming out of residential mortgages being refinanced because of low interest rates, our gain on the sale of mortgage loans was \$78,815 or 20.72% lower for the six months ended June 30, 2011 compared to the same period of 2010. The increase in our noninterest income for the three and six months ended June 30, 2011 compared to the comparable 2010 periods, was positively impacted by the gain recognized on sale of securities available-for-sale.

#### Noninterest Expense

For the quarter ended June 30, 2011, noninterest expense totaled \$5,307,111 which is \$1,119,164, or 26.72%, higher than our noninterest expense for the quarter ended June 30, 2010. For the six months ended June 30, 2011 and 2010, noninterest expense totaled \$10,331,011 and \$8,823,322, respectively, equating to an increase of \$1,507,689, or 17.09% for 2011 compared to 2010.

The primary reason for the increase in our noninterest expense for the three and six months ended June 30, 2011 compared to the same 2010 periods is attributable to the increase in the following expense items:

1. Expenses relating to our other real estate owned for the quarters ended June 30, 2011 and 2010, was \$1,056,394 and \$103,937, respectively, which represents an increase of \$952,457. For the six months ended June 30, 2011, the expense was \$1,532,618 and \$394,663, respectively, which equates to an increase of \$1,137,955. The increase in both periods is attributable to the significant increase in the volume in other real estate owned. At June 30, 2011, our other real estate owned totaled \$19,673,504 compared to \$12,268,366 at June 30, 2010.
2. Mortgage loan expense was \$356,140 and \$351,837 higher for the three and six months ended June 30, 2011, compared to the comparable 2010 periods, respectively. Due to a positive change in our mortgage litigation contingency outlook, the mortgage loan expense for the 2010 periods was reduced by a positive adjustment of \$350,000 to our mortgage loan buyback expense.

Our income tax provision for the three and six months ended June 30, 2011 consists of a tax benefit of \$125,708 and \$419,394, respectively compared to \$658,403 and \$724,635, respectively for the comparable 2010 periods. The decrease in the tax benefit for both periods is attributable to the relationship of our non-taxable income generated from

investments in bank-owned life insurance and tax-exempt municipal bonds to our net income (loss) before income taxes.

## Balance Sheet Review

### General

At June 30, 2011, we had total assets of \$512.2 million, consisting principally of \$328.8 million in loans, \$104.6 million in investment securities, and \$13.2 million in cash and due from banks. Our liabilities at June 30, 2011, totaled \$462.1 million, which consisted principally of \$429.0 million in deposits, \$20.0 million in FHLB advances, and \$10.6 million in other borrowings. At June 30, 2011, our shareholders' equity was \$50.1 million.

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At December 31, 2010, we had total assets of \$530.1 million, consisting principally of \$354.3 million in loans, \$88.8 million in investment securities, and \$25.7 million in cash and due from banks. Our liabilities at December 31, 2010 totaled \$481.5 million, consisting principally of \$455.3 million in deposits, \$13.0 million in FHLB advances, and \$10.8 million in other borrowings. At December 31, 2010, our shareholders' equity was \$48.6 million.

### Investment Securities

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

At June 30, 2011 our investment in available-for sale securities was \$101,164,899, this is \$16,692,346, or 19.76%, higher than our investment of \$84,472,553 in available-for-sale securities at December 31, 2010.

The amortized costs and the fair value of our securities available-for-sale at June 30, 2011 and December 31, 2010 are shown in the following table.

|                                  | June 30, 2011        |                      | December 31, 2010   |                      |
|----------------------------------|----------------------|----------------------|---------------------|----------------------|
|                                  | Amortized Cost       | Estimated Fair Value | Amortized Cost      | Estimated Fair Value |
| Government sponsored enterprises | \$2,898,456          | \$3,045,606          | \$5,031             | \$5,178              |
| Mortgage-backed securities       | 64,944,510           | 65,896,349           | 35,361,686          | 35,769,713           |
| Municipal securities             | 31,972,685           | 32,210,194           | 49,804,336          | 48,657,162           |
| Other                            | 200,000              | 12,750               | 200,000             | 40,500               |
| <b>Total</b>                     | <b>\$100,015,651</b> | <b>\$101,164,899</b> | <b>\$85,371,053</b> | <b>\$84,472,553</b>  |

At June 30, 2011, securities classified as available-for-sale are recorded at fair market value. Approximately 74.31% of the unrealized losses, or five individual securities, consisted of securities in a continuous loss position for twelve months or more. We do not intend to sell these securities in the near future and it is more likely than not that we will not be required to sell these securities before recovery of their amortized cost. We believe, based on industry analyst reports and credit ratings, that the deterioration in value is attributable to changes in market interest rates and is not in the credit quality of the issuer and therefore, these losses are not considered other-than-temporary.

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

Contractual maturities and yields on our available for sale securities at June 30, 2011 are shown in the following table. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (Dollars in thousands)                    | U.S Government Agencies and Corporations |               | Municipals       |               | Total            |               |
|---|--|---------------|------------------|---------------|------------------|---------------|
|   | Amount                                   | Yield         | Amount           | Yield         | Amount           | Yield         |
| Due within one year                       | \$ 129                                   | 4.07 %        | \$ -             | 0.00 %        | \$ 129           | 4.07 %        |
| Due after one year but within five years  | 448                                      | 4.01          | 6,709            | 4.04          | 7,157            | 4.04          |
| Due after five years but within ten years | 675                                      | 4.01          | 10,410           | 4.21          | 11,085           | 4.20          |
| Due after ten years                       | 1,794                                    | 4.01          | 15,091           | 4.30          | 16,885           | 4.27          |
| <b>Total securities (1)</b>               | <b>\$ 3,046</b>                          | <b>4.02 %</b> | <b>\$ 32,210</b> | <b>4.22 %</b> | <b>\$ 35,256</b> | <b>4.20 %</b> |

(1) Excludes mortgage-backed securities totaling \$31,770,000 with a yield of 4.22% and other securities totaling \$12,750.

During the first six months of 2011, we sold \$27,898,732 of available-for-sale securities and replaced them with higher investor-rated securities.

At June 30, 2011 and December 31, 2010, nonmarketable equity securities totaled \$3,463,800 and \$4,357,300, respectively, consisting of Federal Home Loan Bank stock and Community Bankers Bank stock. These stocks are recorded at their original cost. At June 30, 2011 and December 31, 2010 the Federal Home Loan Bank stock totaled \$3,405,700 and \$4,299,200, respectively. The Community Bankers Bank stock totaled \$58,100 at June 30, 2011 and December 31, 2010.

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## Loans

Loans, including loans held for sale, are the largest category of earning assets and typically provide higher yields than the other types of earning assets. Associated with the higher loan yields are the inherent credit and liquidity risks that we attempt to control and counterbalance. Loans averaged \$342,625,450 during the six months ended June 30, 2011 compared to \$393,496,225 during the six months ended June 30, 2010, a decrease of \$50,870,775, or 12.93%. At June 30, 2011, total loans were \$329,507,472 compared to \$355,513,545 at December 31, 2010, a decrease of \$26,006,073, or 7.32%. Excluding loans held for sale, loans were \$328,772,357 at June 30, 2011, compared to \$354,327,969 at December 31, 2010, which equated to a decrease of \$25,555,612, or 7.21%. This decrease is the result of the economic downturn in our markets and worldwide deleveraging that caused the volume of new loan customers and average loan balances carried by current customers to decrease.

The following table summarizes the composition of our loan portfolio June 30, 2011 and December 31, 2010.

|                               | June 30,<br>2011 | % of<br>Total |   | December 31,<br>2010 | % of<br>Total |   |
|-------------------------------|------------------|---------------|---|----------------------|---------------|---|
| Mortgage loans on real estate |                  |               |   |                      |               |   |
| Construction                  | \$50,893,002     | 15.48         | % | \$62,635,354         | 17.68         | % |
| Residential 1-4 family        | 48,429,244       | 14.73         |   | 50,085,085           | 14.13         |   |
| Multifamily                   | 4,893,050        | 1.49          |   | 9,337,285            | 2.64          |   |
| Second mortgages              | 8,043,146        | 2.45          |   | 4,782,583            | 1.35          |   |
| Equity lines of credit        | 26,025,204       | 7.92          |   | 27,989,649           | 7.90          |   |
| Commercial                    | 143,689,916      | 43.70         |   | 152,178,318          | 42.95         |   |
| Total mortgage loans          | 281,973,562      | 85.77         |   | 307,008,274          | 86.65         |   |
| Commercial and industrial     | 38,579,950       | 11.73         |   | 40,856,292           | 11.53         |   |
| Consumer                      | 7,815,669        | 2.38          |   | 6,057,089            | 1.71          |   |
| Other, net                    | 403,176          | 0.12          |   | 406,314              | 0.11          |   |
| Total loans                   | \$328,772,357    | 100.00        | % | \$354,327,969        | 100.00        | % |

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

The largest component of our loan portfolio is real estate mortgage loans. At June 30, 2011, real estate mortgage loans totaled \$231,080,560 and represented 70.29% of the total loan portfolio, compared to \$244,372,920, or 68.97%, at December 31, 2010. This percentage increase is largely attributable to a significant decrease in our portfolio of construction mortgage loans.

Residential mortgage loans totaled \$87,390,644 at June 30, 2011, and represented 26.58% of the total loan portfolio, compared to \$92,194,602 and 26.02%, respectively, at December 31, 2010. Residential real estate loans consist of first and second mortgages on single or multi-family residential dwellings. Nonresidential mortgage loans, which include commercial loans and other loans secured by multi-family properties and farmland, totaled \$143,689,916 at June 30, 2011, compared to \$152,178,318 at December 31, 2010. This represents a decrease of \$8,488,402, or 5.58%, from the December 31, 2010 balance. Real estate construction loans were \$50,893,002 and \$62,635,354 at June 30, 2011 and December 31, 2010, respectively, and represented 15.48% and 17.68% of the total loan portfolio, respectively. Currently, the demand for all types of real estate mortgage loans in our market area is very weak, largely because of

the general economic downturn that has affected many businesses and individuals in our market area.

Commercial and industrial loans decreased \$2,276,342, or 5.57%, to \$38,579,950 at June 30, 2011, from \$40,856,292 at December 31, 2010. The decrease is mainly due to the economic downturn in our markets that caused the demand for these types of loans to decrease. At June 30, 2011 and December 31, 2010, commercial and industrial loans represented 11.73% and 11.53%, respectively, of the total loan portfolio.

Our loan portfolio is also comprised of consumer and other loans that totaled \$8,212,845 and \$6,463,403 at June 30, 2011 and December 31, 2010, respectively. At June 30, 2011 and December 31, 2010, these loans represented 2.50% and 1.82%, respectively, of the total loan portfolio.

Our loan portfolio reflects the diversity of our markets. The economies of our markets contain elements of medium and light manufacturing, higher education, regional health care, and distribution facilities. Over the remainder of 2011, we expect our local economy to remain stable; however, due to the current economic challenges facing our markets, we do not expect any material growth in our loan portfolio in the near future. We do not engage in foreign lending.

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

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

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

The following table summarizes the loan maturity distribution by collateral type and related interest rate characteristics at June 30, 2011.

| (Dollars in thousands)              | One Year or<br>Less | Over<br>One Year<br>Through<br>Five Years | Over Five<br>Years | Total      |
|-------------------------------------|---------------------|---|--------------------|------------|
| Commercial and industrial           | \$ 22,618           | \$ 15,961                                 | \$ 1               | \$ 38,580  |
| Real estate                         | 107,849             | 149,018                                   | 25,107             | 281,974    |
| Consumer and other                  | 4,043               | 3,786                                     | 389                | 8,218      |
|                                     | \$ 134,510          | \$ 168,765                                | \$ 25,497          | \$ 328,772 |
| Loans maturing after one year with: |                     |   |                    |            |
| Fixed interest rates                |                     |   |                    | \$ 121,460 |
| Floating interest rates             |                     |   |                    | 72,802     |
|                                     |                     |   |                    | \$ 194,262 |

## Activity in the Allowance for Loan Losses

The following table summarizes the activity related to our allowance for loan losses for the six months ended June 30, 2011 and 2010.

| (Dollars in thousands)              | Six Months Ended<br>June 30, |          |
|-------------------------------------|------------------------------|----------|
|                                     | 2011                         | 2010     |
| Balance, January 1                  | \$ 6,271                     | \$ 9,801 |
| Loans charged off:                  |                              |          |
| Real estate – construction          | 1,035                        | 2,882    |
| Real estate – mortgage              | 1,052                        | 2,755    |
| Commercial and industrial           | 415                          | 889      |
| Consumer and other                  | 15                           | 63       |
| Total loan losses                   | 2,517                        | 6,589    |
| Recoveries of previous loan losses: |                              |          |
| Real estate – construction          | 253                          | 166      |
| Real estate – mortgage              | 128                          | 1,102    |
| Commercial and industrial           | 38                           | 375      |
| Consumer and other                  | -                            | 128      |
| Total recoveries                    | 419                          | 1,771    |
| Net charge-offs                     | (2,098 )                     | (4,818 ) |
| Provision for loan losses           | 523                          | 2,066    |
| Balance, June 30                    | \$ 4,696                     | \$ 7,049 |



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|  |           |   |           |   |
|--|-----------|---|-----------|---|
| Total loans outstanding, end of period         | \$328,772 |   | \$375,344 |   |
| Allowance for loan losses to loans outstanding | 1.43      | % | 1.88      | % |

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## Risk Elements in the Loan Portfolio

The following table shows the nonperforming assets at June 30, 2011 and 2010.

| June 30,<br>(Dollars in thousands)                                | 2011     | 2010     |   |
|---|----------|----------|---|
| Loans over 90 days past due and still accruing                    | \$4,615  | \$2,260  |   |
| Loans on nonaccrual:  |          |          |   |
| Real Estate Construction  | 9,528    | 13,587   |   |
| Real Estate Mortgage  | 9,941    | 4,917    |   |
| Commercial  | 739      | 988      |   |
| Consumer  | 9        | 9        |   |
| Total nonaccrual loans  | 20,217   | 19,501   |   |
| Total of nonperforming loans                                      | 24,832   | 21,761   |   |
| Other nonperforming assets  | 19,674   | 12,268   |   |
| Total nonperforming assets  | \$44,506 | \$34,029 |   |
| Percentage of nonperforming assets to total assets                | 8.69     | % 5.74   | % |
| Percentage of nonperforming loans to total loans                  | 7.55     | % 5.80   | % |
| Allowance for loan losses as a percentage of non-performing loans | 18.91    | % 32.39  | % |

Loans over 90 days past due and still accruing – As of June 30, 2011 and 2010, we had loans totaling \$4,614,678 and \$2,260,431, respectively, that were past due over 90 days and still accruing interest. All loans are secured by real estate and included in our impaired loan classification at June 30, 2011 and 2010. The increase in this category is primarily attributable to one loan that is more than adequately secured.

Nonaccruing loans – At June 30, 2011 and 2010, loans totaling \$20,217,438 and \$19,501,320, respectively, were in nonaccrual status. Generally, loans are placed on nonaccrual status if principal or interest payments become 90 days past due and/or we deem the collectability of the principal and/or interest to be doubtful. Generally, once a loan is placed in nonaccrual status, all previously accrued and uncollected interest is reversed against interest income, unless collection of interest accrued to date is expected. Interest income on nonaccrual loans is recognized on a cash basis when the ultimate collectability is no longer considered doubtful. Loans are returned to accrual status when the principal and interest amounts contractually due are brought current and future payments are reasonably assured. If interest on our loans classified as nonaccrual at June 30, 2011 and 2010 had been recognized on a fully accruing basis, we would have recorded approximately \$478,000 and \$175,000 of additional interest income for the six months ended June 30, 2011 and 2010, respectively. We note that the increased volume of nonaccrual real estate mortgage loans was roughly offset by a reduction in the volume of non-accrual real estate construction loans that were primarily located in coastal markets that were harder hit by the economic downturn. All nonaccruing loans at June 30, 2011 and 2010 were included in our classification of impaired loans at those dates.

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

At June 30, 2011, we had restructured loans totaling \$2,827,504 consisting of ten borrowers. All loans were secured by real estate and included in our classification of impaired loans at June 30, 2011. These loans were performing and

generally renegotiated for lower interest rates. In most cases, these restructured loans were made as a result of the general economic downturn and its effect on depressing real estate sales and purchases and other economic activity in our market area. Restructured loans totaled \$2,301,000 at June 30, 2010. All restructured loans at June 30, 2011 and 2010 were included in our classification of impaired loans.

Impaired loans - At June 30, 2011, we had impaired loans totaling \$28,402,226, as compared to \$19,501,320 at June 30, 2010. Included in the impaired loans at June 30, 2011 were 10 borrowers that accounted for approximately 69.81% of the total amount of the impaired loans at that date. These loans were primarily commercial real estate loans located in coastal South Carolina. Impaired loans, as a percentage of total loans, were 8.64% at June 30, 2011 as compared to 5.80% at June 30, 2010.

During the first six months of 2011, the average investment in impaired loans was approximately \$25,419,000 as compared to \$23,241,000 during the first six months of 2010. Impaired loans with a specific allocation of the allowance for loan losses totaled approximately \$1,393,000 and \$13,042,000 at June 30, 2011 and 2010, respectively. The amount of the specific allocation at June 30, 2011 and 2010 was \$173,755 and \$663,722, respectively.

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

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

Since December 31, 2010, total loans individually evaluated for impairment increased by approximately \$9,100,000, with practically all of the increase being attributable to loans classified as nonresidential real estate mortgage loans. Our impairment analysis was further supplemented by loan tracking based on geographic segmentation, with additional potential for impairment derived from loans secured by real estate in coastal markets that have been particularly hard hit by the economic downturn. In many cases, the value of the newly impaired nonresidential real estate mortgage loans is equivalent to the volume of our reduced exposure to real estate construction loans. As the volume of these impaired real estate construction loans, which are considered to be of higher risk based on the type and location of their related collateral than nonresidential real estate mortgage loans, has been reduced over the first six months of 2011 we believe that the overall risk of loss in our loan portfolio has decreased. During the second quarter of 2011, three large borrowers went into default. Appropriately, their loans were individually evaluated for potential loss exposure. In each case, it was determined that our collateral position will ultimately lead to collection of all principal and interest due and therefore no specific reserve was necessary. We are actively pursuing workout scenarios on these classified relationships and are optimistic that at least one large borrower will enter into a workout structure during the third quarter of 2011.

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

As of June 30, 2011, we had OREO properties totaling \$19,673,504 geographically located in the following South Carolina areas - 77% in the Coastal area, 12% in the Columbia area and 11% in the Florence area. The combined nature of these properties is 89% commercial and 11% residential and other. While we are diligently trying to dispose of our OREO properties, the currently depressed real estate market affects our ability to do so in a timely manner without experiencing additional losses. Additionally, there can be no assurance that these properties can be sold for their carrying values.

Deposits and Other Interest-Bearing Liabilities

Average interest-bearing liabilities decreased \$90,895,404 or 17.59%, to \$425,955,102 for the six months ending June 30, 2011 from \$516,850,506 for the six months ended June 30, 2010. Deposits declined mainly as a result of our effort to reduce high cost wholesale time deposits.

Deposits - For the six months ended June 30, 2011 and 2010, average total deposits were \$443,495,143 and \$522,559,992, respectively, which is a decrease of \$79,064,849, or 15.13%. At June 30, 2011 and December 31, 2010, total deposits were \$428,971,311 and \$455,250,465, respectively, a decrease of \$26,279,154, or 5.77%.

Average interest-bearing deposits decreased \$82,594,782, or 17.25%, to \$396,241,599 for the six months ended June 30, 2011, from \$478,836,381 for the six months ended June 30, 2010.

The average balance of non-interest bearing deposits increased \$3,529,933, or 8.07%, to \$47,253,544 for the six months ended June 30, 2011, from \$43,723,611 for the six months ended June 30, 2010.

The following table shows the average balance amounts and the average rates paid on deposits held by us for the six months ended June 30, 2011 and 2010.

|                                     | Six Months Ended June 30, |                 |                   |                 |
|-------------------------------------|---------------------------|-----------------|-------------------|-----------------|
|                                     | 2011                      |                 | 2010              |                 |
|                                     | Average<br>Amount         | Average<br>Rate | Average<br>Amount | Average<br>Rate |
| Noninterest bearing demand deposits | \$47,253,544              | 0.00 %          | \$43,723,611      | 0.00 %          |
| Interest bearing demand deposits    | 37,380,951                | 0.52            | 39,295,697        | 0.45            |
| Savings accounts                    | 117,293,516               | 0.81            | 104,039,903       | 1.32            |
| Time deposits                       | 241,567,132               | 2.36            | 335,500,781       | 2.92            |
| Total                               | \$443,495,143             | 1.54 %          | \$522,559,992     | 2.17 %          |

Core deposits, which exclude time deposits of \$100,000 or more, provide a relatively stable funding source for our loan portfolio and other earning assets. Our core deposits were \$308,718,925 and \$297,769,985 at June 30, 2011 and December 31, 2010, respectively. This equates to an increase of \$10,948,940, or 3.68%, which is the result of our continued focus to replace wholesale deposits and other borrowings with core deposits.

Included in time deposits of \$100,000 and over, at June 30, 2011 and December 31, 2010 are brokered time deposits of \$90,860,000 and \$111,929,000, respectively, equating to a decrease of \$21,069,000. In accordance with our asset/liability management strategy, we do not intend to renew or replace the outstanding brokered deposits at June 30, 2011, when they mature.

Deposits, and particularly core deposits, have been our primary source of funding and have enabled us to meet successfully both our short-term and long-term liquidity needs. We anticipate that such deposits will continue to be our primary source of funding in the future. Our loan-to-deposit ratio was 76.64% and 77.83% on June 30, 2011 and December 31, 2010, respectively.

The maturity distribution of our time deposits of \$100,000 or more at June 30, 2011, is set forth in the following table:

|                                   | June 30,<br>2011 |
|-----------------------------------|------------------|
| Three months or less              | \$7,065,666      |
| Over three through twelve months  | 28,487,264       |
| Over one year through three years | 75,359,546       |
| Over three years                  | 9,339,910        |
| Total                             | \$120,252,386    |

Approximately 29.57% of our time deposits of \$100,000 or more had scheduled maturities within one year. Large certificate of deposit customers tend to be extremely sensitive to interest rate levels, making these deposits less reliable sources of funding for liquidity planning purposes than core deposits. We expect most certificates of deposits with maturities less than one year to be renewed upon maturity. However, there is the possibility that some certificates may not be renewed. We believe that, should these certificates of deposit not be renewed, the impact would be minimal on our operations and liquidity due to the availability of other funding sources.

Other Borrowings – Other borrowings at June 30, 2011 and December 31, 2010, consist of the following:

| June 30,<br>2011 | December 31,<br>2010 |
|------------------|----------------------|
|------------------|----------------------|

|   |            |            |
|---|------------|------------|
| Securities sold under agreement to repurchase | \$260,252  | \$ 476,522 |
| Advances from the Federal Home Loan Bank      | 20,000,000 | 13,000,000 |
| Junior subordinated debentures                | 10,310,000 | 10,310,000 |

Securities sold under agreements to repurchase mature on a one to seven day basis. These agreements are secured by U.S. government agency securities. Advances from the Federal Home Loan Bank mature at different periods and are secured by our one to four family residential mortgage loans and our investment in the Federal Home Loan Bank stock. The new advances of \$7,000,000 from the Federal Home Loan Bank were used to repay brokered deposits that matured during the first six months of 2011.

#### Capital Resources

Total shareholders' equity at June 30, 2011 and December 31, 2010 was \$50,061,202 and \$48,591,844, respectively. The \$1,469,358 increase during the first six months of 2011 resulted primarily from the increase in accumulated other comprehensive income of \$1,351,514 and net income of \$536,190. These increases were partially offset by the payment of preferred stock dividends of \$498,495.

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 six months ended June 30, 2011 and 2010. While we have not paid a cash dividend on our common stock since our inception, the Company has declared and paid dividends on its outstanding shares of preferred stock, and made quarterly interest payments on its trust-preferred securities as agreed. Under the terms of the Company MOU, the terms of which are more fully described as part of "Management's Discussion and Analysis of Financial Condition and Results of Operation – Regulatory Matters", the Company must request prior approval from the Federal Reserve prior to declaring or paying dividends on our common stock or preferred stock, or making scheduled interest payments on our trust-preferred securities.

|  | Six Months Ended |   |      |   |
|--|------------------|---|------|---|
|  | June 30,         |   | 2010 |   |
|  | 2011             | % | 0.02 | % |
| Return on average assets               | 0.21             | % | 0.02 | % |
| Return on average equity               | 2.26             |   | 0.22 |   |
| Average equity to average assets ratio | 9.12             |   | 7.61 |   |

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

Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum ratios of Tier 1 and total capital as a percentage of assets and off-balance-sheet exposures, adjusted for risk weights ranging from 0% to 100%. Tier 1 capital of the Company consists of common shareholders' equity, excluding the unrealized gain or loss on securities available-for-sale, minus certain intangible assets. The Company's Tier 2 capital consists of the allowance for loan losses subject to certain limitations. Total capital for purposes of computing the capital ratios consists of the sum of Tier 1 and Tier 2 capital. The regulatory minimum requirements are 4% for Tier 1 capital and 8% for total risk-based capital; under the provisions of the Memorandum the Bank will be required to maintain a Tier 1 leverage ratio of 8% and a total risk-based capital ratio of 10%.

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

The following table sets forth the holding company's and the bank's various capital ratios at June 30, 2011 and at December 31, 2010. For both periods, the bank was considered "well capitalized" and the holding company met or exceeded its applicable regulatory capital requirements.

|  | June 30, 2011 | December 31, 2010 |
|--|---------------|-------------------|
|  | Holding       | Holding           |



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|  | Company |   | Bank  |   | Company |   | Bank  |   |
|--|---------|---|-------|---|---------|---|-------|---|
| Tier 1 capital (to risk-weighted assets)             | 14.04   | % | 12.56 | % | 13.34   | % | 11.87 | % |
| Total capital (to risk-weighted assets)              | 15.24   | % | 13.75 | % | 14.59   | % | 13.13 | % |
| Leverage or Tier 1 capital (to total average assets) | 10.70   | % | 9.65  | % | 9.99    | % | 8.94  | % |

Effect of Inflation and Changing Prices

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

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

## Off-Balance Sheet Risk

Through our operations, we have made contractual commitments to extend credit in the ordinary course of our business activities. These commitments are legally binding agreements to lend money to our customers at predetermined interest rates for a specified period of time. At June 30, 2011 we had issued commitments to extend credit of \$31.6 million and standby letters of credit of \$2.2 million through various types of commercial lending arrangements. Approximately \$28.5 million of these commitments to extend credit had variable rates.

The following table sets forth the length of time until maturity for unused commitments to extend credit and standby letters of credit at June 30, 2011:

| (Dollars in Thousands)              | Within<br>One<br>Month | After One<br>Through<br>Three<br>Months | After<br>Three<br>Through<br>Twelve<br>Months | Within<br>One<br>Year | Greater<br>Than<br>One Year | Total    |
|-------------------------------------|------------------------|---|---|-----------------------|-----------------------------|----------|
| Unused commitments to extend credit | \$2,302                | \$ 38                                   | \$7,223                                       | \$9,563               | \$21,988                    | \$31,551 |
| Standby letters of credit           | -                      | 472                                     | 1,668   | 2,140                 | 25                          | 2,165    |
| Totals                              | \$2,302                | \$ 510                                  | \$8,891                                       | \$11,703              | \$22,013                    | \$33,716 |

## Market Risk

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

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

We were liability sensitive during the year ended December 31, 2010 and during the six months ended June 30, 2011. As of June 30, 2011, we expect to be liability sensitive for the next nine months because a majority of our deposits reprice over a 12-month period. Approximately 48% of our loans were variable rate loans at June 30, 2011. The ratio of cumulative gap to total earning assets after 12 months was (25.42%) because \$113.2 million more liabilities will reprice in a 12 month period than assets. However, our gap analysis is not a precise indicator of our interest sensitivity position. The analysis presents only a static view of the timing of maturities and repricing opportunities, without taking into consideration that changes in interest rates do not affect all assets and liabilities equally. For example, rates paid on a substantial portion of core deposits may change contractually within a relatively short time frame, but those rates are viewed by us as significantly less interest-sensitive than market-based rates such

as those paid on noncore deposits. Net interest income may be affected by other significant factors in a given interest rate environment, including changes in the volume and mix of interest-earning assets and interest-bearing liabilities.

#### Liquidity and Interest Rate Sensitivity

Liquidity represents the ability of a company to convert assets into cash or cash equivalents without significant loss, and the ability to raise additional funds by increasing liabilities. Liquidity management involves monitoring our sources and 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 securities in 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 June 30, 2011, our liquid assets, consisting of cash and cash equivalents amounted to \$13.2 million, or 2.58% of total assets. Our investment securities, excluding nonmarketable securities, at June 30, 2011 amounted to \$101.2 million, or 19.75% of total assets. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, \$23.2 million of these securities were pledged as collateral to secure public deposits and borrowings as of June 30, 2011. At December 31, 2010, our liquid assets, consisting of cash and cash equivalents amounted to \$25.7 million, or 4.84% of total assets. Our investment securities, excluding nonmarketable securities, at December 31, 2010 amounted to \$84.5 million, or 15.94% of total assets. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, \$84.4 million of these securities were pledged as collateral to secure public deposits and borrowings as of December 31, 2010.

Our ability to maintain and expand our deposit base and borrowing capabilities serves as our primary source of liquidity. For the near future, it is our intention to reduce the use of wholesale funding to fund loan demand. We plan to meet our future cash needs through the liquidation of temporary investments, the generation of deposits, and from additional borrowings. In addition, we will receive cash upon the maturity and sale of loans and the maturity of investment securities. At June 30, 2011, we had a federal funds purchase line of credit with a correspondent bank giving us credit availability totaling \$5.0 million for which there were no outstanding borrowings. In addition, at June 30, 2011, we had sufficient unpledged securities that would have allowed us to borrow up to \$85.1 million from the Federal Reserve Bank. Also, we are a member of the Federal Home Loan Bank of Atlanta, (the "FHLB") 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. We have an available line to borrow funds from the Federal Home Loan Bank up to 30% of the Bank's total assets, which provide additional available funds of \$138.9 million at June 30, 2011. At June 30, 2011 the bank had \$20.0 million outstanding in FHLB advances. We believe that the sources described above will be sufficient to meet our future liquidity needs.

The Company is largely dependent upon dividends from the Bank as a source of cash. The Bank MOU restricts the ability of the Bank to declare and pay dividends to the Company. The Company MOU requires the Company to obtain approval of the Federal Reserve Bank prior to declaring dividends. See "Management's Discussion and Analysis of Financial Condition and Results of Operation—Regulatory Matters" for additional information relating to the Company MOU.

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

#### Interest Sensitivity Analysis

The following table sets forth information regarding our rate sensitivity as of June 30, 2011, 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.

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| (Dollars in Thousands)                   | Within<br>One<br>Month | After One<br>Through<br>Three<br>Months | Three<br>Through<br>Twelve<br>Months | Within<br>One<br>Year | Than One<br>Year or<br>Non-<br>Sensitive | Total          |
|--|------------------------|---|--------------------------------------|-----------------------|--|----------------|
| <b>Assets</b>                            |                        |   |                                      |                       |  |                |
| <b>Interest-earning assets</b>           |                        |   |                                      |                       |  |                |
| Interest-bearing deposits in other banks | \$ 10,902              | \$ -                                    | \$ -                                 | \$ 10,902             | \$ -                                     | \$ 10,902      |
| Loans (1)                                | 44,828                 | 21,773                                  | 68,644                               | 135,245               | 194,262                                  | 329,507        |
| Securities, taxable                      | 36                     | 17                                      | 76                                   | 129                   | 68,826                                   | 68,955         |
| Securities, nontaxable                   | -                      | -                                       | -                                    | -                     | 32,210                                   | 32,210         |
| Nonmarketable securities                 | 3,464                  | -                                       | -                                    | 3,464                 | -  | 3,464          |
| Time Deposits in other banks             | -                      | -                                       | 100                                  | 100                   | -  | 100            |
| <b>Total earning assets</b>              | <b>59,230</b>          | <b>21,790</b>                           | <b>68,820</b>                        | <b>149,840</b>        | <b>295,298</b>                           | <b>445,138</b> |

| (Dollars in Thousands)                                     | Within<br>One<br>Month | After One<br>Through<br>Three<br>Months | After<br>Three<br>Through<br>Twelve<br>Months | Within<br>One<br>Year | Greater<br>Than One<br>Year or<br>Non-<br>Sensitive | Total          |
|--|------------------------|---|---|-----------------------|---|----------------|
| <b>Liabilities</b>   |                        |   |   |                       |   |                |
| <b>Interest-bearing liabilities</b>                        |                        |   |   |                       |   |                |
| <b>Interest-bearing deposits:</b>                          |                        |   |   |                       |   |                |
| Demand deposits  | 36,100                 | -                                       | -   | 36,100                | -   | 36,100         |
| Savings deposits   | 124,370                | -                                       | -   | 124,370               | -   | 124,370        |
| Time deposits  | 15,188                 | 20,715                                  | 59,370  | 95,273                | 124,479   | 219,752        |
| <b>Total interest-bearing deposits</b>                     | <b>175,658</b>         | <b>20,715</b>                           | <b>59,370</b>                                 | <b>255,743</b>        | <b>124,479</b>                                      | <b>380,222</b> |
| <b>Federal Home Loan Bank</b>                              |                        |   |   |                       |   |                |
| Advances   | 7,000                  | -                                       | -   | 7,000                 | 13,000  | 20,000         |
| Junior subordinated debentures                             | -                      | -                                       | -   | -                     | 10,310  | 10,310         |
| Repurchase agreements                                      | 260                    | -                                       | -   | 260                   | -   | 260            |
| <b>Total interest-bearing liabilities</b>                  | <b>182,918</b>         | <b>20,715</b>                           | <b>59,370</b>                                 | <b>263,003</b>        | <b>147,789</b>                                      | <b>410,792</b> |
| <b>Period gap</b>  | <b>\$(123,688)</b>     | <b>\$1,075</b>                          | <b>\$9,450</b>                                | <b>\$(113,163)</b>    | <b>\$147,509</b>                                    |                |
| <b>Cumulative gap</b>                                      | <b>\$(123,688)</b>     | <b>\$(122,613)</b>                      | <b>\$(113,163)</b>                            | <b>\$(113,163)</b>    | <b>\$34,346</b>                                     |                |
| <b>Ratio of cumulative gap to total<br/>earning assets</b> | <b>(27.79 )%</b>       | <b>(27.54 )%</b>                        | <b>(25.42 )%</b>                              | <b>(25.42 )%</b>      | <b>7.72 %</b>                                       |                |

(1) Including mortgage loans held for sale.

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

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

### Item 4. Controls and Procedures

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

Our management, including the CEO and CFO, does not expect that our Disclosure Controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because

of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

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

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

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## Part II - Other Information

## Item 1. Legal Proceedings

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

## Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2010, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

(a) Not applicable.

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

| Period                         | Total Number<br>of Shares<br>Purchased | Average Price<br>Paid per<br>Share | Total Number<br>of Shares<br>Purchased as<br>Part of<br>Publicly<br>Announced<br>Plans or<br>Programs | Maximum<br>Number of<br>Shares that<br>May Yet Be<br>Purchased<br>Under the<br>Plans or<br>Programs |
|--------------------------------|--|------------------------------------|---|---|
| April 1, 2011 – April 30, 2011 | 496                                    | \$ 2.97                            | -   | -   |
| May 1, 2011 - May 31, 2011     | 613                                    | \$ 3.00                            | -   | -   |
| June 1, 2011 – June 30, 2011   | 105                                    | \$ 2.97                            | -   | -   |
|                                | 1,214                                  | \$ 2.99                            | -   | -   |

## Item 3. Defaults Upon Senior Securities

Not applicable.

## Item 6. Exhibits

| Exhibit Number | Exhibit  |
|----------------|--|
| 31.1           | Certification pursuant to Rule 13a-15 under the Securities Exchange Act of 1934, as amended. |
| 31.2           | Certification pursuant to Rule 13a-15 under the Securities Exchange Act of 1934, as amended. |
| 32.1           |  |



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Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101 Interactive Data File.

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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.

Date: August 11, 2011

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

Date: August 11, 2011

By: /s/ JEFFERY A. PAOLUCCI  
Jeffery A. Paolucci  
Executive Vice President and Chief Financial  
Officer