FIRST RELIANCE BANCSHARES INC
Form 10-Q
November 14, 2007

FIRST RELIANCE BANCSHARES, INC.
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C.

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended September 30, 2007

OR

o 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 the registrant as specified in its charter)

South Carolina (State or other jurisdiction of incorporation or organization)	80-0030931 (I.R.S. Employer Identification No.)

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

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

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

3,487,393 shares of common stock, par value $0.01 per share, as of September 30, 2007

Indicated 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.

x Yes o No.

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

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

FIRST RELIANCE BANCSHARES, INC.

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FIRST RELIANCE BANCSHARES, INC.
Condensed Consolidated Balance Sheets

	September 30, 2007 (Unaudited)	December 31, 2006 (Audited)
Assets		
Cash and cash equivalents:		
Cash and due from banks	$ 12,303,957	$ 17,328,075
Federal funds sold	-	14,135,000
Total cash and cash equivalents	12,303,957	31,463,075
Securities available-for-sale	34,101,361	35,931,271
Nonmarketable equity securities	1,905,400	2,187,600
Investment in trust	310,000	310,000
Total investment securities	36,316,761	38,428,871
Loans held for sale	9,008,486	6,632,010
Loans receivable	434,389,319	353,491,036
Less allowance for loan losses	(4,736,321)	(4,001,881)
Loans, net	429,652,998	349,489,155
Premises and equipment, net	20,828,686	13,770,135
Accrued interest receivable	2,648,767	2,464,531
Other real estate owned	134,349	1,386,380
Cash surrender value life insurance	10,436,829	10,134,036
Other assets	3,444,406	2,442,529
Total assets	**$ 524,775,239**	**$ 456,210,722**
Liabilities and Shareholders' Equity		
Liabilities		
Deposits		
Noninterest-bearing transaction accounts	$ 42,917,750	$ 42,107,434
Interest-bearing transaction accounts	53,403,111	33,243,099
Savings	82,138,499	78,831,730
Time deposits $100,000 and over	150,067,645	111,991,864
Other time deposits	112,300,558	106,763,956
Total deposits	440,827,563	372,938,083
Securities sold under agreement to repurchase	8,568,084	8,120,014
Federal funds purchased	3,000,000	-
Advances from Federal Home Loan Bank	24,000,000	28,500,000
Junior subordinated debentures	10,310,000	10,310,000
Accrued interest payable	913,244	766,276
Other liabilities	752,981	1,483,086
Total liabilities	488,371,872	422,117,459
Shareholders' Equity		
Common stock, $0.01 par value; 20,000,000 shares authorized, 3,487,393 and 3,424,878 shares issued and outstanding at September 30, 2007 and December 31, 2006, respectively	34,874	34,249
Nonvested restricted stock	(147,729)	(66,131)
Capital surplus	25,808,044	25,257,814
Treasury Stock	(145,198)	-
Retained earnings	11,057,547	8,857,755
Accumulated other comprehensive income (loss)	(204,171)	9,576

Total shareholders’ equity		36,403,367		34,093,263
Total liabilities and shareholders’ equity	**$**	**524,775,239**	**$**	**456,210,722**

See notes to condensed consolidated financial statements.

FIRST RELIANCE BANCSHARES, INC.

Condensed Consolidated Statements of Income
(Unaudited)

	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006	Three Months Ended September 30, 2007	Three Months Ended September 30, 2006
Interest income:				
Loans, including fees	$ 25,745,192	$ 21,274,745	$ 9,234,300	$ 7,794,896
Investment securities:				
Taxable	638,647	782,600	192,571	252,060
Nontaxable	552,593	477,460	199,636	162,552
Federal funds sold	384,420	514,916	48,010	239,121
Other interest income	121,958	95,302	34,078	36,149
Total	27,442,810	23,145,023	9,708,595	8,484,778
Interest expense:				
Time Deposits over $100,000	5,062,204	3,395,663	1,909,567	1,267,808
Other deposits	7,218,069	5,560,118	2,613,580	2,187,338
Other interest expense	1,412,171	1,256,653	488,234	482,954
Total	13,692,444	10,212,434	5,011,381	3,938,100
Net interest income	13,750,366	12,932,589	4,697,214	4,546,678
Provision for loan losses	869,397	1,167,991	408,961	477,205
Net interest income after provision for loan losses	12,880,969	11,764,598	4,288,253	4,069,473
Noninterest income:				
Service charges on deposit accounts	1,394,945	1,225,798	486,508	451,211
Gain on sales of mortgage loans	1,635,949	1,445,891	519,818	506,710
Brokerage fees	124,220	97,226	38,351	37,451
Credit life insurance commissions	3,820	19,365	(786)	8,757
Other charges, commissions and fees	259,087	192,873	96,299	66,999
Gain (loss) on sale of other real estate	4,187	23,529	(16,187)	5,872
Gain (loss) on sale of fixed assets	16,104	(13)	-	-
Gain on sale of securities	5,996	-	-	-
Other non-interest income	437,163	419,450	140,557	155,896
Total	3,881,471	3,424,119	1,264,560	1,232,896
Noninterest expenses:				
Salaries and employee benefits	7,922,140	6,872,949	2,694,710	2,373,243
Occupancy expense	979,034	844,153	323,142	282,565
Furniture and equipment expense	607,784	512,991	188,021	153,718
Other operating expenses	4,107,690	3,701,679	1,418,732	1,214,863
Total	13,616,648	11,931,772	4,624,605	4,024,389
Income before income taxes	3,145,792	3,256,945	928,208	1,277,980
Income tax expense	946,000	995,414	343,331	413,068
Net income	**$ 2,199,792**	**$ 2,261,531**	**$ 584,877**	**$ 864,912**
Earnings per share				
Basic earnings per share	$ 0.64	$ 0.67	$ 0.17	$ 0.25

Diluted earnings per share	$	0.62	$	0.65	$	0.17	$	0.25

See notes to condensed consolidated financial statements.

FIRST RELIANCE BANCSHARES, INC.
Condensed Consolidated Statements of Shareholders' Equity and Comprehensive Income
For the nine months ended September 30, 2007 and 2006
(Unaudited)

	Common Stock Shares	Common Stock Amount	Surplus	Restricted Stock	Treasury Stock	Retained Earnings	Accumulated Other Compre-hensive Income (Loss)	Total
Balance, December 31, 2005	3,306,117	$ 33,061	$ 24,127,329	$ -	$ (9,896)	$ 5,611,847	$ (111,706)	$ 29,650,635
Net income for the period						2,261,531		2,261,531
Other comprehensive, net of tax expense of $9,674							18,779	18,779
Comprehensive income								2,280,310
Issuance of shares to 404(c)	24,800	248	355,930					356,178
Restricted Stock	6,800	68	100,066	(74,979)				25,155
Sale of treasury stock					9,896			9,896
Exercise of stock options	78,400	784	543,354					544,138
Balance, September 30, 2006	**3,416,117**	**$ 34,161**	**$ 25,126,679**	**$ (74,979)**	**$ -**	**$ 7,873,378**	**$ (92,927)**	**$ 32,866,312**
Balance, December 31, 2006	3,424,878	34,249	25,257,814	(66,131)	-	8,857,755	9,576	34,093,263
Net income for the period						2,199,792		2,199,792

Other comprehensive loss, net of tax benefit of $ 110,112							(213,747)	(213,747)
Comprehensive income								1,986,045
Issuance of shares to 404c plan	13,383	134	198,246					198,380
Restricted stock	8,987	90	132,393	(81,598)				50,885
Purchase of treasury stock					(145,198)			(145,198)
Exercise of stock options	40,145	401	219,591					219,992
Balance, September 30, 2007	**3,487,393**	**$ 34,874**	**$ 25,808,044**	**$ (147,729)**	**$ (145,198)**	**$ 11,057,547**	**$ (204,171)**	**$ 36,403,367**

See notes to condensed consolidated financial statements.

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

	Nine Months Ended September 30, 2007	2006
Cash flows from operating activities:		
Net income	$ 2,199,792	$ 2,261,531
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	869,397	1,167,991
Depreciation and amortization expense	576,096	663,571
Accretion and premium amortization	44,933	47,804
Disbursements from loans held-for-sale	(105,965,150)	(95,702,610)
Proceeds from sales of mortgages held-for-sale	103,588,674	94,116,843
Write down of other real estate owned	-	119,146
Deferred income tax provision	(428,749)	(567,977)
Gain on sales of other real estate	(4,187)	(23,529)
Gain on sale of securities	(5,996)	-
Gain on sale of fixed assets	(16,104)	-
Increase in interest receivable	(184,236)	(74,080)
Increase (decrease) in interest payable	146,968	254,193
Increase (decrease) in other liabilities	(730,105)	563,847
Increase in other assets	(953,286)	(6,795,185)
Net cash provided (used) by operating activities	(861,953)	(3,968,455)
Cash flows from investing activities:		
Net increase in loans to customers	(81,375,712)	(50,970,409)
Purchases of securities available-for-sale	(10,019,236)	(1,421,226)
Proceeds on sales of securities available-for-sale		9,785,569
Calls and maturities on securities available-for-sale	1,698,281	2,450,864
Purchases of non marketable equity securities	(1,766,300)	(390,500)
Proceeds on sales of nonmarketable equity securities	2,051,000	-
Proceeds on sales of other real estate	1,598,690	446,794
Proceeds from disposal of premises, furniture and equipment	38,066	-
Purchases of premises and equipment	(7,469,132)	(2,330,227)
Net cash used by investing activities	(85,458,774)	(52,214,704)
Cash flows from financing activities:		
Net increase in deposit accounts	67,889,480	38,926,470
Net increase in securities sold under agreements to repurchase	448,070	3,597,366
Decrease in advances from the Federal Home Loan Bank	(4,500,000)	(1,000,000)
Purchase of federal funds	3,000,000	-
Proceeds from issuance of shares to 404(c) plan	198,380	356,178
Sale (purchase) of treasury stock	(145,198)	9,896
Proceeds from stock issuance	-	-
Proceeds from the exercise of stock options	219,992	544,138
Issuance of restricted stock	50,885	25,155
Net cash provided by financing activities	67,161,609	42,459,203
Net decrease in cash and cash equivalents	(19,159,118)	(13,723,956)
Cash and cash equivalents, beginning of period	31,463,075	29,706,897

Cash and cash equivalents, end of period	**$**	**12,303,957**	**$**	**15,982,941**
Cash paid during the period for				
Income taxes	**$**	**1,111,821**	**$**	**1,277,049**
Interest	**$**	**13,545,476**	**$**	**9,958,241**

See notes to condensed consolidated financial statements.

Notes to Condensed Consolidated Financial Statements
(Unaudited)

Note 1 - Basis of Presentation

The accompanying financial statements have been prepared in accordance with the requirements for interim financial statements and, accordingly, they are condensed and omit disclosures, which would substantially duplicate those contained in the most recent annual report to shareholders. The financial statements as of September 30, 2007 and 2006 and for the interim periods then ended are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation. The financial information as of December 31, 2006 has been derived from the audited financial statements as of that date. For further information, refer to the financial statements and the notes included in First Reliance Bancshares, Inc.'s 2006 Annual Report on Form 10-K.

Note 2 - Recently Issued Accounting Pronouncements

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

In September 2006, the FASB issued Statement of Financial Accounting Standards (“SFAS”) No. 157, “Fair Value Measurements”. SFAS No. 157 provides enhanced guidance for using fair value to measure assets and liabilities. The standard also requires expanded disclosures about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company does not expect the adoption of Statement 157 to materially impact the Company's consolidated financial statements.

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

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities – Including an amendment of SFAS No. 115”. This statement permits, but does not require, entities to measure many financial instruments at fair value. The objective is to provide entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Entities electing this option will apply it when the entity first recognizes an eligible instrument and will report unrealized gains and losses on such instruments in current earnings. This statement 1) applies to all entities, 2) specifies certain election dates, 3) can be applied on an instrument–by–instrument basis with some exceptions, 4) is irrevocable and 5) applies only to entire instruments. One exception is demand deposit liabilities which are explicitly excluded as qualifying for fair value. With respect to SFAS No. 115, available for sale and held to maturity securities at the effective date are eligible for the fair value option at that date. If the fair value option is elected for those securities at the effective date, cumulative unrealized gains and losses at that date shall be included in the cumulative–effect adjustment and thereafter, such securities will be accounted for as trading securities. SFAS No. 159 is effective for the Company on January 1, 2008. Earlier adoption is permitted in 2007 if the Company also elects to apply the provisions of SFAS No. 157. The Company did not early adopt SFAS No. 159 and believes that it is unlikely that it will expand its use of fair value accounting upon the January 1, 2008 effective date.

See notes to condensed consolidated financial statements.

Notes to Condensed Consolidated Financial Statements
(Unaudited)

Note 2 - Recently Issued Accounting Pronouncements - *continued*

In September 2006, the FASB ratified the consensuses reached by the FASB's Emerging Issues Task Force ("EITF") relating to EITF No. 06−4 "Accounting for the Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split−Dollar Life Insurance Arrangements". EITF No. 06−4 addresses employer accounting for endorsement split−dollar life insurance arrangements that provide a benefit to an employee that extends to postretirement periods should recognize a liability for future benefits in accordance with SFAS No. 106, "*Employers' Accounting for Postretirement Benefits Other Than Pensions",* or Accounting Principles Board ("APB") Opinion No. 12, "*Omnibus Opinion−1967".* EITF 06−4 is effective for fiscal years beginning after December 15, 2007. Entities should recognize the effects of applying this Issue through either (a) a change in accounting principle through a cumulative−effect adjustment to retained earnings or to other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption or (b) a change in accounting principle through retrospective application to all prior periods. The company is currently analyzing the effects of EITF No. 06−4 on the Company’s consolidated financial statements.

In September 2006, the FASB ratified the consensus reached related to EITF No. 06−5, "Accounting for Purchases of Life Insurance−Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85−4, Accounting for Purchases of Life Insurance." EITF No. 06−5 states that a policyholder should consider any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value in determining the amount that could be realized under the insurance contract. EITF No. 06−5 also states that a policyholder should determine the amount that could be realized under the life insurance contract assuming the surrender of an individual−life by individual−life policy (or certificate by certificate in a group policy). EITF No. 06−5 is effective for fiscal years beginning after December 15, 2007. Although, the Company does not believe the adoption of EITF No. 06−5 will have a material impact on the Company's consolidated financial statements management is currently analyzing the impact of adoption.

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

Note 3 - Equity Incentive Plan

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

During the nine months ended September 30, 2007 and 2006, the Company granted 62,481 and 45,774 stock appreciation rights, respectively. A stock appreciation right entitles an individual to receive the excess of the fair market value from the grant date to the exercise date in a settlement of Company stock. The Company has funded the liability through charges to earnings. The accrued liability for the stock appreciation rights was $83,127 and $20,089 for the nine months ended September 30, 2007 and 2006, respectively.

During the three months ended September 30, 2007 and 2006, the company did not issue any stock appreciation rights.

See notes to condensed consolidated financial statements.

Notes to Condensed Consolidated Financial Statements
(Unaudited)

<u>Note 3 - Equity Incentive Plan</u> - *continued*

A summary of the status of the Company's stock appreciation rights as of the nine and three months ended September 30, 2007 and 2006 is presented below:

For the Nine Months Ended September 30,	2007		2006	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at January 1	45,501	$ 14.87	-	$ -
Granted	62,481	15.00	45,774	14.87
Exercised	-	-	-	-
Forfeited	-	-	(273)	14.85
Outstanding at September 30	**107,982**	**$ 14.95**	**45,501**	**$ 14.87**

For the Three Months Ended September 30,	2007		2006	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at July 1	107,982	$ 14.95	45,501	$ 14.87
Granted	-	-	-	-
Exercised	-	-	-	-
Forfeited	-	-	-	-
Outstanding at September 30	**107,982**	**$ 14.95**	**45,501**	**$ 14.87**

During the nine months ended September 30, 2007, the Company granted 8,987 shares of restricted stock, pursuant to the 2006 Equity Incentive Plan. The shares "cliff" vest in three years. The weighted average fair value of restricted stock granted in the nine months ended September 30, 2007 was $14.67. Compensation cost associated with the grant was $50,884 for the nine months ended September 30, 2007.

A summary of the status of the Company's restricted stock as of the three months ended September 30, 2007 is presented below:

	Three months ended September 30, 2007	
	Shares	Weighted Average Exercise Price
Outstanding at July 1	11,714	$ 14.88

Granted	1,819		13.75
Exercised	-		-
Forfeited	-		-
Outstanding at September 30, 2007	**13,533**	**$**	**14.72**

See notes to condensed consolidated financial statements.

Notes to Condensed Consolidated Financial Statements
(Unaudited)

Note 3 - Equity Incentive Plan - *continued*

A summary of the status of the Company's restricted stock as of the nine months ended September 30, 2007 is presented below:

	Nine months ended September 30, 2007		
	Shares		Weighted Average Exercise Price
Outstanding at January 1	6,771	$	14.86
Granted	8,987		14.67
Exercised	(2,225)		14.86
Forfeited	-		-
Outstanding at September 30, 2007	**13,533**	**$**	**14.73**

Note 4 - Earnings Per Share

The following schedule reconciles the numerators and denominators of the basic and diluted earnings per share computations for the three and nine month periods ended September 30, 2007 and 2006. Dilutive common shares arise from the potentially dilutive effect of the company's stock options and warrants that are outstanding. The assumed conversion of stock options and warrants can create a difference between basic and dilutive net income per common share.

	Nine Months Ended September 30, 2007				
		Income (Numerator)	Shares (Denominator)		Per Share Amount
Basic earnings per share					
Income available to common shareholders	$	2,199,792	3,458,775	**$**	**0.64**
Effect of dilutive securities					
Stock options		-	85,230		
Non vested restricted stock		-	4,310		
Diluted earnings per share					
Income available to common shareholders plus assumed conversions	**$**	**2,199,792**	**3,548,315**	**$**	**0.62**

	Nine Months Ended September 30, 2006				
		Income (Numerator)	Shares (Denominator)		Per Share Amount
Basic earnings per share					
Income available to common shareholders	$	2,261,531	3,379,624	**$**	**0.67**
Effect of dilutive securities					
Stock options		-	112,057		
Non vested restricted stock		-	747		
Diluted earnings per share					

Income available to common shareholders plus assumed conversions	**$**	**2,261,531**	**3,492,428**	**$**	**0.65**

See notes to condensed consolidated financial statements.

Notes to Condensed Consolidated Financial Statements
(Unaudited)

Note 4 - Earnings Per Share - *continued*

	Three Months Ended September 30, 2007		
	Income (Numerator)	**Shares (Denominator)**	**Per Share Amount**
Basic earnings per share			
Income available to common shareholders	$ 584,877	3,485,861	**$ 0.17**
Effect of dilutive securities			
Stock options	-	31,648	
Non vested restricted stock	-	7,665	
Diluted earnings per share			
Income available to common shareholders plus assumed conversions	**$ 584,777**	**3,525,174**	**$ 0.17**

	Three Months Ended September 30, 2006		
	Income (Numerator)	**Shares (Denominator)**	**Per Share Amount**
Basic earnings per share			
Income available to common shareholders	$ 864,912	3,406,109	**$ 0.25**
Effect of dilutive securities			
Stock options	-	104,447	
Non vested restricted stock	-	777	
Diluted earnings per share			
Income available to common shareholders plus assumed conversions	**$ 864,912**	**3,511,333**	**$ 0.25**

Note 5 - Stock Compensation Plan

On June 19, 2003, the Company established the 2003 First Reliance Bank Employee Stock Option Plan (Stock Plan) that provides for the granting of options to purchase up to 250,000 shares of the Company’s common stock to directors, officers, or employees of the Company. This plan was preceded by the 1999 First Reliance Bank Employee Stock Option Plan, which provided for the granting of options to purchase up to 238,000 shares of the Company’s common stock to directors, officers, or employees of the Company. The per-share exercise price of incentive stock options granted under the Stock Plan may not be less than the fair market value of a share on the date of grant. The per-share exercise price of stock options granted is determined by the Board of Directors. The expiration date of any option may not be greater than ten years from the date of grant. Options that expire unexercised or are canceled become available for reissuance. At September 30, 2007, there were no options available for grant under the 2003 plan and no options available for grant under the 1999 plan.

A summary of the status of the Company’s stock plan as of the nine months ended September 30, 2007 and changes during the period is presented below:

	Nine months ended September 30, 2007	
	Shares	**Average Exercise Price**

Outstanding at January 1	321,992	$	7.95
Granted	-		-
Exercised	(40,145)		5.48
Forfeited	-		-
Outstanding at September 30, 2007	**281,847**	**$**	**8.30**

See notes to condensed consolidated financial statements.

Notes to Condensed Consolidated Financial Statements
(Unaudited)

Note 5 - Stock Compensation Plan - *continued*

A summary of the status of the Company's stock plan as of the three months ended September 30, 2007 and changes during the period is presented below:

	Three months ended September 30, 2007		
	Shares		Average Exercise Price
Outstanding at July 1	282,847	$	7.95
Granted	-		-
Exercised	(1,000)		6.17
Forfeited	-		-
Outstanding at September 30, 2007	**281,847**	**$**	**8.30**

Note 6 - Comprehensive Income

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

		Pre-tax Amount		Tax (Expense) Benefit		Net-of-tax Amount
For the Nine Months Ended September 30, 2007:						
Unrealized losses on securities available-for-sale	$	(327,355)	$	111,301	$	(217,243)
Reclassification adjustment for gains (losses) realized in net income		3,496		(1,189)		2,307
	$	(323,859)	$	110,112	$	(213,747)
For the Nine Months Ended September 30, 2006:						
Unrealized gain on securities available-for-sale	$	28,453	$	(9,674)	$	18,779
Reclassification adjustment for gains (losses) realized in net income		-		-		-
	$	28,453	$	(9,674)	$	18,779
For the Three Months Ended September 30, 2007:						
Unrealized gain on securities available-for-sale	$	333,162	$	(113,275)	$	219,887
Reclassification adjustment for gains (losses) realized in net income		-		-		-
	$	331,162	$	(113,275)	$	219,887
For the Three Months Ended September 30, 2006:						
Unrealized losses on securities available-for-sale	$	(688,143)	$	233,333	$	(454,810)
Reclassification adjustment for gains (losses) realized in net income		-		-		-
	$	(688,143)	$	233,333	$	(454,810)

Accumulated other comprehensive income consists solely of net unrealized gains and losses on securities available for sale, net of the deferred tax effects.

See notes to condensed consolidated financial statements.

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.

Advisory 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 is based on reasonable assumptions within the bounds of our knowledge of our business and operations, there can be no assurance that actual results will not differ materially from our expectations.

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

- the challenges, costs and complications associated with the continued development of our branches;
- the potential that loan charge-offs may exceed the allowance for loan losses or that such allowance will be increased as a result of factors beyond the control of us;
- our dependence on senior management;
- competition from existing financial institutions operating in our market areas as well as the entry into such areas of new competitors with greater resources, broader branch networks and more comprehensive services;
- adverse conditions in the stock market, the public debt market, and other capital markets (including changes in interest rate conditions);
- changes in deposit rates, the net interest margin, and funding sources;
- inflation, interest rate, market, and monetary fluctuations;
- risks inherent in making loans including repayment risks and value of collateral;
- the strength of the United States economy in general and the strength of the local economies in which we conduct operations may be different than expected resulting in, among other things, a deterioration in credit quality or a reduced demand for credit, including the resultant effect on our loan portfolio and allowance for loan losses;
- fluctuations in consumer spending and saving habits;
- the demand for our products and services;
- technological changes;

- the challenges and uncertainties in the implementation of our expansion and development strategies;
- the ability to increase market share;
- the adequacy of expense projections and estimates of impairment loss;
- the impact of changes in accounting policies by the Securities and Exchange Commission;
- unanticipated regulatory or judicial proceedings;
- the potential negative effects of future legislation affecting financial institutions (including without limitation laws concerning taxes, banking, securities, and insurance);
- the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System;
- the timely development and acceptance of products and services, including products and services offered through alternative delivery channels such as the Internet;
- the impact on our business, as well as on the risks set forth above, of various domestic or international military or terrorist activities or conflicts;

See notes to condensed consolidated financial statements.

- other factors described in this report and in other reports we have filed with the Securities and Exchange Commission; and
- our success at managing the risks involved in the foregoing.

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

See notes to condensed consolidated financial statements.

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

Overview

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

See notes to condensed consolidated financial statements.

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

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

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

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

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

Critical Accounting Policies

We have adopted various accounting policies 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, 2006 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

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

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.

See notes to condensed consolidated financial statements.

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

Results of Operations

Income Statement Review

Three months ended September 30, 2007 and 2006:

Our net income was $ 584,877 and $864,912 for the three months ended September 30, 2007 and 2006, respectively, a decrease of $ 280,035, or 32.38%. The $ 280,035 decrease in net income resulted primarily from an increase of $1.1 million in interest expense and $ 600,216 in non-interest expense. The decline in net income can be attributed to our investment in branch expansion and current market conditions.

Nine months ended September 30, 2007 and 2006

Our net income was $ 2.2 million and $2.3 million for the nine months ended September 30, 2007 and 2006, respectively, a decrease of $ 61,739, or 2.73%. The $61,739 decrease in net income resulted primarily from an increase of $ 3.5 million in interest expense and $ 1.7 million in non-interest expense. The discussion and tables that follow address the decrease in net income for this period. The decline in net income can be attributed to our investment in branch expansion and current market conditions.

Net Interest Income

Our level of net interest income is determined by the level of earning assets and the management of our net interest margin. The continuous growth in our loan portfolio is the primary driver of the increase in net interest income. During the nine months ended September 30, 2007, our average loan portfolio increased $55.4 million compared to the average for the nine months ended September 30, 2006. The loan growth in the nine months of 2007 was $80.9 million. We anticipate the growth in loans will continue to drive the growth in assets and the growth in net interest income. However, no assurance can be given that we will be able to continue to increase loans at the same levels we have experienced in the past.

At September 30, 2007, net loans represented 81.9% of total assets, while investments represented 6.9% of total assets. While we plan to continue our focus on increasing the loan portfolio, as rates on investment securities begin to rise and additional deposits are obtained, we also anticipate increasing the size of the investment portfolio.

We continue to aggressively target core deposit growth by offering the best in market deposit and loan rates. This, along with our successful marketing campaigns and cross selling, is producing a more seasoned deposit base. At September 30, 2007, retail deposits represented $275.8 million, or 52.6% of total assets, borrowings represented $45.9 million, or 8.7% of total assets, and wholesale non-core deposits represented $165.1 million, or 31.5% of total assets.

As more fully discussed in the - "Market Risk" and - "Liquidity and Interest Rate Sensitivity" sections below, at September 30, 2007, 59.1% of our loans had variable rates. Given our high percentage of rate-sensitive loans, our primary focus during the past three years has been to obtain short-term liabilities to fund our asset growth. This strategy improves our ability to manage the impact on our earnings. The current market outlook suggest a decline in rates over the short-term.

At September 30, 2007, 93.8% of interest-bearing liabilities had a maturity of less than one year. At September 30, 2007, we had $39.3 million more assets than liabilities that reprice within the next three months.

See notes to condensed consolidated financial statements.

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

We intend to maintain a capital level for the bank that exceeds requirements to be classified as a "well capitalized" bank. To provide the additional capital needed to support our bank's growth in assets, in 2006 we issued $10.3 million in junior subordinated debentures. As of September 30, 2007, the Company's regulatory capital levels were over $5 million in excess of the various well capitalized requirements.

See notes to condensed consolidated financial statements.

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

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

Our net interest income margin for the three months and nine months ended September 30, 2007, exceeded our net interest spread because we had more interest-earning assets than interest-bearing liabilities. Average interest-earning assets exceeded average interest-bearing liabilities by $42.4 million and $45.1 million for the three months and nine months ended September 30, 2007, respectively.

Our net interest spread for the three months and nine months ended September 30, 2007 was 3.62% and 3.72%, respectively. Because we had more interest-earning assets than interest-bearing liabilities that repriced, our net interest spread decreased 26 basis points and 2 basis points in the three months and nine months ended September 30, 2007, respectively versus the prior year's interest spread.

For the three months and nine months ended September 30, 2007, our net interest margin was 4.04% and 4.19%, respectively. The change in our net interest margin was 5 basis points lower than the change in net interest spread for the three month period ended September 30, 2007, when compared to the same period in 2006. For the nine months ended September 30, 2007, when compared to the same period in 2006, the change in our net interest margin equals the change in net interest spread.

We have included a number of tables to assist in our description of various measures of our financial performance. For example, the "Average Balances" table shows the average balance of each category of our assets and liabilities as well as the yield we earned or the rate we paid with respect to each category during both the three months ended September 30, 2007 and 2006 and the nine months of 2007 and 2006. A review of this table shows that our loans typically provide higher interest yields than do other types of interest-earning assets, which is why we direct a substantial percentage of our earning assets into our loan portfolio. Similarly, the "Rate/Volume Analysis" table demonstrates the effect of changing interest rates and changing volume of assets and liabilities on our financial condition during the periods shown. A review of these tables shows that as short-term rates continue to rise, the increase in net interest income is more effected by the changes in rates than in prior years. We also track the sensitivity of our various categories of assets and liabilities to changes in interest rates, and we have included tables to illustrate our interest rate sensitivity with respect to interest-earning accounts and interest-bearing accounts. Finally, we have included various tables that provide detail about our investment securities, our loans, our deposits, and other borrowings.

See notes to condensed consolidated financial statements.

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

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

Average Balances, Income and Expenses, and Rates

	For the three months ended September 30, 2007			For the three months ended September 30, 2006		
	Average Balance	**Income/ Expense**	**Yield/ Rate**	**Average Balance**	**Income/ Expense**	**Yield/ Rate**
(Dollars in thousands)						
Assets						
Securities, taxable	$ 15,720	$ 193	4.87%	$ 21,080	$ 252	4.74%
Securities, nontaxable (1)	18,507	267	5.72	14,984	218	5.77
Loans (2)	428,399	9,234	8.55	361,320	7,795	8.56
Federal funds sold and other	3,361	57	6.73	20,606	252	4.86
Nonmarketable equity securities	1,502	25	6.60	2,169	23	4.22
Total earning assets	467,489	9,776	8.30	420,159	8,540	8.06
Non-earning assets	40,797			31,110		
Total assets	**$ 508,286**			**$ 451,269**		
Liabilities and Stockholders' equity						
Interest bearing transaction accounts	$ 44,256	$ 315	2.82%	$ 27,347	$ 44	0.64%
Savings and money market accounts	80,563	814	4.01	92,733	920	3.93
Time deposits	264,052	3,394	5.10	213,347	2,491	4.63
Total interest bearing deposits	388,871	4,523	4.61	333,426	3,455	4.11
Junior subordinated debentures	10,310	156	6.00	10,310	156	6.01
Other borrowings	25,903	332	5.09	29,995	327	4.32
Total other interest bearing liabilities	36,213	488	5.35	40,305	483	4.75
Total interest bearing liabilities	425,084	5,011	4.68	373,731	3,938	4.18
Non-interest bearing deposits	43,927			45,622		
Other liabilities	3,246			-		
Stockholders' equity	36,029			31,916		
Total liabilities and equity	**$ 508,286**			**$ 451,269**		
Net interest income /interest spread		**4,765**	**3.62%**		**4,602**	**3.88%**
Net yield on earning assets			**4.04%**			**4.35%**

(1) Fully tax- equivalent basis at 34% tax rate for non-taxable securities

(2) Includes mortgage loans held for sale

See notes to condensed consolidated financial statements.

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

Our net interest spread was 3.62% for the three months ended September 30, 2007, compared to 3.88% for the three months ended September 30, 2006. The net interest spread is the difference between the yield we earn on our interest-earning assets and the rate we pay on our interest-bearing liabilities.

Our net interest margin is calculated as net interest income divided by average interest-earning assets. Our net interest margin for the three months ended September 30, 2007 was 4.04%, compared to 4.35% for the three months ended September 30, 2006. During the three months ended September 30, 2007, interest-earning assets averaged $467.5 million, compared to $420.2 million in the three months ended September 30, 2006. Interest earning assets exceeded interest bearing liabilities by $42.4 million and $46.4 million for the three month periods ended September 30, 2007 and 2006, respectively.

Our loan yield decreased 1 basis point for the three months ended September 30, 2007 compared to the three months ended September 30, 2006. Cost of interest bearing liabilities increased 50 basis points for the third quarter of 2007 compared to the same period in 2006. The increase of 218 basis points on our interest bearing transaction accounts, compared to the prior year period, was a result of a marketing campaign to remain competitive in out local market. The 47 basis point increase in cost of time deposits, compared to the prior year period, was a result of renewal rates on time deposits being much higher than the original rates due to past increases in the prime rate. In addition, the cost of our savings and money market accounts has increased by 8 basis points as we have increased the rates we offer on these products in relation to the increase in short-term market rates to stay competitive. The 60 basis point increase in other borrowings in the third quarter of 2007 compared to the same period in 2006 resulted primarily from the impact of the increase in short-term market rates over the past twelve months. As of September 30, 2007, approximately 16.7% of our FHLB advances had fixed rates, while all of our other borrowings had variable rates.

Net interest income, the largest component of our income, was $4.7 million and $4.5 million for the three months ended September 30, 2007 and 2006, respectively. The significant increase in the third quarter of 2007 related to higher levels of both average earning assets and interest-bearing liabilities. Average earning assets were $47.3 million higher during the three months ended September 30, 2007 compared to the same period in 2006.

Interest income for the three months ended September 30, 2007 was $9.7 million, consisting of $9.2 million of interest and fees on loans, $392,207 of investment income, interest of $48,010 on federal funds sold, and $34,078 in other interest income. Interest on loans for the three months ended September 30, 2007 and 2006 represented 95.1% and 91.9%, respectively, of total interest income, while income from investments, federal funds sold, and other interest income represented only 4.9% and 8.1% of total interest income. The high percentage of interest income from loans relates to our strategy to maintain a significant portion of our assets in higher earning loans compared to lower yielding investments. Average loans represented 91.6% and 86.0% of average interest-earning assets for the three months ended September 30, 2007 and 2006, respectively.

Interest expense for the three months ended September 30, 2007 was $5.0 million, consisting of $4.5 million related to deposits and $488,234 related to borrowings. Interest expense for the three months ended September 30, 2006 was $3.9 million, consisting of $3.5 million related to deposits and $482,954 related to borrowings. Interest expense on deposits for the three months ended September 30, 2007 and 2006 represented 90.3% and 87.7%, respectively, of total interest expense, while interest expense on borrowings represented 9.7% and 12.3%, respectively, of total interest expense for the same three month periods. During the three months ended September 30, 2007, average interest-bearing deposits increased by $55.4 million over the same period in 2006, while other interest bearing liabilities during the three months ended September 30, 2007 decreased $4.1 million over the same period in 2006. Alternative borrowings decreased primarily as a result of successful marketing campaigns focusing on core deposit growth and branch expansion.

See notes to condensed consolidated financial statements.

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

Average Balances, Income and Expenses, and Rates

	For the nine months ended September 30, 2007			For the nine months ended September 30, 2006		
(Dollars in thousands)	**Average Balance**	**Income/ Expense**	**Yield/ Rate**	**Average Balance**	**Income/ Expense**	**Yield/ Rate**
Assets						
Securities, taxable	$ 17,797	$ 639	4.80%	$ 21,871	$ 783	4.78%
Securities, nontaxable (1)	17,101	740	5.79	14,725	640	5.81
Loans (2)	398,039	25,745	8.65	342,634	21,275	8.30
Federal funds sold and other	10,181	428	5.62	14,787	546	4.94
Nonmarketable equity securities	1,710	78	6.10	1,973	64	4.33
Total earning assets	444,828	27,630	8.30	395,990	23,308	7.87
Non-earning assets	38,271			28,840		
Total assets	**$ 483,099**			**$ 424,830**		
Liabilities and Stockholders' equity						
Interest bearing transaction accounts	$ 33,632	$ 435	1.73%	$ 26,727	$ 144	0.72%
Savings and money market accounts	78,855	2,378	4.03	86,693	2,396	3.69
Time deposits	248,885	9,467	5.09	199,928	6,416	4.29
Total interest bearing deposits	361,372	12,280	4.54	313,348	8,956	3.82
Junior subordinated debentures	10,310	464	6.02	10,310	462	5.99
Other borrowings	27,976	948	4.54	25,971	794	4.09
Total other interest bearing liabilities	38,286	1,412	4.93	36,281	1,256	4.63
Total interest bearing liabilities	399,657	13,692	4.58	349,629	10,212	3.91
Non-interest bearing deposits	45,506			44,144		
Other Liabilities	2,578					
Stockholders' equity	35,358			31,057		
Total liabilities and equity	**$ 483,099**			**$ 424,830**		
Net interest income /interest spread		**13,938**	**3.72%**		**13,096**	**3.96%**
Net yield on earning assets			**4.19%**			**4.42%**

(1) Fully tax- equivalent basis at 34% tax rate for non-taxable securities

(2) Includes mortgage loans held for sale

See notes to condensed consolidated financial statements.

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

Our net interest spread was 3.72% for the nine months ended September 30, 2007, compared to 3.96% for the nine months ended September 30, 2006. The net interest spread is the difference between the yield we earn on our interest-earning assets and the rate we pay on our interest-bearing liabilities.

Our net interest margin is calculated as net interest income divided by average interest-earning assets. Our net interest margin for the nine months ended September 30, 2007 was 4.19%, compared to 4.42% for the nine months ended September 30, 2006. During the nine months ended September 30, 2007, interest-earning assets averaged $444.8 million, compared to $396.0 million in the nine months ended September 30, 2006. Interest earning assets exceeded interest bearing liabilities by $45.1 million and $46.4 million for the nine month periods ended September 30, 2007 and 2006, respectively.

Our loan yield increased 35 basis points for the nine months ended September 30, 2007 compared to the nine months ended September 30, 2006. Offsetting the increase in our loan yield is an 72 basis point increase in the cost of our interest-bearing deposits for the nine months ended September 30, 2007 compared to the same period in 2006. The increase of 101 basis points on our interest bearing transaction accounts, compared to the prior year period, was a result of a marketing campaign to remain competitive in out local market. The 80 basis point increase in cost of time deposits, compared to the prior year period, was a result of renewal rates on time deposits being much higher than the original rates due to past increases in the prime rate. In addition, the cost of our savings and money market accounts has increased by 34 basis points as we have increased the rates we offer on these products in relation to the increase in short-term market rates to stay competitive. The 45 basis point increase in other borrowings for the nine months ended September 30, 2007 compared to the same period in 2006 resulted primarily from the impact of the increase in short-term market rates over the past twelve months. As of September 30, 2007, approximately 16.7% of our FHLB advances had fixed rates, while all of our other borrowings had variable rates.

Net interest income, the largest component of our income, was $13.8 million and $12.9 million for the nine months ended September 30, 2007 and 2006, respectively. The significant increase for the nine months ended September 30, 2007 related to higher levels of both average earning assets and interest-bearing liabilities. Average earning assets were $48.8 million higher during the nine months ended September 30, 2007 compared to the same period in 2006.

Interest income for the nine months ended September 30, 2007 was $27.4 million, consisting of $25.7 million of interest and fees on loans, $1.2 million of investment income, interest of $384,420 on federal funds sold, and $121,958 in other interest income. Interest income for the nine months ended September 30, 2006 was $23.1 million, consisting of $21.3 million of interest and fees on loans, $1.3 million of investment income, interest of $514,916 on federal funds sold, and $95,302 in other interest income. Interest on loans for the nine months ended September 30, 2007 and 2006 represented 93.8% and 91.9%, respectively, of total interest income, while income from investments, federal funds sold, and other interest income represented only 6.2% and 8.1% of total interest income. The high percentage of interest income from loans relates to our strategy to maintain a significant portion of our assets in higher earning loans compared to lower yielding investments. Average loans represented 89.5% and 86.5% of average interest-earning assets for the nine months ended September 30, 2007 and 2006, respectively.

Interest expense for the nine months ended September 30, 2007 was $13.7 million, consisting of $12.3 million related to deposits and $1.4 million related to borrowings. Interest expense on deposits for the nine months ended September 30, 2007 and 2006 represented 89.7% and 87.7%, respectively, of total interest expense, while interest expense on borrowings represented 10.3% and 12.3%, respectively, of total interest expense for the same nine month periods. During the nine months ended September 30, 2007, average interest-bearing deposits increased by $48.0 million over the same period in 2006, while other borrowings during the nine months ended September 30, 2007 increased $2.0 million over the same period in 2006.

See notes to condensed consolidated financial statements.

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

Rate/Volume Analysis

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

	Three Months Ended September 30, 2007 compared to 2006		
	Rate	Volume	Total
Securities, taxable	$ 7	$ (66)	$ (59)
Securities, nontaxable	29	20	49
Loans	(9)	1,448	1,439
Federal funds sold and other	71	(266)	(195)
Nonmaketable equity securities	10	(8)	2
Total earning assets	108	1,128	1,236
Interest bearing transaction accounts	230	41	271
Savings and money market accounts	18	(124)	(106)
Time deposits	270	633	903
Total deposits	518	550	1,068
Junior subordinated debentures	0	0	0
Other borrowings	53	(48)	5
Total other interest bearing liabilities	53	(48)	5
Total interest-bearing liabilities	571	502	1,073
Net interest income	**$ 463**	**$ 626**	**$ 163**

	Nine Months Ended September 30, 2007 compared to 2006		
	Rate	Volume	Total
Securities, taxable	$ 3	$ (147)	$ (144)
Securities, nontaxable	68	32	100
Loans	925	3,545	4,470
Federal funds sold and other	68	(186)	(118)
Nonmaketable equity securities	24	(10)	14
Total earning assets	1,088	3,234	4,322
Interest bearing transaction accounts	246	45	291
Savings and money market accounts	209	(227)	(18)
Time deposits	1,319	1,732	3,051
Total deposits	1,774	1,550	3,324
Junior subordinated debentures	2	0	2
Other borrowings	90	64	154
Total other interest bearing liabilities	92	64	156
Total interest-bearing liabilities	1,866	1,614	3,480
Net interest income	**$ (778)**	**$ 1,620**	**$ 842**

See notes to condensed consolidated financial statements.

<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation</u> - *continued*

<u>Provision for Loan Losses</u>

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

Three months ended September 30, 2007 and 2006

The provision for loan losses is the charge to operating earnings that we feel is necessary to maintain the allowance for loan losses at an adequate level. For the three months ended September 30, 2007, the provision for loan losses was $408,961. For the three months ended September 30, 2006, the provision for loan losses was $477,205. Based on present information, we believe the allowance for loan losses was adequate at September 30, 2007 to meet presently known and inherent risks in the loan portfolio. The allowance for loan losses was 1.09% and 1.10% of total loans at September 30, 2007 and 2006, respectively. There are risks inherent in making all loans, including risks with respect to the period of time over which loans may be repaid, risks resulting from changes in economic and industry conditions, risks inherent in dealing with individual borrowers, and, in the case of a collateralized loan, risks resulting from uncertainties about the future value of the collateral. We maintain an allowance for loan losses based on, among other things, historical experience, an evaluation of economic conditions, and regular reviews of delinquencies and loan portfolio quality. The allowance is based upon a number of assumptions about future events, which management believes to be reasonable, but which may not prove to be accurate. Thus, there is a risk that charge-offs in future periods could exceed the allowance for loan losses or that substantial additional increases in the allowance for loan losses could be required. Additions to the allowance for loan losses would result in a decrease in net income and, possibly, in capital.

Nine months ended September 30, 2007 and 2006

The provision for loan losses is the charge to operating earnings that we feel is necessary to maintain the allowance for loan losses at an adequate level. For the nine months ended September 30, 2007, the provision for loan losses was $869,397. For the nine months ended September 30, 2006, the provision for loan losses was $1.2 million. Based on present information, we believe the allowance for loan losses was adequate at September 30, 2006 to meet presently known and inherent risks in the loan portfolio. The allowance for loan losses was 1.09% and 1.10% of total loans at September 30, 2007 and 2006, respectively. There are risks inherent in making all loans, including risks with respect to the period of time over which loans may be repaid, risks resulting from changes in economic and industry conditions, risks inherent in dealing with individual borrowers, and, in the case of a collateralized loan, risks resulting from uncertainties about the future value of the collateral. We maintain an allowance for loan losses based on, among other things, historical experience, an evaluation of economic conditions, and regular reviews of delinquencies and loan portfolio quality. The allowance is based upon a number of assumptions about future events, which management believes to be reasonable, but which may not prove to be accurate. Thus, there is a risk that charge-offs in future periods could exceed the allowance for loan losses or that substantial additional increases in the allowance for loan losses could be required. Additions to the allowance for loan losses would result in a decrease in net income and, possibly, in capital.

See notes to condensed consolidated financial statements.

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

Noninterest Income

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

	Three months ended September 30,		Nine months ended September 30,	
	2007	**2006**	**2007**	**2006**
Gain on sale of mortgage loans	$ 519,818	$ 506,710	$ 1,635,949	$ 1,445,891
Service fees on deposit accounts	486,508	451,211	1,394,945	1,225,798
Other income	258,234	274,975	850,577	752,430
Total noninterest income	**$ 1,264,560**	**$ 1,232,896**	**$ 3,881,471**	**$ 3,424,119**

Three months ended September 30, 2007 and 2006

Noninterest income in the three month period ended September 30, 2007 was $1.3 million an increase of 2.6% over noninterest income of $1.2 million in the same period of 2006.

Gain on the sales of mortgage loans consists primarily of fees from mortgage origination fees, mortgage administrative fees, and mortgage yield spread premium from secondary market. Total net gains were $519,818 and $506,710 for the three months ended September 30, 2007 and 2006, respectively. The $13,108 increase for the three months ended September 30, 2007 compared to the same period in 2006 related primarily to an increase of $9,814 in mortgage yield spread premium.

Service fees on deposits consist primarily of income from NSF fees and service charges on transaction accounts. Service fees on deposits were $486,508 and $451,211 for the three months ended September 30, 2007 and 2006, respectively. NSF income was $471,074 and $429,636 for the three months ended September 30, 2007 and 2006, respectively, representing 96.8% of total service fees on deposits in the 2007 period compared to 95.2% of total service fees on deposits in the 2006 period. In addition, service charges on deposit accounts decreased to $15,434 for the three months ended September 30, 2007 compared to $21,576 for the same period ended September 30, 2006. The lower service charges are a result of the bank introducing a totally free business checking product which offsets the service fees that would have been charged on these accounts.

Other income consisted primarily of fees received on cash value of life insurance and rental income. Other income was $258,234 and $274,975 for the three months ended September 30, 2007 and 2006, respectively.

Nine months ended September 30, 2007 and 2006

Noninterest income in the nine month period ended September 30, 2007 was $3.9 million, an increase of 13.4% over noninterest income of $3.4 million in the same period of 2006.

Gain on the sales of mortgage loans consists primarily of fees from mortgage origination fees, mortgage administrative fees, and mortgage yield spread premium from secondary market. Total net gains were $1.6 million and $1.4 million for the nine months ended September 30, 2007 and 2006, respectively. The $190,058 increase for the nine months ended September 30, 2007 compared to the same period in 2006 related primarily to an increase of $21,014 in mortgage yield spread premium, and a $172,235 decrease in mortgage yield spread related expenses. Mortgage application fees were $18,489 and $38,216 for the nine months ended September 30, 2007 and 2006, respectively.

Service fees on deposits consist primarily of income from NSF fees and service charges on transaction accounts. Service fees on deposits were $1.4 million and $1.2 million for the nine months ended September 30, 2007 and 2006, respectively. NSF income was $1.3 million and $1.2 million for the nine months ended September 30, 2007 and 2006, respectively, representing 95.9% of total service fees on deposits in the 2007 period compared to 94.5% of total service fees on deposits in the 2006 period. In addition, service charges on deposit accounts decreased to $57,387 for the nine months ended September 30, 2007 compared to $66,764 for the same period ended September 30, 2006. The lower service charges are a result of the bank introducing a totally free business checking product which offsets the service fees that would have been charged on these accounts.

<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation</u> - *<u>continued</u>*

Other income consisted primarily of fees received on cash value of life insurance and rental income. Other income was $850,577 and $752,430 for the nine months ended September 30, 2007 and 2006, respectively.

See notes to condensed consolidated financial statements.

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

Noninterest Expense

Three months ended September 30, 2007 and 2006

Total noninterest expense for the three months ended September 30, 2007 was $4.6 million, an increase of $600,216, or 14.9% over the three months ended September 30, 2006. The primary reason was the $321,467 increase in salaries and employee benefits over the two periods as we continued to hire employees to staff our new branch locations. In addition, occupancy expense increased $40,577, or 14.4%, for the three months ending September 30, 2007 as compared to the three months ending September 30, 2006. Other operating expenses increased $203,869 or 16.87% for the three months ended September 30, 2007. Income tax expense was $343,331 for the three months ended September 30, 2007 compared to $413,068 during the same period in 2006.

Nine months ended September 30, 2007 and 2006

Total noninterest expense for the nine months ended September 30, 2007 was $13.6 million, an increase of $1.7 million, or 14.1% over the nine months ended September 30, 2006. As was the case with the three months ended, the primary reason was the $1.1 million increase in salaries and employee benefits over the two periods as we continued to hire employees to staff our new branch locations. In addition, occupancy expense increased $134,881, or 16.0%, for the nine months ending September 30, 2007 as compared to the nine months ending September 30, 2006. Other operating expenses increased 11.0% to $406,011 for the nine months ended September 30, 2007. Income tax expense was $946,000 for the nine months ended September 30, 2007 compared to $995,414 during the same period in 2006. The increase related to the higher level of income before taxes.

Balance Sheet Review

General

At September 30, 2007, we had total assets of $524.8 million, consisting principally of $429.7 million in net loans, $36.3 million in investments, and $12.3 million in cash and due from banks. Our liabilities at September 30, 2007 totaled $488.4 million, which consisted principally of $440.8 million in deposits, $24.0 million in FHLB advances, $11.6 million in short-term borrowings, and $10.3 million in junior subordinated debentures. At September 30, 2007, our shareholders' equity was $36.4 million.

At December 31, 2006, we had total assets of $456.2 million, consisting principally of $349.5 million in net loans, $38.4 million in investments, $14.1 million in federal funds sold, and $17.3 million in cash and due from banks. Our liabilities at December 31, 2006 totaled $422.1 million, consisting principally of $372.9 million in deposits, $28.5 million in FHLB advances, $8.1 million in repurchase agreements, and $10.3 million of junior subordinated debentures. At December 31, 2006, our shareholders' equity was $34.1 million.

See notes to condensed consolidated financial statements.

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Investments

Contractual maturities and yields on our investments that are available for sale at September 30, 2007 are shown in the following table. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

Investment Securities Maturity Distribution and Yields

	September 30, 2007		
		Estimated Fair Value	Tax Equivalent Yield
Within One Year			
U.S. government agencies and corporations	$	-	-
Government sponsored enterprises		18,467	5.89
Municipals		-	-
Mortgage back securities		-	-
Total	**$**	**18,467**	**5.89%**
One to Five Years			
U.S. government agencies and corporations	$	-	-
Government sponsored enterprises		196,832	6.22
Municipals		1,098,162	5.37
Mortgage back securities		874,166	3.89
Total	**$**	**2,169,160**	**4.85%**
Five to Ten Years			
U.S. government agencies and corporations	$	-	-%
Government sponsored enterprises		-	-
Municipals		1,032,749	6.36
Mortgage back securities		909,784	3.69
Total	**$**	**1,942,533**	**5.11%**
Over Ten Years			
U.S. government agencies and corporations	$	-	-%
Government sponsored enterprises		-	-
Municipals		16,488,477	6.38
Mortgage back securities		13,190,724	5.02
Total	**$**	**29,679,201**	**5.77%**
Other	**$**	**292,000**	**-%**
Total	**$**	**34,101,361**	**5.67%**

See notes to condensed consolidated financial statements.

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

Investments - *continued*

The amortized costs and the fair value of our investments that are available for sale at September 30, 2007 and December 31, 2006 are shown in the following table.

	September 30, 2007		December 31, 2006	
	Amortized Cost (Book Value)	Estimated Fair Value	Amortized Cost (Book Value)	Estimated Fair Value
U.S. Government agencies and corporations	$ -	$ -	$ 380,315	$ 381,220
Government sponsored enterprises	212,878	215,299	4,990,352	4,950,313
Mortgage-backed securities	15,321,497	14,974,674	15,521,860	15,202,326
Municipal securities	18,657,585	18,619,388	14,805,485	15,085,907
Other	218,750	292,000	218,750	311,505
	$ 34,410,710	**$ 34,101,361**	**$ 35,916,762**	**$ 35,931,271**

At September 30, 2007, we had $34.1 million in our investment securities portfolio which represented approximately 6.5% of our total assets. We held U.S. Government agency securities, municipal securities, mortgage-backed securities, and other with a fair value of $34.1 million and an amortized cost of $34.4 million for an unrealized loss of $309,349. We believe, based on industry analyst reports and credit ratings that the deterioration in value is attributed to changes in market interest rates and not in the credit quality of the issuer and therefore, these losses are not considered other-than-temporary. We have the ability and intent to hold these securities until such time as the value recovers or the securities mature.

Loans

Since loans typically provide higher interest yields than other types of interest earning assets, a substantial percentage of our earning assets are invested in our loan portfolio. For the nine months ended September 30, 2007 and 2006, average loans were $398.0 million and $342.6 million, respectively. Before the allowance for loan losses, total loans outstanding at September 30, 2007 were $434.4 million. Average loans for the year ended December 31, 2006 were $348.7 million. Before the allowance for loan losses, total loans outstanding at December 31, 2006 were $353.5 million.

The following table summarizes the composition of our loan portfolio September 30, 2007 and December 31, 2006.

	September 30, 2007	% of Total	December 31, 2006	% of Total
Mortgage loans on real estate				
Residential 1-4 family	$ 66,523,174	15.31	$ 50,844,955	14.38
Multifamily	11,374,735	2.62	7,826,863	2.21
Commercial	173,867,067	40.03	127,213,968	35.99
Construction	60,950,260	14.03	64,118,098	18.14
Second mortgages	4,234,558	0.97	4,513,048	1.28
Equity lines of credit	36,144,205	8.32	27,853,374	7.88
Total mortgage loans	353,093,999	81.28	282,370,306	79.88
Commercial and industrial	61,720,600	14.21	51,710,250	14.63
Consumer	11,534,703	2.66	12,728,353	3.60

Other, net		8,040,017	1.85		6,682,127	1.89
Total loans	**$**	**434,389,319**	**100.00**	**$**	**353,491,036**	**100.00**

See notes to condensed consolidated financial statements.

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

Maturities and Sensitivity of Loans to Changes in Interest Rates

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

The following table summarizes the loan maturity distribution by type and related interest rate characteristics at September 30, 2007.

September 30, 2007	**One Year or Less**	**Over One Year Through Five Years**	**Over Five Years**	**Total**
(Dollars in thousands)				
Commercial and industrial	$ 31,256	$ 28,799	$ 1,666	$ 61,721
Real estate	139,637	172,779	40,678	353,094
Consumer and other	7,918	11,408	248	19,574
	$ 178,811	**$ 212,986**	**$ 42,592**	**$ 434,389**
Loans maturing after one year with:				
Fixed interest rates				$ 139,009
Floating interest rates				116,566
				$ 255,575

Provision and Allowance for Loan Losses

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

See notes to condensed consolidated financial statements.

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

Provision and Allowance for Loan Losses - *(continued)*

The following table summarizes the activity related to our allowance for loan losses for the nine months ended September 30, 2007 and 2006:

Risk Elements in the Loan Portfolio

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

	September 30, 2007	December 31, 2006
Loans		
Nonaccrual loans	$ 765,321	$ 670,650
Accruing loans more than 90 days past due	548,052	463,991

Activity in the Allowance for Loan Losses is as follows:

	September 30, 2007	2006
Balance, January 1,	$ 4,001,881	$ 3,419,368
Provision for loan losses for the period	869,397	1,167,991
Net loans (charged-off) recovered for the period	(134,957)	(626,354)
Balance, end of period	**$ 4,736,321**	**$ 3,961,005**
Total loans outstanding, end of period	**$ 434,389,319**	**$ 360,080,594**
Allowance for loan losses to loans outstanding	1.09%	1.10%

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

The allowance for loan losses was $4.7 million and $4.0 million at September 30, 2007 and September 30, 2006, respectively, or 1.09% and 1.10% of outstanding loans, respectively. During the nine months ended September 30, 2007 and 2006, we had net charged off loans of $134,957 and $626,354, respectively.

At September 30, 2007 and December 31, 2006, nonaccrual loans represented 0.18% and 0.19% of net loans, respectively. At September 30, 2007 and December 31, 2006, we had $765,321 and $670,650 of loans, respectively, on nonaccrual status. Generally, a loan is placed on nonaccrual status when it becomes 90 days past due as to principal or interest, or when we believe, after considering economic and business conditions and collection efforts, that the borrower's financial condition is such that collection of the loan is doubtful. A payment of interest on a loan that is classified as nonaccrual is recognized as income when received.

Deposits and Other Interest-Bearing Liabilities

Our primary source of funds for loans and investments is our deposits, advances from the FHLB, and short-term repurchase agreements. Through successful marketing campaigns and branch expansion, we have been able to increase our deposits in our local markets. Sometimes it's necessary to obtain a portion of our certificates of deposits from areas outside of our market. The deposits obtained outside of our market area generally have comparable rates compared to rates being offered for certificates of deposits in our local market. We also utilize out-of-market deposits in certain instances to obtain longer-term deposits than are readily available in our local market. We anticipate that the amount of out-of-market deposits will continue to decline as our new retail deposit offices become established. The amount of out-of-market deposits was $74.8 million at September 30, 2007 and $45.4 million at December 31, 2006.

See notes to condensed consolidated financial statements.

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We anticipate being able to either renew or replace these out-of-market deposits when they mature, although we may not be able to replace them with deposits with the same terms or rates. Our loan-to-deposit ratio was 98.5% and 94.8% at September 30, 2007 and December 31, 2006, respectively.

See notes to condensed consolidated financial statements.

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

Deposits and Other Interest-Bearing Liabilities - *continued*

The following table shows the average balance amounts and the average rates paid on deposits held by us for the nine months ended September 30, 2007 and 2006.

	2007		2006	
(Dollars in thousands)	**Average Amount**	**Average Rate**	**Average Amount**	**Average Rate**
Noninterest bearing demand deposits	$ 45,506	%	$ 44,144	-%
Interest bearing demand deposits	33,632	1.73	26,727	0.72
Savings accounts	78,855	4.03	86,693	3.69
Time deposits	248,885	5.09	199,928	4.29
	$ 406,878	**4.04%**	**$ 357,492**	**3.35%**

The increase in time deposits for the nine months ended September 30, 2007 resulted from an increase in retail time deposits, which was offset by a decrease in wholesale deposits. A significant portion of the increase in retail time deposits is attributed to successful pricing and marketing promotions.

All of our time deposits are certificates of deposits. The maturity distribution of our time deposits of $100,000 or more at September 30, 2007 (in thousands) was as follows:

	September 30, 2007
Three months or less	$ 27,612
Over three through twelve months	113,768
Over one year through three years	7,463
Over three years	1,225
Total	**$ 150,068**

Capital Resources

Total shareholders' equity at September 30, 2007 was $36.4 million. At December 31, 2006, total shareholders' equity was $34.1 million. The increase during the first nine months of 2007 resulted primarily from the $2.2 million of net income earned.

The following table shows the return on average assets (net income divided by average total assets), return on average equity (net income divided by average equity), and equity to assets ratio (average equity divided by average total assets) for the nine months ended September 30, 2007 and the year ended December 31, 2006. Since our inception, we have not paid cash dividends.

	September 30, 2007	**September 30, 2006**
Return on average assets	0.61%	0.71%
Return on average equity	8.32%	9.74%
Average equity to average assets ratio	7.32%	7.31%

Our return on average assets was 0.61% for the nine months ended September 30, 2007, a decrease from 0.71% for the nine months ended September 30, 2006. In addition, our return on average equity decreased to 8.32% from 9.74% for the nine months ended September 30, 2007 and the nine months ended September 30, 2006, respectively.

See notes to condensed consolidated financial statements.

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

Capital Resources - *continued*

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

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

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

The following table sets forth the holding company's and the bank's various capital ratios at September 30, 2007 and at December 31, 2006. For all periods, the bank was considered "well capitalized" and the holding company met or exceeded its applicable regulatory capital requirements.

	September 30, 2007		December 31, 2006	
	Holding Company	Bank	Holding Company	Bank
Tier 1 capital (to risk-weighted assets)	10.13%	9.74%	11.42%	10.84%
Total capital (to risk-weighted assets)	11.15%	10.76%	12.45%	11.86%
Leverage or Tier 1 capital (to total average assets)	9.24%	8.89%	9.90%	9.45%

Borrowings

The following table outlines our various sources of borrowed funds during the nine months ended September 30, 2007 and the year ended December 31, 2006, the amounts outstanding at the end of each period, at the maximum point for each component during the periods and on average for each period, and the average interest rate that we paid for each borrowing source. The maximum month-end balance represents the high indebtedness for each component of borrowed funds at any time during each of the periods shown.

(Dollars in thousands) At or for the nine months ended September 30, 2007	Ending Balance	Period-End Rate	Maximum Month-end Balance	Average for the Period Balance	Average for the Period Rate
Federal Home Loan Bank advances	$ 24,000	3.37%	$ 26,000	$ 17,843	4.53%

Securities sold under agreement to repurchase	8,568	4.89	11,651	9,470	4.43
Federal funds purchased	3,000	1.06	3,000	663	4.80
Junior subordinated debentures	10,310	6.01	10,310	10,310	6.02

See notes to condensed consolidated financial statements.

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Borrowings - *continued*

(Dollars in thousands) At or for the year ended December 31, 2006	Ending Balance	Period-End Rate	Maximum Month-end Balance	Average for the Period Balance	Average for the Period Rate
Federal Home Loan Bank advances	$ 28,500	3.81%	$ 29,800	$ 21,028	4.24%
Securities sold under agreement to repurchase	8,120	6.02	8,190	6,065	4.27
Federal funds purchased	-	-	-	-	-
Junior subordinated debentures	10,310	5.93	10,310	10,310	5.99

Effect of Inflation and Changing Prices

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

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

Off-Balance Sheet Risk

Through our operations, we have made contractual commitments to extend credit in the ordinary course of our business activities. These commitments are legally binding agreements to lend money to our customers at predetermined interest rates for a specified period of time. At September 30, 2007, we had issued commitments to extend credit of $79.2 million and standby letters of credit of $1.4 million through various types of commercial lending arrangements. Approximately $63.9 million of these commitments to extend credit had variable rates.

The following table sets forth the length of time until maturity for unused commitments to extend credit and standby letters of credit at September 30, 2007.

(Dollars in thousands)	Within One Month	After One Through Three Months	After Three Through Twelve Months	Within One Year	Greater Than One Year	Total
Unused commitments to extend credit	$ 6,541	$ 5,538	$ 31,976	$ 44,055	$ 35,109	$ 79,164
Standby letters of credit	255	106	577	938	419	1,357
Total	**$ 6,796**	**$ 5,644**	**$ 32,553**	**$ 44,993**	**$ 35,528**	**$ 80,521**

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

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Market Risk

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

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

We were asset sensitive during most of the year ended December 31, 2006 and during the nine months ended September 30, 2007. As of September 30, 2007, we expect to be asset sensitive for the next three months. Approximately 59.1% of our loans were variable rate loans at September 30, 2007. The ratio of cumulative gap to total earning assets after 12 months was 7.5% because $35.9 million more assets will reprice in a 12 month period than liabilities. However, our gap analysis is not a precise indicator of our interest sensitivity position. The analysis presents only a static view of the timing of maturities and repricing opportunities, without taking into consideration that changes in interest rates do not affect all assets and liabilities equally. For example, rates paid on a substantial portion of core deposits may change contractually within a relatively short time frame, but those rates are viewed by us as significantly less interest-sensitive than market-based rates such as those paid on noncore deposits. Net interest income may be affected by other significant factors in a given interest rate environment, including changes in the volume and mix of interest-earning assets and interest-bearing liabilities.

Liquidity and Interest Rate Sensitivity

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

At September 30, 2007, our liquid assets, consisting of cash and due from banks and federal funds sold, amounted to $12.3 million, or 2.4% of total assets. Our investment securities at September 30, 2007 amounted to $36.3 million, or 6.9% of total assets. Investment securities traditionally provide a secondary source of liquidity since they can be converted into cash in a timely manner. However, $8.6 million of these securities are pledged against repurchase agreements, other required deposit accounts, and unused FHLB borrowing lines. At December 31, 2006, our liquid assets amounted to $31.5 million, or 6.9% of total assets. Our investment securities at December 31, 2006 amounted to $38.4 million, or 8.4% of total assets. However, $8.1 million of these securities were pledged.

See notes to condensed consolidated financial statements.

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

Liquidity and Interest Rate Sensitivity - *continued*

Our ability to maintain and expand our deposit base and borrowing capabilities serves as our primary source of liquidity. We plan to meet our future cash needs through the liquidation of temporary investments, the generation of deposits, and from additional borrowings. In addition, we will receive cash upon the maturity and sale of loans and the maturity of investment securities. During most of 2006 and the first nine months of 2007, as a result of historically low rates that were being earned on short-term liquidity investments, we chose to maintain a lower than normal level of short-term liquidity securities. In addition, we maintain nine federal funds purchased lines of credit with correspondent banks giving us credit availability totaling $32.5 million. There were 3 million in borrowings against the lines at September 30, 2007. We are also a member of the Federal Home Loan Bank of Atlanta, from which applications for borrowings can be made for leverage purposes. The FHLB requires that securities, qualifying mortgage loans, and stock of the FHLB owned by the bank be pledged to secure any advances from the FHLB. The Company has an available line to borrow funds from the Federal Home Loan Bank up to 30% of the Bank’s total assets which provide additional available funds of $157.4 million at September 30, 2007. At September 30, 2007 the bank had $24.0 million outstanding in FHLB advances. We believe that these funds will be sufficient to meet our future liquidity needs.

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

The following table sets forth information regarding our rate sensitivity as of September 30, 2007 for each of the time intervals indicated. The information in the table may not be indicative of our rate sensitivity position at other points in time. In addition, the maturity distribution indicated in the table may differ from the contractual maturities of the earning assets and interest-bearing liabilities presented due to consideration of prepayment speeds under various interest rate change scenarios in the application of the interest rate sensitivity methods described above.

Interest Sensitivity Analysis
September 30, 2007

(Dollars in thousands)	**Within One Month**	**After One Through Three Months**	**Three Through Twelve Months**	**Within One Year**	**Greater Than One Year or Non-Sensitive**	**Total**
Assets						
Interest-earning assets						
Loans	$ 264,630	$ 4,293	$ 20,787	$ 289,710	$ 144,679	$ 434,389
Loans held for sale	-	-	-	-	9,008	9,008
Securities, taxable	454	338	1,485	2,277	13,205	15,482
Securities, nontaxable	-	-	972	972	17,647	18,619
Nonmarketable securities	1,905	-	-	1,905	-	1,905
Federal funds sold	-	-	-	-	-	-
Investment in trust	-	-	-	-	310	310

Total earning assets	266,989	4,631	23,244	294,864	184,849	479,713

See notes to condensed consolidated financial statements.

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

Liquidity and Interest Rate Sensitivity - *(continued)*

Interest Sensitivity Analysis
September 30, 2007

(Dollars in thousands)	Within One Month	After One Through Three Months	Three Through Twelve Months	Within One Year	Greater Than One Year or Non-Sensitive	Total
Liabilities						
Interest-bearing liabilities						
Interest-bearing deposits:						
Demand deposits	53,403	-	-	53,403	-	53,403
Savings deposits	82,138	-	-	82,138	-	82,138
Time deposits	21,651	52,520	177,046	251,217	11,151	262,368
Total interest-bearing deposits	157,192	52,520	177,046	386,758	11,151	397,909
Federal Home Loan Bank Advances	6,500	4,500	7,000	18,000	6,000	24,000
Junior sub debentures	-	-	-	-	10,310	10,310
Federal funds purchased and other	11,568	-	-	11,568	-	11,568
Total interest-bearing Liabilities	175,260	57,020	184,046	416,326	27,461	443,787
Period gap	**$ 91,729**	**$ (52,389)**	**$ (160,802)**	**$ (121,462)**	**$ 157,388**	
Cumulative gap	**$ 91,729**	**$ 39,340**	**$ (121,462)**	**$ (121,462)**	**$ 35,926**	
Ratio of cumulative gap to total earning assets	19.12%	8.20%	(25.32)%	(25.32)%	7.49%	

See notes to condensed consolidated financial statements.

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

Liquidity and Interest Rate Sensitivity - *(continued)*

The following table sets forth information regarding our rate sensitivity, as of December 31, 2006, at each of the time intervals.

December 31, 2006	Within One Month	After One Through Three Months	After Three Through Twelve Months	Within One Year	Greater Than One Year or Non-Sensitive	Total
(Dollars in thousands)						
Assets						
Interest-earning assets						
Loans, including held for sale	$ 229,803	$ 4,381	$ 16,493	$ 250,677	$ 109,446	$ 360,123
Securities, taxable	539	314	1,336	2,189	18,656	20,845
Securities, nontaxable	-	-	-	-	15,086	15,086
Nonmarketable securities	2,188	-	-	2,188	-	2,188
Investment in trust	-	-	-	-	310	310
Federal funds sold	14,135	-	-	14,135	-	14,135
Total earning assets	246,665	4,695	17,829	269,189	143,498	412,687
Liabilities						
Interest-bearing liabilities:						
Interest-bearing deposits:						
Demand deposits	33,243	-	-	33,243	-	33,243
Savings deposits	78,832	-	-	78,832	-	78,832
Time deposits	16,565	53,523	124,049	194,137	24,619	218,756
Total interest-bearing deposits	128,640	53,523	124,049	306,212	24,619	330,831
Advances from Federal Home Loan Bank	10,500	9,000	8,000	27,500	1,000	28,500
Junior subordinated debentures	-	-	-	-	10,310	10,310
Repurchase agreements	8,120	-	-	8,120	-	8,120
Total interest-bearing liabilities	147,260	62,523	132,049	341,832	35,929	377,761
Period gap	**$ 99,405**	**$ (57,828)**	**$ (114,220)**	**$ (72,643)**	**$ 107,569**	
Cumulative gap	**$ 99,405**	**$ 41,577**	**$ (72,643)**	**$ (72,643)**	**$ 34,926**	
Ratio of cumulative gap to total earning assets	24.09%	10.07%	(17.60%)	(17.60%)	8.46%	

See notes to condensed consolidated financial statements.