

GrandSouth Bancorporation and Subsidiary

Report on Consolidated Financial Statements

For the years ended December 31, 2016 and 2015

GrandSouth Bancorporation and Subsidiary

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Independent Auditor's Report

To the Board of Directors and Shareholders
GrandSouth Bancorporation
Greenville, South Carolina

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of GrandSouth Bancorporation and its Subsidiary which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for the years then ended and the related notes to the consolidated financial statements collectively, the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of GrandSouth Bancorporation and its Subsidiary as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Greenville, South Carolina
March 30, 2017

Elliott Davis Decosimo, LLC

Grandsouth Bancorporation and Subsidiary

Consolidated Balance Sheets

As of December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)	
Assets		
Cash and due from banks	\$ 34,923	\$ 11,695
Interest bearing transaction accounts with other banks	3,086	456
Federal funds sold	5,309	3,701
Cash and cash equivalents	43,318	15,852
Certificates of deposit with other banks	2,500	2,000
Securities available-for-sale	25,543	14,885
Other investments, at cost	1,319	1,276
Loans, net of allowance for loan losses of \$5,158 for 2016 and \$4,315 for 2015	413,633	365,035
Premises and equipment, net	10,211	8,814
Bank owned life insurance	6,390	6,226
Assets acquired in settlement of loans	4,902	5,275
Interest receivable	3,755	3,133
Deferred income taxes	1,530	1,274
Goodwill	737	737
Other assets	1,676	1,983
Total assets	<u>\$ 515,514</u>	<u>\$ 426,490</u>
Liabilities and Shareholders' Equity		
Deposits		
Noninterest bearing	\$ 69,878	\$ 45,515
Interest bearing	360,449	304,746
Total deposits	430,327	350,261
Federal Home Loan Bank advances	22,000	22,000
Junior subordinated debentures	8,247	8,247
Interest payable	111	98
Other liabilities	4,140	3,138
Total liabilities	464,825	383,744
Commitments and Contingencies - Notes 11 and 14		
Shareholders' equity		
Preferred stock - Series A - no par value; shares issued and outstanding - 287,895	1,298	1,298
Preferred stock - Series T-3 - \$1,000 per share liquidation preference; shares issued and outstanding - 0 for 2016 and 3,922 for 2015	-	3,895
Common stock - no par value; 20,000,000 shares authorized; shares issued and outstanding - 4,483,990 for 2016 and 3,522,645 for 2015	32,058	20,996
Retained earnings	17,528	16,310
Accumulated other comprehensive income (loss)	(195)	247
Total shareholders' equity	50,689	42,746
Total liabilities and shareholders' equity	<u>\$ 515,514</u>	<u>\$ 426,490</u>

See Notes to Consolidated Financial Statements

Grandsouth Bancorporation and Subsidiary**Consolidated Statements of Income****For the years ended December 31, 2016 and 2015**

	<u>2016</u>	<u>2015</u>
	(Dollars in thousands, except per share)	
Interest income		
Interest and fees on loans	\$ 29,109	\$ 26,082
Investment securities:		
Taxable	371	399
Nontaxable	242	320
Dividends	42	54
Other	178	68
Total interest income	<u>29,942</u>	<u>26,923</u>
Interest expense		
Deposits	2,174	1,670
Federal Home Loan Bank advances	134	183
Junior subordinated debt	213	179
Total interest expense	<u>2,521</u>	<u>2,032</u>
Net interest income	27,421	24,891
Provision for loan losses	3,269	1,100
Net interest income after provision for loan losses	<u>24,152</u>	<u>23,791</u>
Noninterest income		
Service charges on deposit accounts	441	283
Gain on sale of securities	120	23
Net gain on sale of premises and equipment	11	103
Increase in value of life insurance assets	164	130
Other	272	148
Total noninterest income	<u>1,008</u>	<u>687</u>
Noninterest expenses		
Salaries and employee benefits	12,905	9,855
Premises and equipment	1,441	966
(Gain) loss on sale and impairment of assets acquired in settlement of loans	(325)	228
Data processing	1,014	726
Insurance	438	444
Printing, postage and supplies	423	239
Professional fees	1,528	658
Miscellaneous loan expense	1,599	1,208
Other operating	1,078	837
Total noninterest expenses	<u>20,101</u>	<u>15,161</u>
Income before income taxes	5,059	9,317
Income tax provision	1,875	3,306
Net income	3,184	6,011
Deductions for amounts not available to common shareholders:		
Dividends declared or accumulated on preferred stock	(121)	(146)
Net income available to common shareholders	<u>\$ 3,063</u>	<u>\$ 5,865</u>
Per common share		
Net income, basic	\$ 0.69	\$ 1.73
Net income, assuming dilution	\$ 0.66	\$ 1.56

See Notes to Consolidated Financial Statements

Grandsouth Bancorporation and Subsidiary**Consolidated Statements of Comprehensive Income****For the years ended December 31, 2016 and 2015**

	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)	
Net income	\$ 3,184	\$ 6,011
Other comprehensive loss		
Change in unrealized gain (loss) on securities available for sale		
Unrealized holding loss arising during the period	(571)	(181)
Tax expense	208	62
Reclassification of realized gain	(120)	(23)
Tax expense	41	8
Other comprehensive loss	<u>(442)</u>	<u>(134)</u>
Comprehensive income	<u>\$ 2,742</u>	<u>\$ 5,877</u>

See Notes to Consolidated Financial Statements

Grandsouth Bancorporation and Subsidiary
Consolidated Statements of Changes in Shareholders' Equity
For the years ended December 31, 2016 and 2015

	Shares of common stock	Common stock	Preferred stock	Retained earnings	Accumulated other comprehensive income (loss)	Total
	(Dollars in thousands)					
Balance, December 31, 2014	3,325,481	\$ 19,470	\$ 9,193	\$ 11,338	\$ 381	\$ 40,382
Net income	-	-	-	6,011	-	6,011
Other comprehensive loss	-	-	-	-	(134)	(134)
Dividends on preferred stock	-	-	-	(146)	-	(146)
Dividends on common stock	-	-	-	(887)	-	(887)
Redemption of series T-3 preferred stock	-	-	(4,000)	(6)	-	(4,006)
Exercise of stock options	197,164	1,296	-	-	-	1,296
Share-based compensation	-	230	-	-	-	230
Balance, December 31, 2015	3,522,645	\$ 20,996	\$ 5,193	\$ 16,310	\$ 247	\$ 42,746
Net income	-	-	-	3,184	-	3,184
Other comprehensive loss	-	-	-	-	(442)	(442)
Dividends on preferred stock	-	-	-	(121)	-	(121)
Dividends on common stock	-	-	-	(1,815)	-	(1,815)
Redemption of series T-3 preferred stock	-	-	(3,895)	(30)	-	(3,925)
Issuances of common stock	1,000,000	11,439	-	-	-	11,439
Redemption of common stock	(75,585)	(1,000)	-	-	-	(1,000)
Exercise of stock options	36,930	194	-	-	-	194
Share-based compensation	-	429	-	-	-	429
Balance, December 31, 2016	4,483,990	\$ 32,058	\$ 1,298	\$ 17,528	\$ (195)	\$ 50,689

See Notes to Consolidated Financial Statements

Grandsouth Bancorporation and Subsidiary

Consolidated Statements of Cash Flows

For the years ended December 31, 2016 and 2015

	2016	2015
	(Dollars in thousands)	
Operating activities		
Net income	\$ 3,184	\$ 6,011
Adjustments to reconcile net income to net cash provided by operating activities		
Provision for loan losses	3,269	1,100
Writedowns of assets acquired in settlement of loans	245	116
Depreciation	600	435
Securities accretion and premium amortization, net	62	(12)
Gain on sale and call of available-for-sale securities	(120)	(23)
Gain on sale or other disposition of premises and equipment	(11)	(103)
Loss (gain) on sale of assets acquired in settlement of loans	(570)	112
Increase in cash surrender value of bank owned life insurance	(164)	(129)
Deferred income tax expense (benefit)	(7)	55
Increase in interest receivable	(622)	(218)
Increase in interest payable	13	16
Increase (decrease) in other assets	307	(316)
Increase (decrease) in other liabilities	1,013	(42)
Share-based compensation expense	429	230
Net cash provided by operating activities	<u>7,628</u>	<u>7,232</u>
Investing activities		
Purchases of available-for-sale securities	(27,531)	-
Purchases of certificates of deposit	(1,000)	-
Maturities and calls of available-for-sale securities	12,751	12,984
Paydowns of available-for-sale mortgage-backed securities	1,523	1,488
Proceeds from sale of available-for-sale securities	1,966	-
Proceeds from sale of certificates of deposit	500	250
Purchase of other investments	(1,254)	(395)
Proceeds of redemptions of other investments	1,211	460
Net (increase) decrease in loans made to customers	(52,349)	(63,090)
Purchases of premises and equipment and construction in progress	(2,029)	(2,102)
Proceeds from sale of premises and equipment	43	176
Proceeds from sale of assets acquired in settlement of loans	1,169	2,474
Net cash used for investing activities	<u>(65,000)</u>	<u>(47,755)</u>
Financing activities		
Net increase in deposits	80,066	44,676
Proceeds from Federal Home Loan Bank advances	28,500	20,000
Repayment of Federal Home Loan Bank advances	(28,500)	(20,000)
Proceeds from issuances of common stock	11,439	-
Cash dividends paid on preferred stock	(121)	(146)
Cash dividends paid on common stock	(1,815)	(887)
Redemption of series T-3 preferred stock	(3,925)	(4,006)
Redemption of common stock	(1,000)	-
Exercise of stock options	194	1,296
Net cash provided by financing activities	<u>84,838</u>	<u>40,933</u>
Increase in cash and cash equivalents	27,466	410
Cash and cash equivalents, beginning	15,852	15,442
Cash and cash equivalents, ending	<u>\$ 43,318</u>	<u>\$ 15,852</u>
Supplemental disclosure of cash flow information		
Cash paid during the period for:		
Interest	\$ 2,508	\$ 2,016
Income taxes	1,892	3,096
Noncash investing and financing activities:		
Transfer of loans to assets acquired in settlement of loans	483	412
Change in unrealized gain or loss on available for sale securities	(571)	(181)
Charge offs of loans	(2,821)	(1,949)

See Notes to Consolidated Financial Statements

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 1. Organization and Significant Accounting Policies

GrandSouth Bancorporation (the “Company”) is a South Carolina corporation organized in 2000 for the purpose of being a holding company for GrandSouth Bank (the “Bank”). On October 2, 2000, pursuant to a Plan of Exchange approved by the shareholders, all of the outstanding shares of \$2.50 par value common stock of the Bank were exchanged for shares of no par value common stock of the Company. The Company presently engages in no business other than that of owning the Bank, has no employees, and operates as one business segment. The Company is regulated by the Federal Reserve Board. The consolidated financial statements include the accounts of the Company and the Bank. All significant intercompany transactions and accounts have been eliminated in consolidation. The GrandSouth Capital Trust 1 (see Note 10) is an unconsolidated subsidiary.

The Bank was incorporated in 1998 and operates as a South Carolina chartered bank providing full banking services to its customers. The Bank is subject to regulation by the South Carolina State Board of Financial Institutions and the Federal Deposit Insurance Corporation (“FDIC”).

Basis of presentation:

The accounting and reporting policies conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The Company uses the accrual basis of accounting. In certain instances, amounts reported in prior years’ consolidated financial statements have been reclassified to conform to the current presentation. Such reclassifications had no effect on previously reported shareholders’ equity or net income.

Estimates:

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amounts of income and expenses during the reporting periods. Actual results could differ from those estimates.

Concentrations of credit risk:

The Company makes loans to individuals and small businesses for various personal and commercial purposes primarily in the upstate region of South Carolina. The Company’s loan portfolio is not concentrated in loans to any single borrower or in a relatively small number of borrowers; however, 60% of the loan portfolio is secured by real estate. The market risk associated with declining real estate values exposes the Company to potential losses in the event of borrower default. An additional 19% of the Company’s loan portfolio is collateralized by automobiles; this concentration is somewhat mitigated by low per-borrower exposure and by the geographical diversity of the borrowers. Management is not aware of any other concentrations of loans to classes of borrowers or industries.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 1. Organization and Significant Accounting Policies, Continued

Concentrations of credit risk, continued:

In addition to monitoring potential concentrations of loans to particular borrowers or groups of borrowers, industries and geographic regions, management monitors exposure to credit risks that could arise from potential concentrations of lending products and practices such as loans that subject borrowers to substantial payment increases (e.g., principal deferral periods, loans with initial interest-only periods, etc.), and loans with high loan-to-value ratios. Additionally, there are industry practices that could subject the Company to increased credit risk should economic conditions change over the course of a loan's life. For example, the Company makes variable rate loans and fixed rate principal-amortizing loans with maturities prior to the loan being fully paid (i.e., balloon payment loans). These loans are underwritten and monitored to manage the associated risks. Management has determined that there is no concentration of credit risk associated with its lending policies or practices.

The Company's investment portfolio consists principally of obligations of the United States of America, government-sponsored entities and general obligation municipal securities. In the opinion of management, there is no concentration of credit risk in its investment portfolio. The Company places its deposits and correspondent accounts with and sells its federal funds to high quality institutions. Management believes credit risk associated with correspondent accounts is not significant.

Investment securities:

The Bank's investments in equity and debt securities are classified into one of three categories:

1. Available-for-sale: Securities that are not classified as either held-to-maturity or as trading securities and are reported at fair value, which is determined using quoted market prices. Unrealized gains and losses are reported, net of income taxes, as separate components of shareholders' equity (accumulated other comprehensive income). Gains or losses on dispositions of securities are based on the difference between the net proceeds and the adjusted carrying amounts of the securities sold using the specific identification method. Premiums and discounts are amortized into interest income by a method that approximates a level yield.
2. Held-to-maturity: Securities that the Company has the ability and intent to hold until maturity. These securities are stated at cost, adjusted for the amortization of premiums and the accretion of discounts. Premiums and discounts are included in interest income using a method that approximates a level yield. The Company has no held-to-maturity securities.
3. Trading: Securities that are bought and held principally for the purpose of selling in the near future. Trading securities are reported at fair value, and related unrealized gains and losses are recognized in the income statement. The Company has no trading securities.

Securities are evaluated for other-than-temporary impairment on a quarterly basis or more often if a potential loss-triggering event occurs. Impairment is considered to be other-than-temporary if it is more likely than not that a security will mature or be sold before its amortized cost can be recovered. In determining if there is evidence of credit deterioration, various factors are considered, including the severity of decline in market value below cost, the period of time over which the decline in fair value has existed, and the financial condition and near-term prospects of the issuer, including any specific events that may influence the operations of the issuer.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 1. Organization and Significant Accounting Policies, Continued

Investment securities, continued:

Investment securities are considered to be other-than-temporarily impaired if it is probable that the issuer will be unable to make contractual payments as required or if management believes that the security's value will not recover within the estimated recovery period. For debt securities, management also considers the causes of the decline in value including changes in the general level of interest rates, as well as industry and issuer-specific factors, the issuer's financial condition, its near-term prospects and current ability to make future payments in a timely manner, changes in rating agencies' ratings at the evaluation date as compared with such ratings at the date of acquisition, and any likely action by such agencies. In addition, for asset-backed securities, the credit performance of the underlying collateral, including delinquency rates, cumulative losses to date, and any remaining credit enhancements is compared with expected credit losses. Other-than-temporary impairments related to credit issues are recognized through earnings.

Other investments:

Other investments include the Bank's investment in the Federal Home Loan Bank of Atlanta ("FHLB") in which, as a member institution, the Bank is required to own stock. The stock is generally pledged against any borrowings from the FHLB. No ready market exists for the stock and it has no quoted market value. However, redemption of the stock historically has been at par value.

Loans and interest income on loans:

Loans are stated at the principal balance outstanding, increased or reduced by deferred net loan costs or fees. The allowance for loan losses is deducted from total loans in the consolidated balance sheets. Loan origination and commitment fees and certain direct loan origination costs (principally salaries and employee benefits) are deferred and amortized as an adjustment of the related loan's yield. Generally, these amounts are amortized over the contractual life of the related loans or commitments. Interest income is recognized on an accrual basis over the term of the loan based on the principal amount outstanding.

Loans are generally placed on nonaccrual status when principal or interest becomes ninety days past due, or when payment in full is not anticipated. When a loan is placed on nonaccrual status, interest accrued but not received is generally reversed against interest income. If collectability is in doubt, cash receipts on nonaccrual loans are not recorded as interest income, but are used to reduce principal. Loans are not returned to accrual status until the borrower demonstrates the ability to pay principal and interest.

Allowance for loan losses:

The provision for loan losses charged to operating expense reflects the amount deemed appropriate by management to establish an adequate allowance to meet the present estimated loss characteristics of the current loan portfolio. Management's estimate is based on periodic and regular evaluation of individual loans, the overall risk characteristics of the various portfolio segments, past experience with losses, and prevailing and anticipated economic conditions. Loans that are determined to be uncollectible are charged against the allowance. The provision for loan losses and recoveries on loans previously charged off are added to the allowance.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 1. Organization and Significant Accounting Policies, Continued

Allowance for loan losses, continued:

The Company accounts for impaired loans at the loan's fair value if it is probable that the lender will be unable to collect all amounts due in accordance with the terms of the loan agreement. Fair value may be determined based upon the present value of expected cash flows, market price of the loan, if available, or value of the underlying collateral. Expected cash flows are required to be discounted at the loan's effective interest rate.

When the ultimate collectability of an impaired loan's principal is in doubt, wholly or partially, all cash receipts are applied to principal. Once the reported principal balance has been reduced to zero, future cash receipts are applied to interest income to the extent that any interest has been foregone. Further cash receipts are recoveries of any amounts previously charged off.

The Company designates loan modifications as troubled debt restructurings ("TDRs") when, for economic or legal reasons related to the borrower's financial difficulties, a concession is granted to the borrower that would not otherwise be considered. Once a loan is classified as a TDR, it is also classified as an impaired loan. If a loan demonstrated performance under the previous terms and shows capacity to continue performing under the restructured terms, the loan will remain on accrual status. If the loan does not perform under the modified terms, the loan is placed on nonaccrual status. However, if a loan is materially delinquent on payments prior to the restructuring, but shows capacity to perform under the modified terms, the loan will be placed on nonaccrual status.

A loan currently on nonaccrual status will return to accrual status when there is economic substance to the restructuring, any portion of the debt not expected to be repaid has been charged off, the remaining note is reasonably assured of repayment in accordance with its modified terms, and the borrower has demonstrated sustained repayment performance in accordance with the modified terms for a reasonable period of time (typically six months).

Premises and equipment:

Premises and equipment are stated at cost, less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets. Maintenance and repairs are charged to operations while major improvements are capitalized. Upon retirement, sale or other disposition of premises and equipment, the cost and accumulated depreciation are eliminated from the accounts and any gain or loss is included in income from operations.

Bank owned life insurance:

The Company has entered into arrangements that provide for deferred compensation for certain officers. Bank owned life insurance policies provide an informal and indirect method for funding those arrangements. The amounts recorded as bank owned life insurance in the consolidated balance sheets represent the cash surrender value of the policies. The deferred compensation liability is included in other liabilities at the present value of the obligation.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 1. Organization and Significant Accounting Policies, Continued

Assets acquired in settlement of loans:

Assets acquired in settlement of loans include real estate acquired through foreclosure or deed taken in lieu of foreclosure and repossessed assets. These assets are recorded at fair value, less estimated costs to sell, at the date of foreclosure, establishing a new cost basis. Loan losses arising from the acquisition of such property as of that date are charged against the allowance for loan losses. Subsequent to foreclosure, valuations are periodically performed by management, and the assets are carried at the lower of the new cost basis or fair value, less estimated costs to sell. Revenues and expenses from operations and changes in any subsequent valuation allowance are included in other noninterest expense in the Consolidated Statements of Income.

Goodwill:

Goodwill is calculated as the purchase premium after adjusting for the fair value of net assets acquired. Goodwill is not amortized but is reviewed for potential impairment on an annual basis, or when events or circumstances indicate a potential impairment, at the reporting unit level. The impairment test is performed in two phases. The first step of the goodwill impairment test compares the fair value of the reporting unit with its carrying amount, including goodwill. If the fair value of the reporting unit exceeds its carrying amount, goodwill of the reporting unit is not considered impaired; however, if the carrying amount of the reporting unit exceeds its fair value, an additional step has to be performed. This additional step compares the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill. An impairment loss is recorded to the extent that the carrying amount of goodwill exceeds its implied fair value. As of December 31, 2016 and 2015, it was determined that the Company's recorded goodwill was not impaired.

Income taxes:

The Company uses an asset and liability approach for financial accounting and reporting of deferred income taxes. Deferred tax assets and liabilities are determined based on the difference between the financial statement and income tax bases of assets and liabilities as measured by the currently enacted tax rates which are assumed will be in effect when these differences reverse. If it is more likely than not that some portion or all of a deferred tax asset will not be realized, a valuation allowance is recognized. Deferred income tax expense or credit is the result of changes in deferred tax assets and liabilities.

Advertising and public relations expense:

The Company generally expenses advertising and promotion costs as they are incurred. External costs incurred in producing media advertising are expensed the first time the advertising takes place. External costs relating to direct mailings are expensed in the period in which the direct mailings are sent.

Earnings per common share:

Net income available to common shareholders per share is computed on the basis of the weighted average number of common shares outstanding. The treasury stock method is used to compute the effect of stock options on the weighted average number of common shares outstanding for diluted earnings per common share.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 1. Organization and Significant Accounting Policies, Continued

Earnings per common share, continued:

As it relates to the Series A Preferred Stock, for diluted earnings per share, it is assumed that the preferred stock was converted to common stock during the reporting period. Dividends on the preferred stock are added back to net income and the shares assumed to be converted are included in the number of shares outstanding.

Statement of cash flows:

For purposes of reporting cash flows, cash and cash equivalents are defined as those amounts included in the balance sheet caption "Cash and cash equivalents". Cash and cash equivalents have an original maturity of three months or less.

Retirement plan:

The Company has a salary reduction profit sharing plan pursuant to Section 401(k) of the Internal Revenue Code as more fully described in Note 15. The Company does not sponsor any postretirement or postemployment benefits, except with respect to certain supplemental benefits that were provided to certain executive officers by the Board of Directors, as more fully described in Note 15.

Fair value of financial instruments:

The Company is required to provide disclosures of fair value information for financial instruments, whether or not recognized in the consolidated balance sheets, when it is practicable to estimate the fair value. Financial instruments are defined as cash, evidence of an ownership interest in an entity or contractual obligations, which require the exchange of cash or other financial instruments. Certain items are specifically excluded from the disclosure requirements, including the Company's common stock and other nonfinancial instruments such as property and equipment and other assets and liabilities. See Note 18 for fair value disclosures.

Risks and uncertainties:

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

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

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 1. Organization and Significant Accounting Policies, Continued

Share-based compensation:

The Company has a share-based employee compensation plan, which is described more fully in Note 16.

Comprehensive income (loss):

Comprehensive income (loss) consists of net income or loss for the current period and other comprehensive income (loss), defined as income, expenses, gains and losses that bypass the consolidated statements of income and are reported directly in a separate component of shareholders' equity. The Company classifies and reports items of other comprehensive income (loss) according to their nature, reports total comprehensive income or loss in the consolidated statements of comprehensive income and displays the accumulated balance of other comprehensive income or loss separately in consolidated statements of changes in shareholders' equity and in the shareholders' equity section of the consolidated balance sheets. See Note 17 for further discussion.

Recently issued accounting pronouncements:

The following is a summary of recent authoritative pronouncements:

In May 2014, the FASB issued guidance to change the recognition of revenue from contracts with customers. The core principle of the new guidance is that an entity should recognize revenue to reflect the transfer of goods and services to customers in an amount equal to the consideration the entity receives or expects to receive. The guidance will be effective for the Company for reporting periods beginning after December 15, 2017. The Company will apply the guidance using a full retrospective approach. The Company does not expect these amendments to have a material effect on its financial statements.

In February 2015, the FASB issued guidance which amends the consolidation requirements and significantly changes the consolidation analysis required under U.S. GAAP. Although the amendments are expected to result in the deconsolidation of many entities, the Company will need to reevaluate all its previous consolidation conclusions. The amendments will be effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015, with early adoption permitted (including during an interim period), provided that the guidance is applied as of the beginning of the annual period containing the adoption date. These amendments did not have a material effect on the Company's financial statements.

In April 2015, the FASB issued guidance which changes the presentation of debt issuance costs. The amendments will be effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015, with early adoption permitted for financial statements that have not been previously issued. These amendments did not have a material effect on the Company's financial statements.

In August 2015, the FASB deferred the effective date of ASU 2014-09, Revenue from Contracts with Customers. As a result of the deferral, the guidance in ASU 2014-09 will be effective for the Company for reporting periods beginning after December 15, 2017. The Company will apply the guidance using a full retrospective approach. The Company does not expect these amendments to have a material effect on its financial statements.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 1. Organization and Significant Accounting Policies, Continued

Recently issued accounting pronouncements, continued:

In August 2015, the FASB issued amendments to the Interest topic of the Accounting Standards Codification to clarify the SEC staff's position on presenting and measuring debt issuance costs incurred in connection with line-of-credit arrangements. The amendments were effective upon issuance. These amendments did not have a material effect on the Company's financial statements.

In September 2015, the FASB amended the Business Combinations topic of the Accounting Standards Codification to simplify the accounting for adjustments made to provisional amounts recognized in a business combination by eliminating the requirement to retrospectively account for those adjustments. The amendments will be effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015, with early adoption permitted for financial statements that have not been issued. All entities are required to apply the amendments prospectively to adjustments to provisional amounts that occur after the effective date. These amendments did not have a material effect on the Company's financial statements.

In November 2015, the FASB amended the Income Taxes topic of the Accounting Standards Codification to simplify the presentation of deferred income taxes by requiring that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. The amendments will be effective for financial statements issued for annual periods beginning after December 15, 2016, and interim periods within those annual periods, with early adoption permitted as of the beginning of an interim or annual reporting period. The Company will apply the guidance prospectively. The Company does not expect these amendments to have a material effect on its financial statements.

In January 2016, the FASB amended the Financial Instruments topic of the Accounting Standards Codification to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The amendments will be effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. The Company will apply the guidance by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values will be applied prospectively to equity investments that exist as of the date of adoption of the amendments. The Company does not expect these amendments to have a material effect on its financial statements.

In February 2016, the FASB amended the Leases topic of the Accounting Standards Codification to revise certain aspects of recognition, measurement, presentation, and disclosure of leasing transactions. The amendments will be effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted. The Company is currently evaluating the effect that implementation of the new standard will have on its financial position, results of operations, and cash flows.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 1. Organization and Significant Accounting Policies, Continued

Recently issued accounting pronouncements, continued:

In March 2016, the FASB amended the Derivatives and Hedging topic of the Accounting Standards Codification to clarify that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument does not, in and of itself, require dedesignation of that hedging relationship provided that all other hedge accounting criteria continue to be met. The amendments will be effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. Early adoption is permitted. The Company will apply the guidance prospectively to each period presented. The Company does not expect these amendments to have a material effect on its financial statements.

In March 2016, the FASB amended the Investments—Equity Method and Joint Ventures topic of the Accounting Standards Codification to eliminate the requirement to retroactively adopt the equity method of accounting. The amendments are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. Early adoption is permitted. The Company will apply the guidance prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the adoption of the equity method. The Company does not expect these amendments to have a material effect on its financial statements.

In March 2016, the FASB issued guidance to simplify several aspects of the accounting for share-based payment award transactions including the income tax consequences, the classification of awards as either equity or liabilities, and the classification on the statement of cash flows. Additionally, the guidance simplifies two areas specific to entities other than public business entities allowing them apply a practical expedient to estimate the expected term for all awards with performance or service conditions that have certain characteristics and also allowing them to make a one-time election to switch from measuring all liability-classified awards at fair value to measuring them at intrinsic value. The amendments will be effective for the Company for annual periods beginning after December 15, 2016 and interim periods within those annual periods. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

In June 2016, the FASB issued guidance to change the accounting for credit losses and modify the impairment model for certain debt securities. The amendments will be effective for the Company for reporting periods beginning after December 15, 2020. Early adoption is permitted for all organizations for periods beginning after December 15, 2018. The Company is currently evaluating the effect that implementation of the new standard will have on its financial position, results of operations, and cash flows.

In October 2016, the FASB amended the Consolidation topic of the Accounting Standards Codification to revise the consolidation guidance on how a reporting entity that is the single decision maker of a variable interest entity (VIE) should treat indirect interests in the entity held through related parties that are under common control with the reporting entity when determining whether it is the primary beneficiary of that VIE. The amendments will be effective for the Company for fiscal years beginning after December 15, 2016 including interim periods within those fiscal years. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

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

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 2. Restrictions on Cash and Due from Banks

Recently issued accounting pronouncements, continued:

The Bank is required by regulation to maintain average cash reserve balances, computed by applying prescribed percentages to its various types of deposits, either at the Bank or in an account maintained with the Federal Reserve Bank. The average amounts of the cash reserve balances required at December 31, 2016 and 2015 were approximately \$878,000 and \$386,000, respectively.

Note 3. Investment Securities

The aggregate amortized cost and estimated fair values of securities, as well as gross unrealized gains and losses of securities were as follows:

	December 31							
	2016			2015				
	Amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Estimated fair value	Amortized cost	Gross unrealized holding gains	Gross unrealized holding losses	Estimated fair value
	(Dollars in thousands)							
Available-for-sale								
Government-sponsored enterprises (GSEs)	\$ 7,000	\$ -	\$ 139	\$ 6,861	\$ 1,036	\$ -	\$ 11	\$ 1,025
State, county and municipal	6,716	50	64	6,702	7,307	174	17	7,464
Mortgage-backed securities issued by GSEs	12,144	49	213	11,980	6,014	249	16	6,247
Mortgage-backed securities not issued by GSEs	-	-	-	-	154	-	5	149
Total	<u>\$ 25,860</u>	<u>\$ 99</u>	<u>\$ 416</u>	<u>\$ 25,543</u>	<u>\$ 14,511</u>	<u>\$ 423</u>	<u>\$ 49</u>	<u>\$ 14,885</u>

Securities issued by government-sponsored enterprises include debt instruments issued by the Federal Home Loan Banks, Federal Home Loan Mortgage Company, and the Federal National Mortgage Association. The amortized cost and estimated fair value of securities by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available-for-sale	
	Amortized cost	Estimated fair value
	(Dollars in thousands)	
Due within one year	\$ 2,685	\$ 2,723
Due after one through five years	4,394	4,382
Due after five through ten years	5,722	5,635
Due after ten years	13,059	12,803
	<u>\$ 25,860</u>	<u>\$ 25,543</u>

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 3. Investment Securities, Continued

The estimated fair values and gross unrealized losses of all of the Company's investment securities whose estimated fair values were less than amortized cost as of December 31, 2016 and 2015 which had not been determined to be other-than-temporarily impaired are presented below. The securities have been aggregated by investment category and the length of time that individual securities have been in a continuous unrealized loss position.

	Continuously in Unrealized Loss Position for a Period of					
	Less than 12 Months		12 Months or more		Total	
	Estimated fair value	Unrealized loss	Estimated fair value	Unrealized loss	Estimated fair value	Unrealized loss
Available-for-sale, December 31, 2016:	(Dollars in thousands)					
Government-sponsored enterprises	\$ 5,861	\$ 139	\$ -	\$ -	\$ 5,861	\$ 139
State, county and municipal securities	2,802	64	-	-	2,802	64
Mortgage-backed securities issued by GSEs	<u>8,573</u>	<u>213</u>	-	-	<u>8,573</u>	<u>213</u>
Total	<u>\$ 17,236</u>	<u>\$ 416</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 17,236</u>	<u>\$ 416</u>
Available-for-sale, December 31, 2015:	(Dollars in thousands)					
Government-sponsored enterprises	\$ -	\$ -	\$ 1,025	\$ 11	\$ 1,025	\$ 11
State, county and municipal securities	504	6	491	11	995	17
Mortgage-backed securities issued by GSEs	-	-	920	16	920	16
Mortgage-backed securities not issued by GSE's	-	-	<u>149</u>	<u>5</u>	<u>149</u>	<u>5</u>
Total	<u>\$ 504</u>	<u>\$ 6</u>	<u>\$ 2,585</u>	<u>\$ 43</u>	<u>\$ 3,089</u>	<u>\$ 49</u>

The Company individually evaluated the above noted securities that were in an unrealized loss position at December 31, 2016 and 2015, noting that the securities are primarily in an unrealized loss position due to interest rate factors and the broader economy in general. Based on this evaluation of these securities, no other-than-temporary impairment was noted at December 31, 2016 and 2015. In prior years, securities were evaluated for other-than-temporary impairment and one collateralized mortgage obligation (CMO) was determined to be other-than-temporarily impaired because the underlying mortgage loans that comprised the collateral pool for the security consisted of seven year balloon loans that were experiencing significant levels of delinquency. The Company had recorded credit-related impairment losses on the CMO of \$59,000 cumulatively prior to 2014. The bank sold this security during 2016.

The Bank is a member of the Federal Home Loan Bank of Atlanta ("FHLB") and, accordingly, is required to own restricted stock in that institution in amounts that may vary from time to time. The FHLB stock is carried at cost because it has no quoted market value and no ready market exists. Investment in FHLB stock is a condition of borrowing from the FHLB, and the stock is pledged to collateralize the borrowings. Dividends received on FHLB stock are included in other interest income. During 2016, the Bank purchased \$1,254,000 and redeemed \$1,211,000 in FHLB stock. At December 31, 2016 and 2015, the investment in FHLB stock was \$1,319,000 and \$1,276,000, respectively.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 3. Investment Securities, Continued

At December 31, 2016 and 2015, securities with a carrying value of \$250,000 and \$10,158,000, respectively, were pledged as collateral to secure FHLB advances, public deposits and other purposes.

Note 4. Loans

Loans consisted of the following as of December 31:

	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)	
Commercial, financial and agricultural	\$ 130,577	\$ 100,485
Real estate - construction, land development and other land loans	38,371	47,714
Real estate - mortgage	214,679	182,284
Installment loans to individuals	<u>35,164</u>	<u>38,867</u>
Loans, gross	418,791	369,350
Allowance for possible loan losses	<u>(5,158)</u>	<u>(4,315)</u>
Loans - net	<u>\$ 413,633</u>	<u>\$ 365,035</u>

Variable rate and fixed rate loans totaled \$104,949,000 and \$313,843,000, respectively, at December 31, 2016.

At December 31, 2016, approximately \$32,503,000 of loans were pledged as collateral to secure amounts borrowed from the FHLB.

The Company has purchased a portfolio of student loans with a carrying value of \$30,219,000 and \$35,868,000 at December 31, 2016 and 2015, respectively. The carrying value and accrued interest of these loans is 98% guaranteed by the issuing guarantee agency. These loans are included above in Installment loans to individuals.

Credit quality:

The following table summarizes delinquencies and nonaccruals, by portfolio class, as of December 31, 2016.

	<u>Commercial, financial and agricultural</u>	<u>Real estate - construction, land development and other land loans</u>	<u>Real estate- mortgage</u>	<u>Installment loans to individuals</u>	<u>Total</u>
	(Dollars in thousands)				
30-59 days past due	\$ 18	\$ 1,070	\$ 614	\$ 2,070	\$ 3,772
60-89 days past due	-	-	1,140	938	2,078
90 days, still accruing	-	-	-	4,627	4,627
Nonaccrual	<u>1,117</u>	<u>78</u>	<u>1,975</u>	<u>-</u>	<u>3,170</u>
Total past due and nonaccrual	1,135	1,148	3,729	7,635	13,647
Current	<u>129,442</u>	<u>37,223</u>	<u>210,950</u>	<u>27,529</u>	<u>405,144</u>
Total loans	<u>\$ 130,577</u>	<u>\$ 38,371</u>	<u>\$ 214,679</u>	<u>\$ 35,164</u>	<u>\$ 418,791</u>

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4. Loans, Continued

Credit quality, continued:

Of the amounts listed above, \$2,067,000 of the 30-59 days past due, \$910,000 of the 60-89 days past due and \$4,627,000 of the greater than 90 days past due, still accruing are 98% guaranteed as to principal and interest by the issuing guarantee agency and therefore have continued to be accounted for as accruing loans.

The following table summarizes delinquencies and nonaccruals, by portfolio class, as of December 31, 2015.

	<u>Commercial, financial and agricultural</u>	<u>Real estate - construction, land development and other land loans</u>	<u>Real estate- mortgage</u>	<u>Installment loans to individuals</u>	<u>Total</u>
	(Dollars in thousands)				
30-59 days past due	\$ 4	\$ -	\$ 458	\$ 1,990	\$ 2,452
60-89 days past due	-	-	233	2,007	2,240
90 days, still accruing	-	-	-	6,440	6,440
Nonaccrual	<u>525</u>	<u>123</u>	<u>960</u>	<u>-</u>	<u>1,608</u>
Total past due and nonaccrual	529	123	1,651	10,437	12,740
Current	<u>99,956</u>	<u>47,591</u>	<u>180,633</u>	<u>28,430</u>	<u>356,610</u>
Total loans	<u>\$ 100,485</u>	<u>\$ 47,714</u>	<u>\$ 182,284</u>	<u>\$ 38,867</u>	<u>\$ 369,350</u>

Of the installment loans to individuals listed above, \$1,990,000 of the 30-59 days past due, \$1,999,000 of the 60-89 days past due and \$6,437,000 of the greater than 90 days past due, still accruing are 98% guaranteed as to principal and interest by the issuing guarantee agency and therefore have continued to be accounted for as accruing loans.

The gross interest income that would have been recorded under the original terms of the nonaccrual loans was \$152,000 and \$307,000 for 2016 and 2015, respectively.

As part of the loan review process, loans are given individual credit grades, representing the risk the Company believes is associated with the loan balance. Credit grades are assigned based on factors that impact the collectability of the loan, the strength of the borrower, the type of collateral, and loan performance. Commercial loans are individually graded at origination and credit grades are reviewed on a regular basis in accordance with our loan policy. Consumer loans are assigned a "pass" credit rating unless something within the loan warrants a specific classification grade.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4. Loans, Continued

Credit quality, continued:

The following table summarizes management's internal credit risk grades, by portfolio class, as of December 31, 2016.

	<u>Commercial, financial and agricultural</u>	<u>Real estate - construction, land development and other land loans</u>	<u>Real estate- mortgage</u>	<u>Installment loans to individuals</u>	<u>Total</u>
	(Dollars in thousands)				
Grade 1 – Minimum risk	\$ 93	\$ -	\$ -	\$ 165	\$ 258
Grade 2 – High quality	108	-	355	-	463
Grade 3 – Above average	1,466	-	12,262	34	13,762
Grade 4 – Average	15,784	13,890	62,567	508	92,749
Grade 5 – Acceptable	111,329	18,966	123,267	34,450	288,012
Grade 6 – Watch list	397	1,755	9,364	2	11,518
Grade 7 – Substandard	1,400	3,760	6,864	5	12,029
Total loans	<u>\$ 130,577</u>	<u>\$ 38,371</u>	<u>\$ 214,679</u>	<u>\$ 35,164</u>	<u>\$ 418,791</u>

The following table summarizes management's internal credit risk grades, by portfolio class, as of December 31, 2015.

	<u>Commercial, financial and agricultural</u>	<u>Real estate - construction, land development and other land loans</u>	<u>Real estate- mortgage</u>	<u>Installment loans to individuals</u>	<u>Total</u>
	(Dollars in thousands)				
Grade 1 – Minimum risk	\$ 110	\$ -	\$ -	\$ 116	\$ 226
Grade 2 – High quality	11	-	375	57	443
Grade 3 – Above average	347	-	13,082	1	13,430
Grade 4 – Average	13,938	24,103	62,043	99	100,183
Grade 5 – Acceptable	84,981	18,441	93,632	38,575	235,629
Grade 6 – Watch list	288	3,367	8,574	6	12,235
Grade 7 – Substandard	810	1,803	4,578	13	7,204
Total loans	<u>\$ 100,485</u>	<u>\$ 47,714</u>	<u>\$ 182,284</u>	<u>\$ 38,867</u>	<u>\$ 369,350</u>

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4. Loans, Continued

Credit quality, continued:

At December 31, 2016 and 2015, approximately 94% and 95%, respectively, of the loan portfolio, had a credit grade of Acceptable or better. For loans to qualify for this grade, they must be performing relatively close to expectations, with no significant departures from the intended source and timing of repayment. Loans totaling \$11.5 million and \$12.2 million were classified as watch list at December 31, 2016 and 2015, respectively. This classification is utilized for loans with an elevated credit risk to borrowers with an adequate credit history and financial strength and are experiencing declining trends (e.g., financial, economic, or industry specific). Loans are designated as such in order to be monitored more closely than other credits in the loan portfolio. At December 31, 2016 and 2015, substandard loans totaled \$12.0 million and \$7.2 million, respectively. This classification is employed when loans are inadequately protected by the current sound worth and paying capacity of the borrower or of the collateral pledged; have well-defined weaknesses that jeopardize the liquidation of the loan; and there is a distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

The following tables summarize information relative to impaired loans individually evaluated for impairment, by portfolio class, at December 31, 2016 and 2015. The recorded investment in impaired loans is the unpaid principal balance, net of loan principal charged off.

	<u>December 31, 2016</u>		
	<u>Unpaid principal balance</u>	<u>Recorded investment</u>	<u>Related allowance</u>
	(Dollars in thousands)		
With no related allowance recorded:			
Commercial, financial and agricultural	\$ 1,117	\$ 1,117	\$ -
Real estate- construction, land development and other land loans	2,186	2,186	-
Real estate - mortgage	5,430	5,430	-
Installment loans to individuals	-	-	-
With related allowance recorded:			
Commercial, financial and agricultural	-	-	-
Real estate- construction, land development and other land loans	1,360	1,360	359
Real estate - mortgage	606	606	2
Installment loans to individuals	-	-	-
Total:			
Commercial, financial and agricultural	1,117	1,117	-
Real estate- construction, land development and other land loans	3,546	3,546	359
Real estate - mortgage	6,036	6,036	2
Installment loans to individuals	-	-	-
	<u>\$ 10,699</u>	<u>\$ 10,699</u>	<u>\$ 361</u>

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4. Loans, Continued

Credit quality, continued:

	December 31, 2015		
	Unpaid principal balance	Recorded investment	Related allowance
	(Dollars in thousands)		
With no related allowance recorded:			
Commercial, financial and agricultural	\$ 22	\$ 22	\$ -
Real estate- construction, land development and other land loans	-	-	-
Real estate - mortgage	1,200	1,200	-
Installment loans to individuals	-	-	-
With related allowance recorded:			
Commercial, financial and agricultural	-	-	-
Real estate- construction, land development and other land loans	-	-	-
Real estate - mortgage	774	774	229
Installment loans to individuals	-	-	-
Total:			
Commercial, financial and agricultural	22	22	-
Real estate- construction, land development and other land loans	-	-	-
Real estate - mortgage	1,974	1,974	229
Installment loans to individuals	-	-	-
	<u>\$ 1,996</u>	<u>\$ 1,996</u>	<u>\$ 229</u>

The average amounts of impaired loans were \$4,051,000 and \$4,712,000 for 2016 and 2015, respectively. Interest income recognized on impaired loans during the time that the loans were impaired in 2016 and 2015 was \$123,000 and \$89,000, respectively.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4. Loans, Continued

Provision and allowance for loan losses:

The following tables summarize activity related to our allowance for loan losses for the years ended December 31, 2016 and 2015 by portfolio segment.

	December 31, 2016				
	Commercial, financial and agricultural	Real estate - construction, land development and other land loans	Real estate- mortgage	Installment loans to individuals	Total
	(Dollars in thousands)				
Allowance for loan losses:					
Balance, beginning of year	\$ 2,973	\$ 169	\$ 654	\$ 519	\$ 4,315
Provision for loan losses	2,112	406	1,133	(382)	3,269
Loan charge-offs	(1,954)	(10)	(856)	(1)	(2,821)
Loan recoveries	373	13	9	-	395
Balance, end of year	<u>\$ 3,504</u>	<u>\$ 578</u>	<u>\$ 940</u>	<u>\$ 136</u>	<u>\$ 5,158</u>
Individually reviewed for impairment	\$ -	\$ 359	\$ 2	\$ -	\$ 361
Collectively reviewed for impairment	<u>3,504</u>	<u>219</u>	<u>938</u>	<u>136</u>	<u>4,797</u>
Total allowance for loan losses	<u>\$ 3,504</u>	<u>\$ 578</u>	<u>\$ 940</u>	<u>\$ 136</u>	<u>\$ 5,158</u>
Gross loans, end of period:					
Individually reviewed for impairment	\$ 1,117	\$ 3,546	\$ 6,036	\$ -	\$ 10,699
Collectively reviewed for impairment	<u>129,460</u>	<u>34,825</u>	<u>208,643</u>	<u>35,164</u>	<u>408,092</u>
Total loans	<u>\$ 130,577</u>	<u>\$ 38,371</u>	<u>\$ 214,679</u>	<u>\$ 35,164</u>	<u>\$ 418,791</u>

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4. Loans, Continued

Provision and allowance for loan losses, continued:

	December 31, 2015				
	Commercial, financial and agricultural	Real estate - construction, land development and other land loans	Real estate- mortgage	Installment loans to individuals	Total
	(Dollars in thousands)				
Allowance for loan losses:					
Balance, beginning of year	\$ 2,436	\$ 467	\$ 1,495	\$ 415	\$ 4,813
Provision for loan losses	1,804	(370)	(441)	107	1,100
Loan charge-offs	(1,441)	(40)	(460)	(7)	(1,948)
Loan recoveries	174	112	60	4	350
Balance, end of year	<u>\$ 2,973</u>	<u>\$ 169</u>	<u>\$ 654</u>	<u>\$ 519</u>	<u>\$ 4,315</u>
Individually reviewed for impairment	\$ -	\$ -	\$ 229	\$ -	\$ 229
Collectively reviewed for impairment	<u>2,973</u>	<u>169</u>	<u>425</u>	<u>519</u>	<u>4,086</u>
Total allowance for loan losses	<u>\$ 2,973</u>	<u>\$ 169</u>	<u>\$ 654</u>	<u>\$ 519</u>	<u>\$ 4,315</u>
Gross loans, end of period:					
Individually reviewed for impairment	\$ 22	\$ -	\$ 1,974	\$ -	\$ 1,996
Collectively reviewed for impairment	<u>100,463</u>	<u>47,714</u>	<u>180,310</u>	<u>38,867</u>	<u>367,354</u>
Total loans	<u>\$ 100,485</u>	<u>\$ 47,714</u>	<u>\$ 182,284</u>	<u>\$ 38,867</u>	<u>\$ 369,350</u>

There were no irrevocable commitments to lend additional funds to debtors owing amounts on impaired loans at December 31, 2016.

Troubled debt restructurings are loans which have been restructured from their original contractual terms and include concessions that would not otherwise have been granted outside of the financial difficulty of the borrower. Concessions can relate to the contractual interest rate, maturity date, or payment structure of the note. As part of our workout plan for individual loan relationships, we may restructure loan terms to assist borrowers facing challenges in the current economic environment. The purpose of a troubled debt restructuring is to facilitate ultimate repayment of the loan.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4. Loans, Continued

Provision and allowance for loan losses, continued:

At December 31, 2016 and 2015, the principal balance of troubled debt restructurings totaled \$1.7 million and \$1.8 million, respectively. All troubled debt restructurings were considered classified and impaired. None of the balance outstanding at December 31, 2016 and 2015, was on nonaccrual. All such loans are currently performing in accordance with the new terms. The allowance for loan losses associated with those loans, on the basis of a current evaluation of loss was \$0 and \$229,000 at December 31, 2016 and 2015, respectively.

During the year ended December 31, 2016, the Company did not modify any loans that were considered to be troubled debt restructurings.

As of December 31, 2016, one loan that had previously been restructured prior to December 31, 2015, was in default with a recorded investment of \$0 as of year end. No loans restructured in the 12 months prior to December 31, 2016 went into default during the period.

During the year ended December 31, 2015, the Company did not modify any loans that were considered to be troubled debt restructurings.

As of December 31, 2015, three loans that had previously been restructured prior to December 31, 2014, were in default with a recorded investment of \$0 as of year end. No loans restructured in the 12 months prior to December 31, 2015 went into default during the period.

Note 5. Assets Acquired In Settlement of Loans

Activity in the accounts for assets acquired in settlement of loans is as follows:

	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)	
Balance, beginning of year	\$ 5,275	\$ 7,615
Additions	483	412
Sales	(611)	(2,636)
Impairment write downs	(245)	(116)
Balance, end of year	<u>\$ 4,902</u>	<u>\$ 5,275</u>

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 6. Premises and Equipment

Premises and equipment consisted of the following as of December 31:

	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)	
Land and land improvements	\$ 4,226	\$ 3,206
Building and leasehold improvements	6,228	6,179
Furniture and equipment	1,937	1,666
Vehicles	762	623
Construction-in-progress	<u>242</u>	<u>-</u>
Total	13,395	11,674
Accumulated depreciation	<u>(3,184)</u>	<u>(2,860)</u>
Premises and equipment, net	<u>\$ 10,211</u>	<u>\$ 8,814</u>

The balance of construction-in-progress as of December 31, 2016 was related to a branch the Company will open in 2017, the expansion of a current branch, research and development, and software and equipment that has not yet been placed into service. Additional commitments related to the construction of the branch that the Company will open in 2017 and the expansion of a current branch amount to \$1,842,000.

Depreciation expense was \$600,000 and \$435,000 for the years ended December 31, 2016 and 2015, respectively. Estimated useful lives and methods of depreciation for the principal items follow:

<u>Type of Asset</u>	<u>Life in Years</u>	<u>Depreciation Method</u>
Software	3	Straight-line
Furniture and equipment	5 to 7	Straight-line
Buildings and improvements	5 to 40	Straight-line
Vehicles	3	Straight-line

Note 7. Deposits

A summary of deposits follows as of December 31:

	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)	
Noninterest bearing demand	\$ 69,878	\$ 45,515
Interest bearing:		
Demand accounts	6,855	18,228
Money market accounts	186,330	125,603
Savings	<u>3,324</u>	<u>1,972</u>
	<u>266,387</u>	<u>191,318</u>
Time certificates of deposit, less than \$100,000	49,983	43,869
Time certificates of deposit, \$100,000 and over	<u>113,957</u>	<u>115,074</u>
	<u>163,940</u>	<u>158,943</u>
Total deposits	<u>\$ 430,327</u>	<u>\$ 350,261</u>

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 7. Deposits, Continued

Interest expense on time deposits greater than \$100,000 was \$1,114,000 and \$1,042,000 in 2016 and 2015, respectively. Brokered deposits were \$16,976,000 and \$32,554,000 as of December 31, 2016 and 2015, respectively. As of December 31, 2016 and 2015, \$86,000 and \$6,000, respectively, of overdrawn demand deposit balances were reclassified as loans.

At December 31, 2016, the scheduled maturities of time deposits are as follows (dollars in thousands):

2017	\$	83,238
2018		67,390
2019		10,776
2020		2,324
2021		211
Thereafter		<u>1</u>
Total time deposits	\$	<u>163,940</u>

Time deposits that meet or exceed the FDIC insurance limit of \$250,000 as of December 31, 2016 and 2015 were \$25,304,000 and \$28,472,000 respectively. These amounts do not include brokered deposits greater than \$250,000 which are fully insured.

Note 8. Short-Term Borrowings

As of December 31, 2016, the banking subsidiary had unused short-term credit accommodations available from two unrelated banks which allows the banking subsidiary to purchase up to \$16 million of federal funds. The lenders reserve the right to withdraw the lines at their option. As of December 31, 2016 and 2015, respectively there were no federal funds purchased under these lines.

Note 9. Federal Home Loan Bank Advances

The FHLB advances are secured with approximately \$32.5 million of mortgage loans and \$1.3 million of stock in the FHLB. The FHLB advances had a weighted average interest rate of 0.80% and 0.92% as of December 31, 2016 and 2015, respectively.

The Company's FHLB Advances as of December 31, 2016 and 2015 with fixed rates are as follows:

	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)	
Interest rate 1.140%, maturing September 6, 2016	\$ -	\$ 5,000
Interest rate 1.365%, maturing April 26, 2018	<u>-</u>	<u>7,000</u>
Total	<u>\$ -</u>	<u>\$ 12,000</u>

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 9. Federal Home Loan Bank Advances, Continued

The Company's FHLB Advances as of December 31, 2016 and 2015 with variable rates are as follows:

	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)	
Interest rate of the FHLB Daily Rate (0.800% at December 31, 2016), maturing December 26, 2017	\$ 22,000	\$ -
Interest rate of the FHLB Daily Rate (0.490% at December 31, 2015), maturing December 19, 2016	-	<u>10,000</u>
Total	<u>\$ 22,000</u>	<u>\$ 10,000</u>

At December 31, 2016, the Bank had unused credit availability of up to \$122,478,000 under the FHLB's various credit programs, subject to pledging and other requirements. The amount of eligible collateral instruments available as of December 31, 2016 to secure any additional FHLB borrowings totaled approximately \$1,760,000.

Note 10. Capital Trust and Junior Subordinated Debentures

On May 3, 2006, the Company sponsored the creation of a Delaware statutory trust, GrandSouth Capital Trust I, (the "Trust") and is the sole owner of the \$247,000 of common securities issued by the Trust. On May 10, 2006, the Trust issued \$8,000,000 in floating rate capital securities. The proceeds of this issuance, and the amount of the Company's investment in the common securities, were used to acquire \$8,247,000 principal amount of the Company's floating rate junior subordinated debt securities due in 2036 ("Debentures"). These securities, and the accrued interest thereon, now constitute the Trust's sole assets. The interest rate associated with the debt securities, and the distribution rate on the common securities of the Trust, is adjustable quarterly at 3 month LIBOR plus 185 basis points (aggregating 2.78417% at December 31, 2016). The Company may defer interest payments on the Debentures for up to 20 consecutive quarters, but not beyond the stated maturity of the Debentures. In the event that such interest payments are deferred by the Company, the Trust may defer distributions on the capital and common securities. In such an event, the Company would be restricted in its ability to pay dividends on its common stock and perform under obligations that are not senior to the Debentures. The Company has not elected to defer any distributions.

The Debentures are redeemable at par at the option of the Company, in whole or in part, on any interest payment date on or after June 23, 2011. Upon repayment or redemption of the Debentures, the Trust will use the proceeds of the transaction to redeem an equivalent amount of capital securities and common securities. The Trust's obligations under the capital securities are unconditionally guaranteed by the Company. In accordance with applicable accounting standards, the Trust is not consolidated in the Company's financial statements.

Note 11. Commitments and Contingencies

During 2016, the Company incurred approximately \$800,000 in legal and consulting fees associated with an investigation into possible wrongdoing by a former customer of the Company and three former employees of the Company. The Company has not been named a defendant in the case. Investigation of the matter is currently ongoing. The outcome is not known or determinable at this time.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 11. Commitments and Contingencies, Continued

The Company is party to other litigation and claims arising in the normal course of business, other than that noted above. Management, after consultation with legal counsel, believes that the liabilities, if any, arising from such litigation and claims will not be material to the Company's financial position or results of operations.

The Company leases land upon which it constructed a branch office under a non-cancelable operating lease which expires in March 2018. The lease requires monthly lease payments of \$800 and contains four renewal options of five years each which contain provisions for adjustments to the monthly lease payments. The lease agreement requires the Company to pay all property taxes.

The future minimum lease payments due under the current operating leases as of December 31, 2016, are as follows (dollars in thousands):

2017	\$	235
2018		211
2019		211
2020		215
2021		72
Thereafter		0
Total	\$	<u>944</u>

Note 12. Income Taxes

The following summary of the provision for income taxes includes tax deferrals, which arise from temporary differences in the recognition of certain items of revenues and expense for tax and financial reporting purposes:

	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)	
<u>Current</u>		
Federal expense	\$ 1,739	\$ 3,074
State expense	<u>143</u>	<u>232</u>
Total current	1,882	3,306
<u>Deferred</u>		
Federal expense/(benefit)	(11)	41
State expense/(benefit)	<u>9</u>	<u>14</u>
	(2)	3,361
Change in valuation allowance	<u>(5)</u>	<u>(55)</u>
Total income tax expense	<u>\$ 1,875</u>	<u>\$ 3,306</u>

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 12. Income Taxes, Continued

The income tax effects of cumulative temporary differences at December 31 are as follows:

	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)	
Deferred tax assets		
Allowance for loan losses	\$ 325	\$ -
Other real estate owned	801	745
Amortization of intangibles	397	518
Nonaccrual loan interest	53	108
State net operating loss carryforward	150	155
Deferred compensation	390	351
Unrealized net holding losses on available-for-sale securities	122	-
Other	<u>107</u>	<u>206</u>
Gross deferred tax assets	2,345	2,083
Valuation allowance	<u>(150)</u>	<u>(155)</u>
Total	<u>\$ 2,195</u>	<u>\$ 1,928</u>
Deferred tax liabilities		
Unrealized net holding gains on available-for-sale securities	\$ -	\$ 127
Allowance for loan losses	-	136
Accelerated depreciation	306	260
Other	<u>359</u>	<u>131</u>
Gross deferred tax liabilities	<u>665</u>	<u>654</u>
Net deferred income tax assets	<u>\$ 1,530</u>	<u>\$ 1,274</u>

Deferred tax assets represent the future benefit of deductible differences, and if it is more likely than not that a tax asset will not be realized, a valuation allowance is required to reduce the recorded deferred tax assets to net realizable value. The deferred tax asset valuation allowance for 2016 and 2015 is related to the Company's stand-alone state net operating loss carryforwards. Management believes realization of all other deferred tax assets is more likely than not and accordingly has not recorded any other valuation allowance.

The Company has state net operating losses for income tax purposes of approximately \$4,549,000 as of December 31, 2016. These state net operating losses expire 2017 through 2036.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 12. Income Taxes, Continued

The provision for income taxes is reconciled to the amount of income tax computed at the federal statutory rate of 34% on income before income taxes as follows for the year ended December 31:

	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)	
Tax expense at statutory rate	\$ 1,720	\$ 3,167
State income tax, net of federal income tax benefit	101	167
Tax-exempt interest income	(71)	(98)
Bank-owned life insurance increase	(48)	(17)
Change in valuation allowance	(5)	(55)
Other, net	178	142
Total	<u>\$ 1,875</u>	<u>\$ 3,306</u>

The company has analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions in accordance with current accounting guidance.

The Company and its subsidiary file income tax returns with the federal government and various states. With few exceptions, the Company is no longer subject to federal or state income tax examinations by tax authorities for years before 2013.

Note 13. Related Party Transactions

Certain directors, executive officers and companies with which they are affiliated are customers of and have banking transactions, including loans and commitments to lend, with the Bank in the ordinary course of business. Such transactions are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable arms-length transactions. A summary of loan and commitment transactions with directors and executive officers, including their affiliates, follows:

	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)	
Balance, beginning of year	\$ 3,800	\$ 3,906
New loans	1,759	1,104
Less loan payments	(471)	(1,210)
Balance, end of year	<u>\$ 5,088</u>	<u>\$ 3,800</u>

Deposits of directors and their related interests at December 31, 2016 and 2015 approximated \$5,312,000 and \$3,740,000, respectively.

The Company leases land from a relative of a director, shareholder and executive officer of the Company (see Note 11). Lease expenses charged to operations under these arrangements totaled \$12,000 in 2016 and 2015.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 14. Financial Instruments with Off-Balance Sheet Risk

In the ordinary course of business, and to meet the financing needs of its customers, the Bank is party to various financial instruments with off-balance sheet risk. These financial instruments, which include commitments to extend credit and standby letters of credit, involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the balance sheets. The contract amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amounts of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any material condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a fee. At December 31, 2016 and 2015, unfunded commitments to extend credit were \$148,550,000 and \$129,013,000, respectively. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the borrower. Collateral varies but may include accounts receivable, inventory, property, plant and equipment, and commercial and residential real estate. At December 31, 2016 and 2015, there were outstanding letters of credit totaling \$1,190,000 and \$1,156,000, respectively.

Note 15. Employee Benefit Plan

The Bank sponsors the GrandSouth Bank Profit Sharing Section 401(k) Plan (the "Plan") for the benefit of all eligible employees. The Bank contributes 100% of the first 3% and 50% of the next 2% of the employee's compensation contributed to the Plan. Contributions made to the Plan in 2016 and 2015 were \$310,000 and \$245,000, respectively.

In 2001, supplemental benefits were approved by the Board of Directors for certain executive officers of the Bank. These benefits are not qualified under the Internal Revenue Code, and they are not funded. However, certain funding is provided informally and indirectly by life insurance policies owned by the Bank. The Company recorded net expense related to these benefits of \$113,000 and \$109,000 in 2016 and 2015, respectively.

Note 16. Stock Option Plan

During 1998, the Board of Directors approved a stock option plan for the benefit of the directors, officers and employees (the "1998 Plan"). The plan provided that the Board could grant options to purchase up to 856,028 shares of common stock (after the shareholders approved an amendment to increase the number of shares in the plan at the 2005 Annual Meeting) at an exercise price per share not less than the fair market value on the date of grant. The Company issues new shares to satisfy option exercises. The stock option plan expired in 2008. Consequently, unexpired options granted under the Plan remain outstanding and exercisable subject to their terms, but no more options may be granted under the Plan.

Upon the expiration of the 1998 Plan, the Board of Directors approved a stock option plan for the benefit of the directors, officers and employees effective June 17, 2009 (the "2009 Plan"). The plan provided that the Board could grant options to purchase up to 275,000 shares of common stock at an exercise price per share not less than the fair market value on the date of grant. Consistent with the 1998 Plan, the Company will issue new shares to satisfy option exercises under the 2009 Plan.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 16. Stock Option Plan, Continued

See summary of option activity in table below. In 2012, the 2009 Plan was amended, allowing the Board to increase the number of options to purchase up to 487,000 shares of common stock. In 2015, the 2009 Plan was amended, allowing the Board to increase the number of options to purchase up to 737,000 shares of common stock. In 2016, an amendment to the 2009 Plan was approved by the Board of Directors, allowing the Board to increase the number of options to purchase up to 987,000 shares of common stock. This amendment has not yet been approved by shareholders of the Company.

In 2016, the Company granted 120,500 options to directors, officers and employees that vest 20 percent each year for five years and expire 10 years from the grant date. The related compensation expense of the options is recognized over the vesting period. In 2015, the Company granted 97,000 options to directors, officers and employees that vest 20 percent each year for five years and expire 10 years from the grant date. The related compensation expense of the options is recognized over the vesting period. The Company measures the fair value of each option award on the date of the grant using the Black-Scholes option-pricing model with the following assumptions used for awards granted in 2016 and 2015:

	<u>2016</u>	<u>2015</u>
Assumptions:		
Dividend yield	2.98%	2.28%
Weighted average risk-free interest rate	1.57%	1.85%
Weighted average expected volatility	96.85%	108.33%
Weighted average expected life in years	6.50	6.50
Weighted average grant date fair value	\$8.57	\$8.85

The Company determines the assumptions used in the Black-Scholes option-pricing model as follows:

Based on the historical dividend yield of the Company's stock, adjusted to reflect the expected dividend yield over the expected life of the option, the risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of the grant; volatility is based on the historical volatility adjusted to reflect the ways in which current information indicates that the future is reasonably expected to differ from the past; and the average life is based on historical behaviors of employees related to exercises, forfeitures and cancellations.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 16. Stock Option Plan, Continued

The following table summarizes the activity during 2016 related to stock options awarded by the Company:

	Year Ended December 31, 2016			
	Shares	Weighted average exercise price per share	Weighted average remaining contractual life (years)	Intrinsic value
Outstanding at beginning of year	348,398	\$ 7.41	6.61	\$ 2,309,446
Granted	120,500	13.47	9.51	
Exercised	(36,930)	5.24	-	301,922
Forfeited or expired	<u>(49,350)</u>	8.15	-	277,819
Outstanding at end of year	<u>382,618</u>	9.43	7.23	1,587,197
Options outstanding and expected to vest	382,618	9.43	7.23	1,587,197
Options exercisable at year-end	155,001	5.62	4.74	1,234,214

The following table summarizes the activity during 2015 related to stock options awarded by the Company:

	Year Ended December 31, 2015			
	Shares	Weighted average exercise price per share	Weighted average remaining contractual life (years)	Intrinsic value
Outstanding at beginning of year	461,842	\$ 5.97	5.00	\$ 1,184,495
Granted	97,000	12.23	9.71	
Exercised	(197,164)	6.59	-	1,451,602
Forfeited or expired	<u>(13,280)</u>	4.82	-	121,301
Outstanding at end of year	<u>348,398</u>	7.41	6.61	2,309,446
Options outstanding and expected to vest	348,398	7.41	6.61	2,309,446
Options exercisable at year-end	166,601	6.21	4.51	1,321,680

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 16. Stock Option Plan, Continued

The following table summarizes the vesting activity during 2016 related to stock options awarded by the Company:

	<u>Year Ended December 31, 2016</u>	
	<u>Shares</u>	<u>Weighted average grant date fair values per share</u>
Nonvested at beginning of year	181,797	\$ 6.45
Granted	120,500	8.57
Vested	(47,630)	5.38
Forfeited or expired	<u>(27,050)</u>	3.13
Nonvested at end of year	<u>227,617</u>	8.19

The following table summarizes the vesting activity during 2015 related to stock options awarded by the Company:

	<u>Year Ended December 31, 2015</u>	
	<u>Shares</u>	<u>Weighted average grant date fair values per share</u>
Nonvested at beginning of year	150,347	\$ 3.48
Granted	97,000	8.85
Vested	(52,270)	2.96
Forfeited or expired	<u>(13,280)</u>	4.18
Nonvested at end of year	<u>181,797</u>	6.45

As of December 31, 2016, total compensation costs of unvested options that have not yet been recognized were \$1,691,000. Those compensation costs will be recognized over the remaining weighted average vesting period of 4.02 years.

Intrinsic value is calculated for shares outstanding and exercisable by taking the closing price of the Company's common stock as of December 31, 2016, as reported by the Over the Counter Bulletin Board (OTCBB), and subtracting the exercise price of each stock option grant. When the result is a positive number, the difference is multiplied by the number of options outstanding for each such grant and the total of those values is shown in the table. Intrinsic value for shares exercised represents the closing price of the stock on the date of exercise as reported by the OTCBB less the actual exercise price of the options exercised multiplied by the number of options exercised. These intrinsic values are calculated for each exercise during the year, and the resulting total is presented.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 17. Shareholders' Equity

Preferred stock:

On January 20, 2010, the Company's shareholders approved amendments of its Articles of Incorporation authorizing the issuance of up to 287,895 shares of Series A Preferred Stock in one or more series. The Series A Preferred Stock has rights equal to common stock with regard to dividends and rights upon liquidation. Unlike common stock, the Series A Preferred Stock will not have voting rights except under very limited circumstances. The Series A Preferred Stock pays dividends at the rate of 5% greater than common stock per share dividends.

On September 8, 2011, the Company entered into an agreement with the US Treasury as part of a fund established under the Small Business Jobs Act of 2010 that was created to encourage lending to small businesses by providing capital to qualified community banks with assets less than \$10 billion. Pursuant to the agreement, the Company issued and sold to the US Treasury, for an aggregate purchase price of \$15,422,000, 15,422 shares of the Company's Senior Non-Cumulative Perpetual Preferred Stock, Series T-3. The proceeds from the issuance of the Series T-3 stock, along with other available funds, were used to redeem the Series T, T-2 and W preferred stock. The dividend rate, as a percentage of the liquidation amount, can fluctuate on a quarterly basis during the first 10 quarters during which the preferred stock is outstanding, based upon changes in the level of Qualified Small Business Lending. As of December 31, 2015, the Company's effective dividend rate was 1.00%.

On August 26, 2015, the Company repurchased 4,000 shares of the Company's Senior Non-Cumulative Perpetual Preferred Stock, Series T-3. At December 31, 2015, the US Treasury held 3,922 shares of the Series T-3 stock.

On January 25, 2016, the Company repurchased the remaining 3,922 shares of the Company's Senior Non-Cumulative Perpetual Preferred Stock, Series T-3. At that date, the US Treasury no longer held any shares of Series T-3 stock.

Subject to regulatory approval, the Company was generally permitted to redeem the preferred stock at par plus unpaid interest. The preferred stock qualified as Tier 1 capital.

All Series of the Company's Preferred Stock are treated as components of Tier 1 capital for purposes of computing the Company's regulatory capital ratios.

Restrictions on subsidiary dividends, loans or advances:

In addition to the restrictions specified under the heading "Preferred Stock," South Carolina banking regulations restrict the amount of dividends that banks can pay to shareholders. Any of the banking subsidiary's dividends to the parent company which exceed the amount of the subsidiary's current year-to-date earnings (\$3,384,000) at December 31, 2016) are subject to the prior approval of the South Carolina Commissioner of Banking. In addition, dividends paid by the banking subsidiary to the parent company would be prohibited if the effect thereof would cause the Bank's capital to be reduced below applicable minimum capital requirements. Under Federal Reserve Board regulations, the amounts of loans or advances from the banking subsidiary to the parent company are generally limited to 10% of the Bank's capital stock and surplus on a secured basis. Furthermore, in the event that interest payments on the junior subordinated debentures (see Note 10) are deferred by the Company, the Company would be restricted in its ability to pay dividends on its common stock. The terms of the Company's preferred stock also impose limits on its ability to pay dividends.

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 17. Shareholders' Equity, Continued

Accumulated other comprehensive income:

As of December 31, 2016 and 2015, accumulated other comprehensive income included as a component of shareholders' equity in the Consolidated Balance Sheets consisted of accumulated changes in the unrealized holding gains and (losses) on available-for-sale securities, net of income tax effects, amounting to (\$195,000) and \$247,000, respectively.

Earnings per common share:

Net income available to common shareholders per share, basic and net income available to common shareholders per share, assuming dilution, were computed as follows:

	<u>2016</u>	<u>2015</u>
	(Dollars in thousands except share amounts)	
Earnings per common share, basic		
Numerator - net income available to common shareholders	\$ <u>3,063</u>	\$ <u>5,865</u>
Denominator		
Weighted average common shares issued and outstanding	<u>4,434,979</u>	<u>3,380,715</u>
Earnings per common share, basic	\$ <u>0.69</u>	\$ <u>1.73</u>
Earnings per common share, assuming dilution		
Numerator - net income available to common shareholders	\$ 3,063	\$ 5,865
Dividends on Series A preferred stock	<u>121</u>	<u>78</u>
	<u>\$ 3,184</u>	<u>\$ 5,943</u>
Denominator		
Weighted average common shares issued and outstanding	4,434,979	3,380,715
Effect of dilutive stock options	97,883	143,875
If-converted shares of Series A preferred stock	<u>287,895</u>	<u>287,895</u>
Total shares outstanding diluted	<u>4,820,757</u>	<u>3,812,485</u>
Earnings per common share, assuming dilution	\$ <u>0.66</u>	\$ <u>1.56</u>

GrandSouth Bancorporation and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 17. Shareholders' Equity, Continued

Regulatory capital:

All bank holding companies and banks are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, bank holding companies and banks must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. Capital amounts and classification 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 and its banking subsidiary to maintain minimum amounts and ratios (set forth in the table below) of Tier 1, Common Equity Tier 1 ("CET1"), and Total Capital (as defined in the regulations) to risk-weighted assets and average assets (as defined). Management believes, as of December 31, 2016 and 2015, that the Company and its subsidiary bank exceeds all capital adequacy requirements to which it is subject.

Effective March 31, 2015, quantitative measures established by applicable regulatory standards, including the newly implemented Basel III revised capital adequacy standards and relevant provisions of the Dodd-Frank All Street Report and Consumer Protection Act ("Dodd-Frank Act"), require the Bank to maintain (i) a minimum ratio of Tier 1 capital to average total assets, after certain adjustments, of 4.00%, (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of 6.00%, (iii) a minimum ratio of total-capital to risk-weighted assets of 8.00% and (iv) a minimum ratio of CET1 to risk-weighted assets of 4.50%. A "well-capitalized" institution must generally maintain capital ratios 2.00% higher than the minimum guidelines.

In order to avoid restrictions on capital distributions or discretionary bonus payments to executives, the Company and Bank will also be required to maintain a "capital conservation buffer" in addition to its minimum risk-based capital requirements. The buffer will be required to consist solely of CET1, but the buffer will apply to all three risk-based measurements (CET1, Tier 1 and total capital). The capital conservation buffer will be phased in incrementally over time, beginning January 1, 2016 and becoming fully effective on January 1, 2019, and will ultimately consist of an additional amount of Tier 1 capital equal to 2.50% of risk-weighted assets.

As of December 31, 2016, the most recent notification from the FDIC categorized the Bank as well capitalized under the capital adequacy guidelines and regulatory framework for prompt corrective action. To be categorized as well capitalized as defined in the Federal Deposit Insurance Act, the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category. Bank holding companies with higher levels of risk, or that are experiencing or anticipating significant growth, are expected by the Federal Reserve to maintain capital well above the minimums. The Company's and Bank's actual capital amounts and ratios are also presented in the table.

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Note 17. Shareholders' Equity, Continued

Regulatory capital:

	<u>Actual</u>		<u>Minimum for capital adequacy</u>		<u>Minimum to be well capitalized</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
(Dollars in thousands)						
December 31, 2016						
Tier 1 Capital (to Average Assets)						
Company	\$ 58,148	11.7%	\$ 19,908	4.0%	NA	NA
GrandSouth Bank	57,485	11.6%	19,898	4.0%	\$ 24,872	5.0%
Tier 1 Capital (to Risk Weighted Assets)						
Company	\$ 58,148	13.9%	\$ 25,105	6.0%	NA	NA
GrandSouth Bank	57,485	13.7%	25,090	6.0%	\$ 33,453	8.0%
Total Capital (to Risk Weighted Assets)						
Company	\$ 63,307	15.1%	\$ 33,473	8.0%	NA	NA
GrandSouth Bank	62,643	15.0%	33,453	8.0%	\$ 41,817	10.0%
Common Equity Tier 1 Capital (to Risk Weighted Assets)						
Company	\$ 50,148	12.0%	\$ 18,829	4.5%	NA	NA
GrandSouth Bank	57,485	13.7%	18,817	4.5%	\$ 27,181	6.5%
December 31, 2015						
Tier 1 Capital (to Average Assets)						
Company	\$ 49,762	11.7%	\$ 17,045	4.0%	NA	NA
GrandSouth Bank	46,422	10.9%	17,035	4.0%	\$ 21,293	5.0%
Tier 1 Capital (to Risk Weighted Assets)						
Company	\$ 49,762	13.6%	\$ 21,917	6.0%	NA	NA
GrandSouth Bank	46,422	12.7%	21,900	6.0%	\$ 29,200	8.0%
Total Capital (to Risk Weighted Assets)						
Company	\$ 54,076	14.8%	\$ 29,222	8.0%	NA	NA
GrandSouth Bank	50,737	13.9%	29,200	8.0%	\$ 36,500	10.0%
Common Equity Tier 1 Capital (to Risk Weighted Assets)						
Company	\$ 41,762	11.4%	\$ 16,438	4.5%	NA	NA
GrandSouth Bank	46,422	12.7%	16,425	4.5%	\$ 23,725	6.5%

Note 18. Disclosures about Fair Values of Financial Instruments

The Company has not elected to value any financial instruments at fair value under the Fair Value Option of ASC Topic 825, but is required by other accounting standards to disclose relevant information about the fair values of financial instruments and certain other items.

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Note 18. Disclosures about Fair Values of Financial Instruments, Continued

Fair value is the price that would be received to sell an asset or transfer a liability in an orderly transaction between market participants at the measurement date. Fair value may reflect actual transaction prices or may reflect the application of valuation techniques if the transaction was between related parties, the transaction occurred under duress, or other circumstances where the transaction price may not be indicative of the fair value of the particular asset or liability. When valuation techniques are used, the inputs may be either observable or unobservable. Assets or liabilities may be measured at fair value on either a recurring basis or a non-recurring basis.

A three level hierarchy is used for fair value measurements based upon the transparency of inputs to the valuation technique. When available, fair value is based upon quoted market prices in active markets for identical assets or liabilities (Level 1 inputs) or for similar assets and liabilities or upon inputs that are observable for the asset or liability, either directly or indirectly (Level 2 inputs). When neither Level 1 nor Level 2 inputs are available, the Company may use unobservable inputs which may be significant to the fair value measurement (Level 3). The lowest level of input that is significant to the fair value measurement determines an item's categorization within the fair value hierarchy.

The following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis in the Consolidated Balance Sheets, including the general classification of such instruments pursuant to the valuation hierarchy.

	<u>Fair value measurement at reporting date using</u>			
	<u>Total</u>	<u>Quoted prices in active markets for identical assets (Level 1)</u>	<u>Significant other observable inputs (Level 2)</u>	<u>Significant unobservable inputs (Level 3)</u>
	(Dollars in thousands)			
December 31, 2016				
Government sponsored enterprises (GSEs)	\$ 6,861	\$ -	\$ 6,861	\$ -
State, county, and municipal	11,980	-	11,980	-
Mortgage-backed securities issued by GSEs	6,702	-	6,702	-
Mortgage-backed securities not issued by GSEs	-	-	-	-
Total	<u>\$ 25,543</u>	<u>\$ -</u>	<u>\$ 25,543</u>	<u>\$ -</u>
December 31, 2015				
Government sponsored enterprises (GSEs)	\$ 1,025	\$ -	\$ 1,025	\$ -
State, county, and municipal	7,464	-	7,464	-
Mortgage-backed securities issued by GSEs	6,247	-	6,247	-
Mortgage-backed securities not issued by GSEs	149	-	-	149
Total	<u>\$ 14,885</u>	<u>\$ -</u>	<u>\$ 14,736</u>	<u>\$ 149</u>

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Note 18. Disclosures about Fair Values of Financial Instruments, Continued

Pricing for the Company's securities available-for-sale is obtained from an independent third-party that uses a process that may incorporate current prices, benchmark yields, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, other reference items and industry and economic events that a market participant would be expected to use as inputs in valuing the securities. Not all of the inputs listed apply to each individual security at each measurement date. The independent third party assigns specific securities into an "asset class" for the purpose of assigning the applicable level of the fair value hierarchy used to value the securities. The CMO categorized as Level 3 above has been valued using a discounted cash flow analysis using inputs including the discount margin, default rates and prepayment speeds of the underlying collateral.

The following is a description of the valuation methodologies used for financial instruments measured at fair value on a non-recurring basis in the Consolidated Balance Sheets including the general classification of such instruments pursuant to the valuation hierarchy.

	<u>Fair value measurement at reporting date using</u>			
	Quoted prices		Significant	Significant
	in active	other	other	unobservable
	markets for	observable	observable	unobservable
	identical	inputs	inputs	inputs
	assets	(Level 2)	(Level 2)	(Level 3)
	(Level 1)	(Level 2)	(Level 2)	(Level 3)
<u>Total</u>	<u>(Level 1)</u>	<u>(Level 2)</u>	<u>(Level 2)</u>	<u>(Level 3)</u>
	(Dollars in thousands)			
December 31, 2016				
Loans individually reviewed for impairment	\$ 10,338	\$ -	\$ -	\$ 10,338
Assets acquired in settlement of loans	4,902	-	-	4,902
	<u>\$ 15,240</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 15,240</u>
December 31, 2015				
Loans individually reviewed for impairment	\$ 1,767	\$ -	\$ -	\$ 1,767
Assets acquired in settlement of loans	5,275	-	-	5,275
	<u>\$ 7,042</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 7,042</u>

Fair values of impaired loans are estimated based on discounted cash flow analyses or on recent appraisals of the underlying properties or other information derived from market sources.

Assets acquired in settlement of loans are carried at the lower of cost or fair value. Fair value is measured on a non-recurring basis and is based on independent market prices or current appraisals that are generally prepared using an income or market valuation approach and conducted by an independent licensed third party appraiser, adjusted for estimated selling costs.

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Note 18. Disclosures about Fair Values of Financial Instruments, Continued

For Level 3 assets and liabilities measured at fair value on a non-recurring basis as of December 31, 2016, the significant unobservable inputs used in the fair value measurements were as follows:

Description	<u>Valuation Technique</u>	<u>Significant Unobservable Inputs</u>	<u>General Range of Significant Unobservable Input Values</u>
Loans individually reviewed for impairment	Appraisal value; Present value of discounted cash flows	Discounts to appraisals or cash flows for estimated holdings and/ or selling costs	0 – 15%
Assets acquired in settlement of loans	Appraisal value; List or contract price	Discounts to appraisals for estimated holding or selling costs	0 – 15%

Note 19. Subsequent Events

The Company has evaluated subsequent events through March 30, 2017, the date the financial statements were available for distribution.