Highlands Bancorp, Inc.

2014 Annual Report

Highlands Bancorp, Inc.
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To Our Shareholders:

Your company achieved important progress during 2014, continuing the outstanding growth and drive towards the kind of profitability we all feel is important. During the year we opened our new branch office in the central business area of Sparta; opened a new branch in downtown Denville; completed the acquisition of our mortgage subsidiary, Secured Lending Solutions, Inc.; acquired $5.0 Million in subordinated debt that helped augment capital to our growth, and began our first shareholder common stock dividends totaling $.04 per share for the year. Total Assets reached $272.6 million at the end of 2014 as compared to $223.5 million at the end of 2013, an increase of 22.0% year over year. Net loans, a key driver of our revenue, grew from $189.3 million to $235.1 million, an increase of $45.8 million or 24.2%.

Our primary strategic goal is to focus our efforts on business relationships, and the major portion of the loan growth is due to this commercial emphasis which includes Commercial and Industrial lending, as well as Commercial Real Estate lending. This business focus also helps us to grow our transactional deposit accounts; both interest bearing and non-interest bearing. In 2014, non-interest bearing demand account increased $8.4 million to $51.3 million, up 19.6%. Interest-Bearing checking showed a 21.3% increase to $23.6 million. Overall, deposits ended the year at $234.4 million up $38.3 million or 19.5% over the end of last year.

Net Income available to shareholders for the year was $611,000 or $.33 per diluted common share compared to $2,201,000 or $1.21 per diluted common share for 2013. Our 2014 net income was negatively impacted by a wire fraud that totaled $393,000 and occurred in the fourth quarter of the year. As we mentioned in earlier releases, this loss was not the result of our systems being compromised, but by a customer’s personal email identify account being breached. We are pursuing recovery through insurance coverage, but have no assurance that we will be successful in our efforts to recover the losses, accordingly, we elected to take the loss in the last quarter. Last year’s net income was positively impacted by our deferred tax asset valuation allowance in the amount of $1,699,000 or $.93 per diluted common share. On a pre-tax basis, without giving effect to the 2014 wire fraud charge, pre-tax net income increased by $566,000 to $1,526,000 compared to $960,000 in 2013, an increase of 59.0% (non-GAAP).

With the growth of our lending and the cost-effective funding sources of low cost transaction accounts, our net interest income continues a strong upwards momentum. In 2014, net interest income (loan loss provisions) was $9,177,000, compared to $8,036,000 in 2013, an increase of 14.2% or $1,141,000. Non-Interest Income grew from $180,000 to $2,235,000. Much of this increase in non-interest income was due gains on sales of mortgage loans by Secured Lending Solutions (SLS), our residential mortgage subsidiary which we acquired at the end of February 2014. SLS brings us a strong mortgage origination platform, and gives us the ability to provide competitive mortgage products to our customers and our market, and importantly, the ability to sell those mortgages to investors for fee income rather than placing these loans in our portfolio.

Non-Interest Expense was $9,608,000 for the year, compared with $6,529,000 in 2013. The majority of the increase was due to higher salary costs from the addition of SLS to our company, increases in occupancy expenses with the addition of the two new branch offices, and the wire fraud charge that was mentioned earlier.

During 2014 we further reduced non-performing loans, both in dollars and as a percent of our total loans. At the end of the year, non-accrual loans totaled $2,559,000 and represented 1.07% of total outstanding loans; in comparison to $4,409,000 and 2.30% of total loans for 2013. Our loan loss provision was $671,000 in 2014 versus $727,000 in 2013. Charge-offs were $500,000 for the year compared to $760,000 in 2013. The reduction in provision and net charge-offs represent the continued improvement in our overall asset quality.

Looking into 2015, we plan to continue the introduction of technology to help serve our customers and reflect the changes that are occurring in how we and other banks deliver services to customers. Branches are still important to many customers and continue as a critical part of building relationships, but increasingly people are using electronic means of doing their banking. Our Internet banking, mobile banking, mobile deposit capture and business check scanning venues have experienced strong adoption and growth among our customers. This year we plan on enhancing the alert capabilities of our electronic products to allow customer to monitor their accounts as they desire and to enhance their security. We also will move to instant issuance of debit cards to allow new customers to use their Highlands State Bank account immediately upon opening. This will also allow us to replace lost cards immediately, vastly improving customer convenience.

As the year ended we announced the closing of one of our Sparta offices. We entered Sparta in 2008 with the merger with Noble Community Bank, and it is that former headquarters of Noble that we are closing. We will continue to serve Sparta through our newly acquired and renovated office at 31 Sparta Avenue.

We were proud to begin paying dividends in 2014. We feel this is an indication of your Company's progress and performance. We thank you for your support and look forward to continuing the Company's growth and profitability.

George E. Irwin	**Steven C. Ackmann**
Chairman of the Board	President and CEO

Highlands Bancorp, Inc.

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BDO

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Independent Auditor's Report

Board of Directors and Stockholders
Highlands Bancorp, Inc.
Vernon, New Jersey

We have audited the accompanying consolidated financial statements of Highlands Bancorp, Inc. and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 2014 and 2013, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated 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 consolidated 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 consolidated 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 consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated 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 consolidated 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 consolidated 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Highlands Bancorp, Inc. and its subsidiaries as of December 31, 2014 and 2013, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

BDO USA, LLP

Woodbridge, New Jersey
March 31, 2015

Highlands Bancorp, Inc.

Consolidated Balance Sheets
December 31, 2014 and 2013

	2014	2013
	(In Thousands, except share and per share data)	
ASSETS		
Cash and due from banks	**$ 4,143**	$ 2,823
Interest bearing deposits in other banks	**57**	30
Federal funds sold	**5,292**	-
Cash and Cash Equivalents	**9,492**	2,853
Time deposits in other banks	**3,479**	8,660
Securities available for sale	**10,877**	14,658
Restricted investment in bank stock	**343**	452
Loans held for sale	**4,456**	-
Loans receivable, net of allowance for loan losses of $2,770 and $2,597, respectively	**235,146**	189,346
Premises and equipment, net	**2,877**	2,150
Goodwill	**992**	804
Accrued interest receivable	**792**	658
Foreclosed assets	**610**	609
Deferred income tax assets, net	**2,080**	2,574
Other assets	**1,478**	774
Total Assets	**$ 272,622**	$ 223,538
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Deposits:		
Non-interest bearing	**$ 51,338**	$ 42,926
Interest-bearing	**183,034**	153,188
Total Deposits	**234,372**	196,114
Borrowings	**12,916**	3,853
Accrued interest payable	**82**	48
Other liabilities	**2,441**	1,507
Total Liabilities	**249,811**	201,522
Stockholders' Equity		
Preferred stock, Series C, liquidation preference of $1,000 per share, 6,853 shares outstanding	**6,853**	6,853
Common stock, no par value; authorized 10,000,000 shares; issued and outstanding 1,796,679 shares on December 31, 2014 and 1,788,262 shares on December 31, 2013	**16,168**	16,045
Accumulated deficit	**(213)**	(747)
Accumulated other comprehensive income (loss)	**3**	(135)
Total Stockholders' Equity	**22,811**	22,016
Total Liabilities and Stockholders' Equity	**$ 272,622**	$ 223,538

See notes to consolidated financial statements.

Highlands Bancorp, Inc.

Consolidated Statements of Income

Years Ended December 31, 2014 and 2013

	2014	2013
	(In Thousands except share and per share data)	
Interest income:		
Loans	**$ 10,230**	$ 8,568
Securities	**231**	223
Federal funds sold	**5**	10
Other interest-earning assets	**45**	69
Total interest income	**10,511**	8,870
Interest expense:		
Deposits	**1,009**	798
Borrowings	**325**	36
Total interest expense	**1,334**	834
Net Interest Income	**9,177**	8,036
Provision for loan losses	**671**	727
Net interest income after provision for loan losses	**8,506**	7,309
Non-interest income		
Fees and service charges	**825**	475
Gain on sale of loans	**1,294**	-
Gain on sale of securities available for sale	**93**	16
Loss on sale of foreclosed assets	**-**	(68)
Loss on branch lease	**-**	(76)
Writedown on foreclosed property	**(58)**	(227)
Other income	**81**	60
Total non-interest income	**2,235**	180
Non-interest expense		
Salaries and employee benefits	**4,882**	3,055
Occupancy and equipment	**1,417**	982
Professional fees	**513**	470
Advertising and promotion	**201**	104
Data processing	**832**	713
FDIC insurance premium	**202**	182
Foreclosed asset expense	**62**	255
Wire fraud writeoff	**393**	-
Other	**1,106**	768
Total non-interest expense	**9,608**	6,529
Net income before income taxes	**$ 1,133**	$ 960
Income tax expense (benefit)	**453**	(1,310)
Net income	**$ 680**	$ 2,270
Preferred stock dividends	**(69)**	(69)
Net income available to common stockholders	**$ 611**	$ 2,201
Net income per common share		
Basic	**$ 0.34**	$ 1.23
Diluted	**$ 0.33**	$ 1.21
Weighted average common shares outstanding		
Basic	**1,795,342**	1,788,262
Diluted	**1,847,330**	1,819,724

See notes to consolidated financial statements.

Consolidated Statements of Comprehensive Income

Years Ended December 31, 2014 and 2013

(In Thousands)

	2014	2013
	(In Thousands)	
Net income	**$ 680**	$ 2,270
Other comprehensive income (loss):		
Unrealized holding gains (losses) on securities available for sale	**322**	(383)
Reclassification adjustment for realized gains included in the statements of income	**(93)**	(16)
	229	(399)
Tax effect	**(91)**	159
Other comprehensive income (loss)	**$ 138**	$ (240)
Comprehensive income	**$ 818**	$ 2,030

See notes to consolidated financial statements.

Consolidated Statements of Stockholders' Equity
Years Ended December 31, 2014 and 2013
(In Thousands)

	Preferred Stock	Common Stock	Accumulated Deficit	Accumulated Other Comprehensive (Loss) Income	Total
Balance - December 31, 2012	$ 6,853	$ 15,972	$ (2,948)	$ 105	$ 19,982
Net income	-	-	2,270	-	2,270
Other comprehensive loss	-	-	-	(240)	(240)
Preferred stock dividends	-	-	(69)	-	(69)
Share-based compensation expense	-	73	-	-	73
Balance - December 31, 2013	6,853	16,045	(747)	(135)	22,016
Net income	-	-	680	-	680
Stock issued pursuant to purchase of Secure Lending Solutions, Inc. (8,417 shares)	-	50	-	-	50
Other comprehensive income	-	-	-	138	138
Preferred stock dividends	-	-	(69)	-	(69)
Common stock dividends	-	-	(77)	-	(77)
Share-based compensation expense	-	73	-	-	73
Balance - December 31, 2014	$ 6,853	$ 16,168	$ (213)	$ 3	$ 22,811

See notes to consolidated financial statements.

Highlands Bancorp, Inc.

Consolidated Statements of Cash Flows

Years Ended December 31, 2014 and 2013

	2014	2013
	(In Thousands)	
Cash flows from operating activities:		
Net income	**$ 680**	$ 2,270
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation of premises and equipment	**448**	277
Amortization and accretion, net	**(138)**	209
Gain on sale of available for sale securities	**(93)**	(16)
Proceeds of sales of loans held for sale	**28,810**	-
Origination of loans held for sale	**(31,972)**	-
Gain on sales of loans held for sale	**(1,294)**	-
Provision for loan losses	**671**	727
Loss on sale of foreclosed assets	**-**	68
Writedown on foreclosed assets	**58**	227
Loss on branch lease	-	76
Share-based compensation expense	**73**	73
Deferred income tax	**403**	(1,365)
(Increase) decrease in interest receivable	**(134)**	10
(Increase) decrease in other assets	**(502)**	367
Increase (decrease) in accrued interest payable	**34**	(5)
Increase in other liabilities	**896**	328
Net cash (used in) provided by operating activities	**(2,060)**	3,246
Cash flows from investing activities:		
Purchases of time deposits	**(3,230)**	(8,665)
Principal repayments on time deposits	**8,411**	8,340
Purchases of securities available for sale	**(6,007)**	(11,490)
Proceeds from sales of securities available for sale	**4,497**	1,512
Proceeds from maturities, calls and prepayments of securities available for sale	**5,622**	6,739
Net increase in loans receivable	**(46,458)**	(29,646)
Purchases of restricted stock	**(2,092)**	(981)
Redemption of restricted stock	**2,201**	992
Purchases of premises and equipment	**(1,167)**	(1,396)
Acquisition of Secure Lending Solutions, Inc., net of cash received	**(258)**	-
Proceeds from the sale of foreclosed assets	**-**	2,239
Net cash used in investing activities	**(38,481)**	(32,356)
Cash flows from financing activities:		
Net increase in deposits	**38,258**	29,232
Increase (decrease) in short term borrowings	**4,063**	(236)
Increase (decrease) in long term borrowings	**5,000**	(1,000)
Cash dividends paid on common stock	**(72)**	-
Cash dividends paid on preferred stock	**(69)**	(69)
Net cash provided by financing activities	**47,180**	27,927
Net increase (decrease) in cash and cash equivalents	**6,639**	(1,183)
Cash and cash equivalents-beginning	**2,853**	4,036
Cash and cash equivalents-ending	**$ 9,492**	$ 2,853
Supplemental information:		
Cash paid during the year for interest	**$ 1,300**	$ 839
Cash paid during the year for income taxes	**$ 225**	$ 9
Supplemental schedule of Non-cash Investing Activities:		
Foreclosed real estate acquired in settlement of loans	**$ 55**	$ -
Common stock issued in acquisition of Secure Lending Solutions, Inc.	**$ 50**	$ -

See notes to consolidated financial statements.

Note 1 - Summary of Significant Accounting Policies

Organization and Nature of Operations

The consolidated financial statements include the accounts of Highlands Bancorp, Inc. (the "Company") and its wholly-owned subsidiary, Highlands State Bank (the "Bank" or "Highlands") and the Bank's wholly-owned subsidiaries, Secure Lending Solutions, Inc., HSB Mountain Lakes LLC, HSB Chapel LLC, HSB Village Way LLC, HSB Empire LLC, and 31 Sparta Avenue LLC. All significant intercompany accounts and transactions have been eliminated in the consolidated financial statements.

The only activity of Highlands Bancorp, Inc. is the ownership of Highlands State Bank. The Company is subject to the supervision and regulation of the Board of Governors of the Federal Reserve System (the "FRB") and New Jersey Department of Banking and Insurance ("NJDOBI"). The Bank is subject to supervision and regulation by the NJDOBI and the Federal Deposit Insurance Corporation ("FDIC").

On February 28, 2014, the Company's wholly owned subsidiary, Highlands State Bank, completed the purchase of Secure Lending Solutions, Inc., (SLS) after receiving the appropriate regulatory approvals. The consideration paid for this purchase consisted of 8,417 shares of Company common stock having a fair value of $50,000 and cash of $300,000. SLS, a New Jersey licensed mortgage banking company, operates as a wholly owned subsidiary of the Bank, and continues to operate out of its office at 266 Harristown Road, Glen Rock, NJ. SLS has developed a strong presence in northern New Jersey and southern New York State, and specializes in conventional 1-4 family mortgage lending that includes FHA, VA, and USDA Rural development loans. SLS also offers reverse mortgage products.

Highlands State Bank is a New Jersey state chartered bank which commenced operations on October 31, 2005. The Bank is a full service bank providing personal and business lending and deposit services. The area served by the Bank includes Sussex, Passaic, and Morris Counties of New Jersey. Secure Lending Solutions Inc., was acquired as part of the Bank's strategy of entering the mortgage origination market. HSB Mountain Lakes, LLC, and HSB Chapel LLC were formed in 2010 and 2011, respectively, and HSB Village Way LLC and HSB Empire LLC were formed in 2012, to hold certain real estate properties acquired in settlement of loans. 31 Sparta Avenue LLC was acquired in 2013 as part of the Bank's purchase of its new Sparta branch location.

Estimates

The preparation of 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 at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of foreclosed assets and the valuation of deferred tax assets.

Significant Group Concentrations of Credit Risk

Most of the Company's activities are with customers located within northern New Jersey. Note 3 discusses the types of securities that the Company invests in. Note 4 discusses the types of lending that the Company engages in. Although the Company has a diversified loan portfolio, its debtors' ability to honor their

Note 1 - Summary of Significant Accounting Policies (Continued)

contracts is influenced by the region's economy. The Company does not have any significant concentrations to any one industry or customer.

Presentation of Cash Flows

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold and short-term interest-bearing deposits in other banks all with original maturities within ninety days. Generally, federal funds are purchased or sold for one day periods.

Time Deposits in Other Banks

Interest-bearing time deposits in other banks mature within one year and are carried at cost. All time deposits are covered by FDIC insurance.

Securities

Securities classified as available for sale are those securities that the Company intends to hold for an indefinite period of time but not necessarily to maturity. Securities available for sale are carried at fair value. Any decision to sell a security classified as available for sale would be based on various factors, including significant movement in interest rates, changes in maturity mix of the Company's assets and liabilities, liquidity needs, regulatory capital considerations and other similar factors. Unrealized gains and losses are reported as increases or decreases in other comprehensive income (loss). Realized gains or losses, determined on the basis of the cost of the specific securities sold, are included in earnings. Premiums and discounts are recognized in interest income using the interest method over the terms of the securities.

Securities classified as held to maturity are those debt securities the Company has both the intent and ability to hold to maturity regardless of changes in market conditions, liquidity needs or changes in general economic conditions. These securities are carried at cost, adjusted for the amortization of premium and accretion of discount, computed by the interest method over the terms of the securities. At December 31, 2014 and 2013, the Company held no securities classified as held to maturity.

Other-than-temporary impairment losses accounting guidance specifies that (a) if a company does not have the intent to sell a debt security prior to recovery and (b) it is more likely than not to it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired unless there is a credit loss. When an entity does not intend to sell the security, and it is more likely than not, the entity will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income.

The Company did not recognize any other-than-temporary impairment losses in the years ended December 31, 2014 or 2013.

Restricted Investment in Bank Stock

Restricted stock is comprised of stock of the Federal Home Loan Bank of New York (FHLB) in the amount of $243,300 and Atlantic Community Bankers Bank in the amount of $100,000 as of December 31, 2014. Federal law requires a member institution of the FHLB to hold stock according to a predetermined formula. All restricted stock is recorded at cost. Management has evaluated the restricted stock for impairment and

Note 1 - Summary of Significant Accounting Policies (Continued)

believes no impairment charge was necessary at December 31, 2014. The determination of whether a decline affects the ultimate recovery of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for FHLB and the length of time this situation has persisted, (2) commitment by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, and (3) the impact of legislative and regulatory changes on institutions and accordingly, on the customer base of the FHLB.

Loans Held For Sale

Loans held for sale are carried at the lower of cost or fair value in the aggregate based on investor quotes. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income.

Loans Receivable

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at their outstanding unpaid principal balances, net of an allowance for loan losses and any deferred fees or costs. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the yield (interest income) of the related loans. The Company is amortizing these amounts over the contractual life of the loan. Premiums and discounts on purchased loans are amortized as adjustments to interest income using the effective yield method.

The loans receivable portfolio is segmented into commercial and consumer loans. Commercial loans consist of the following classes: commercial real estate, commercial construction, and commercial. Consumer loans consist of the following classes: residential real estate loans, home equity loans and other consumer loans.

For all classes of loans receivable, the accrual of interest is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectability of principal or interest, even though the loan is currently performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on nonaccrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan losses. Interest received on nonaccrual loans, including impaired loans, generally is either applied against principal or reported as interest income, according to management's judgment as to the collectability of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time (generally six months) and the ultimate collectability of the total contractual principal and interest is no longer in doubt. The past due status of all classes of loans receivable is determined based on contractual due dates for loan payments.

Allowance for Loan Losses

The allowance for loan losses represents management's estimate of losses inherent in the loan portfolio as of the balance sheet date and is recorded as a reduction to loans. The allowance for loan losses is increased by the provision for loan losses, and decreased by charge-offs, net of recoveries. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance. All, or part, of the principal balance of loans receivable are charged off to the allowance as soon as it is determined that the repayment of all, or part, of the principal balance is highly unlikely. Because

Note 1 - Summary of Significant Accounting Policies (Continued)

all identified losses are immediately charged off, no portion of the allowance for loan losses is restricted to any individual loan or groups of loans, and the entire allowance is available to absorb any and all loan losses. The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management performs a periodic evaluation of the adequacy of the allowance. The allowance is based on the Company's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as impaired. For loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers pools of loans by loan class including commercial loans not considered impaired, as well as smaller balance homogeneous loans, such as residential real estate, home equity and other consumer loans. These pools of loans are evaluated for loss exposure based upon historical loss rates for each of these categories of loans, adjusted for qualitative factors. These qualitative risk factors include:

1. Lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices.

2. National, regional, and local economic and business conditions as well as the condition of various market segments, including the value of underlying collateral for collateral dependent loans.

3. Nature and volume of the portfolio and terms of loans.

4. Experience, ability, and depth of lending management and staff.

5. Volume and severity of past due, classified and nonaccrual loans as well as other loan modifications.

6. Quality of the Company's loan review system, and the degree of oversight by the Company's Board of Directors.

7. Existence and effect of any concentrations of credit and changes in the level of such concentrations.

8. Effect of external factors, such as competition and legal and regulatory requirements.

An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

The Company engages in a variety of lending activities, including commercial, construction, residential real estate and consumer/installment transactions. The Company focuses its lending activities on individuals, professionals and small- to medium sized businesses.

Note 1 - Summary of Significant Accounting Policies (Continued)

Commercial real estate loans include long-term loans financing commercial properties, either owner occupied or investment properties. Repayment is dependent upon either the ongoing business cash flow of the borrowing entity, resale of the property, or leases in the case of an investment property. Bank policy requires commercial real estate loans to have a loan to value ratio of 75% or less. Loan amortizations vary typically and do not exceed 25 years. These amortizing loans have a five year interest rate reset provision and in addition many have a 10 year balloon payment or call option.

Commercial construction loans terms are one year to eighteen months and have a floating rate tied to the Wall Street Journal prime rate. The Company requires a loan-to-value of not less than 75% before, during, and after the construction. At this time the Company does not finance any speculative commercial construction projects and only considers construction projects that are pre-leased or owner occupied, with cash flow meeting Company policy.

Commercial loans are also made to entrepreneurs, proprietors, professionals, partnerships, LLPs, LLCs and corporations. The assets financed are used within the business for its ongoing operation. Repayment of these kinds of loans generally comes from the cash flow of the business or the ongoing conversions of assets, such as accounts receivable and inventory, to cash. Commercial term loans may have maturities up to 10 years and generally have fixed interest rates for up to five years. Commercial lines of credit are renewed annually and generally carry variable interest rates. Typical collateral for commercial loans include the borrower’s accounts receivable, inventory and machinery and equipment.

Residential mortgages are secured by the borrower’s residential real estate in a first lien position. These loans have variable rates and are based on a 30 year amortization with a 30 year term. The Company also offers home equity lines of credit and home equity loans. Risks associated with loans secured by residential properties are generally lower than commercial loans and include general economic risks, such as the strength of the job market, employment stability and the strength of the housing market. Since most loans are secured by a primary or secondary residence, the borrower’s continued employment is the greatest risk to repayment.

The Company offers a variety of loans to individuals for personal and household purposes. Consumer loans, including home equity loans, are generally considered to have greater risk than first or second mortgages on real estate because they may be unsecured, or, if they are secured, the value of the collateral may be difficult to assess and more likely to decrease in value than real estate.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower’s prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis by either the present value of expected future cash flows discounted at the loan’s effective interest rate or the fair value of the collateral if the loan is collateral dependent.

An allowance for loan losses is established for an impaired loan if its carrying value exceeds its estimated fair value. The estimated fair values of substantially all of the Company’s impaired loans are measured based on the estimated fair value of the loan’s collateral.

Note 1 - Summary of Significant Accounting Policies (Continued)

For commercial loans secured by real estate, estimated fair values are determined primarily through third-party appraisals. When a real estate secured loan becomes impaired, a decision is made regarding whether an updated certified appraisal of the real estate is necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the original appraisal and the condition of the property. Appraised values are discounted to arrive at the estimated selling price of the collateral, which is considered to be the estimated fair value. The discounts also include estimated costs to sell the property.

For commercial loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower's financial statements, inventory reports, accounts receivable agings or equipment appraisals or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets.

Loans whose terms are modified are classified as troubled debt restructurings if the Company grants such borrowers concessions and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a troubled debt restructuring generally involve a temporary reduction in interest rate or an extension of a loan's stated maturity date. Non-accrual troubled debt restructurings are restored to accrual status if principal and interest payments, under the modified terms, are current for six consecutive months after modification. Loans classified as troubled debt restructurings are designated as impaired.

The allowance calculation methodology includes further segregation of loan classes into risk rating categories. The borrower's overall financial condition, repayment sources, guarantors and value of collateral, if appropriate, are evaluated annually for commercial loans or when credit deficiencies arise, such as delinquent loan payments, for commercial and consumer loans. Credit quality risk ratings include regulatory classifications of special mention, substandard, doubtful and loss. Loans classified as special mention have potential weaknesses that deserve management's close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They include loans that are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified as doubtful have all the weaknesses inherent in loans classified substandard with the added characteristic that collection or liquidation in full, on the basis of current conditions and facts, is highly improbable. Loans classified as a loss are considered uncollectible and are charged to the allowance for loan losses. Loans not classified are rated pass.

In addition, Federal regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses and may require the Company to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not be currently available to management. Based on management's comprehensive analysis of the loan portfolio, management believes the current level of the allowance for loan losses is adequate.

Foreclosed Assets

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations are included in other expenses. Changes in the valuation allowance and direct write-downs are included in other non-interest income. Gains and losses on sales of foreclosed assets are included in other non-interest income.

Note 1 - Summary of Significant Accounting Policies (Continued)

Transfers of Financial Assets

Transfers of financial assets, including loan and loan participation sales, are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the related assets.

Goodwill

Goodwill was recognized in connection with the acquisition of Secure Lending Solutions, Inc. in 2014, and Noble Community Bank in December 2008. Goodwill represents the purchase price over the fair value of net assets acquired. In accordance with current accounting standards, goodwill is not amortized, but evaluated at least annually for impairment or more often if events and circumstances indicated that there may be impairment. Any impairment of goodwill results in a charge to income. Goodwill was tested for impairment as of December 31, 2014 and 2013 and there was no impairment.

Advertising Costs

The Company follows the policy of charging the costs of advertising to expense as incurred.

Income Taxes

Income tax accounting guidance results in two components of income tax expense, current and deferred. Current income taxes reflect taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to taxable income or excess of deduction over revenue. Deferred income taxes are provided on the liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and net operating loss carryforwards and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. The Company accounts for uncertain tax positions if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management’s judgment. The Company had no uncertain tax positions as of

Note 1 - Summary of Significant Accounting Policies (Continued)

December 31, 2014 and 2013. The Company recognizes interest and penalties on income taxes as a component of income tax expense. The Company is no longer subject to examination by taxing authorities for the years before January 1, 2010.

Share-Based Compensation

The Company has stock option plans for the benefit of its employees and directors. Stock compensation accounting guidance requires that the compensation cost relating to share-based payment transactions be recognized in the financial statements. That cost will be measured based on the grant date fair value of the equity or liability instruments issued. The stock compensation accounting guidance covers a wide range of share-based compensation arrangements including stock options.

The stock compensation accounting guidance requires that compensation cost for all stock awards be calculated and recognized over the employees' service period, generally defined as the vesting period. For awards with graded-vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. A Black-Scholes model is used to estimate the fair value of stock options.

Comprehensive Income

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

Off-Balance Sheet Financial Instruments

In the ordinary course of business, the Company has entered into off-balance sheet financial instruments consisting of commitments to extend credit and letters of credit. Such financial instruments are recorded in the balance sheet when they are funded.

Net Income Per Common Share

Basic income per share represents net income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company relate solely to outstanding stock options, and are determined using the treasury stock method.

Note 1 - Summary of Significant Accounting Policies (Continued)

The following table presents the potential common shares related solely to the Company's outstanding stock options during the years ended December 31, 2014 and 2013.

	2014	2013
	(In Thousands, except share and per share data)	
Net income available to common stockholders	**$ 611**	$ 2,201
Weighted average shares outstanding	**1,795,342**	1,788,262
Dilutive effect of potential common shares, stock options	**51,988**	31,462
Diluted weighted average common shares outstanding	**1,847,330**	1,819,724
Basic net income per common share	**$ 0.34**	$ 1.23
Diluted net income per common share	**$ 0.33**	$ 1.21

For both years ended December 31, 2014 and 2013, 124,000 stock options were anti-dilutive.

Subsequent Events

The Company has evaluated events and transactions occurring subsequent to the balance sheet date of December 31, 2014 for items that should potentially be recognized or disclosed in these financial statements. The evaluation was conducted through March 31, 2015, the date these consolidated financial statements were available to be issued.

Note 2 – Acquisition of Secure Lending Solutions, Inc.

On February 28, 2014, Highlands State Bank completed its acquisition of Secure Lending Solutions, Inc. ("SLS"), a New Jersey mortgage banking company which has developed a strong presence in northern New Jersey and southern New York State. Secure Lending Solutions, Inc. operates as a wholly owned subsidiary of the Bank, and specializes in conventional one-to-four family mortgage lending that includes FHA, VA, and USDA Rural development loans, and also offers reverse mortgage loans.

The acquisition was consummated pursuant to the Stock Purchase Agreement ("the Agreement") dated October 23, 2013, by and among the Bank and Secure Lending Solutions, Inc. Under the Agreement, the Bank acquired 100% of the outstanding shares of SLS from its ownership partners, in exchange for a combination of cash and Highlands Bancorp Inc. common stock shares. As a result of the acquisition, the Bank recorded an intangible asset (mortgage broker licenses) at its fair value of $175,000, other assets of $17,000, other liabilities of $30,000, and goodwill of $188,000. As per the Agreement, the first $50,000 of the cash purchase price is being held in escrow for a period of one year after the acquisition date to secure the indemnification obligations of SLS' ownership partners.

Note 3 - Securities Available for Sale

The amortized cost, gross unrealized gains and losses, and estimated fair value of securities available for sale at December 31, 2014 and 2013 are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(In Thousands)		
December 31, 2014:				
U.S. Treasuries	**$ 2,470**	**$ 2**	**$ 1**	**$ 2,471**
U.S. Government agencies and sponsored agencies	**6,445**	**33**	**48**	**6,430**
U.S. Government sponsored enterprises (GSEs)-mortgage-backed securities	**1,262**	**17**	**1**	**1,278**
Other	**696**	**2**	**-**	**698**
	$ 10,873	**$ 54**	**$ 50**	**$ 10,877**
December 31, 2013:				
U.S. Treasuries	$ 1,467	$ -	$ 115	$ 1,352
U.S. Government agencies and sponsored agencies	9,934	-	214	9,720
U.S. Government sponsored enterprises (GSEs)-mortgage-backed securities	2,731	68	22	2,777
Other	750	60	1	809
	$ 14,882	$ 128	$ 352	$ 14,658

The amortized cost and fair value of securities at December 31, 2014 by contractual maturity are shown below. Expected maturities may differ from contractual maturities because the borrowers may have the right to prepay obligations with or without penalties.

	Available for Sale	
	Amortized Cost	Fair Value
	(In Thousands)	
Due within one year	**$ 600**	**$ 600**
Due after one year through five years	**8,012**	**7,966**
Due after five years through ten years	**945**	**978**
Due after ten years	**54**	**55**
Mortgage-backed securities	**1,262**	**1,278**
	$ 10,873	**$ 10,877**

Note 3 - Securities Available for Sale (Continued)

The tables below shows the Company's securities, their gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2014 and 2013:

	Less Than Twelve Months		Twelve Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
(In Thousands)						
December 31, 2014:						
U.S. Treasuries	**$ 986**	**$ 1**	**$ -**	**$ -**	**$ 986**	**$ 1**
U.S. Government agencies and sponsored agencies	**998**	**2**	**4,454**	**45**	**5,452**	**47**
U.S. Government sponsored enterprises (GSEs) - mortgage-backed securities	**-**	**-**	**838**	**1**	**838**	**1**
	$ 1,984	**$ 3**	**$ 5,292**	**$ 46**	**$ 7,276**	**$ 49**
December 31, 2013:						
U.S. Treasuries	$ 1,352	$ 115	$ -	$ -	$ 1,352	$ 115
U.S. Government agencies and sponsored agencies	9,720	214	-	-	9,720	214
U.S. Government sponsored enterprises (GSEs) - mortgage-backed securities	952	22	-	-	952	22
Other	599	1	-	-	599	1
	$ 12,623	$ 352	$ -	$ -	$ 12,623	$ 352

Management evaluates all securities with unrealized losses quarterly to determine whether the loss is other than temporary. At December 31, 2014, the Company had 8 securities in an unrealized loss position. Unrealized losses on these securities are due to interest rate fluctuations. Management therefore concluded that these securities were not other-than-temporarily impaired at December 31, 2014. Sales of available for sale securities during 2014 and 2013 resulted in gross gains of $93,000 and $16,000 respectively.

Note 4 - Loans Receivable

The composition of loans receivable at December 31, 2014 and 2013 is as follows:

(In Thousands)	**2014**	2013
Commercial	**$ 38,433**	$ 29,990
Commercial real estate	**166,223**	135,033
Construction	**7,965**	3,386
Residential real estate	**5,145**	6,362
Home equity	**19,728**	17,091
Consumer	**634**	268
Total Loans	**238,128**	192,130
Allowance for loan losses	**(2,770)**	(2,597)
Net deferred loan fees	**(212)**	(187)
	(2,982)	(2,784)
	$ 235,146	$ 189,346

Note 4 - Loans Receivable (Continued)

The following tables summarize information in regards to the allowance for loan losses and the recorded investment in loans receivable as of December 31, 2014 and 2013 and the activity in the allowance for loan losses for the years ended December 31, 2014 and 2013:

	Commercial	Commercial Real Estate	Construction	Residental Real Estate	Home Equity	Consumer	Unallocated	Total
Allowance for credit losses:								
Beginning Balance 1/1/14	**$ 353**	**$ 1,549**	**$ 287**	**$ 194**	**$ 193**	**$ 8**	**$ 13**	**$ 2,597**
Charge-offs	**(85)**	**(172)**	**-**	**(223)**	**(20)**	**-**	**-**	**(500)**
Recoveries	**-**	**-**	**-**	**-**	**-**	**2**	**-**	**2**
Provisions	**764**	**(149)**	**(105)**	**76**	**98**	**(1)**	**(12)**	**671**
Ending balance 12/31/14	**$ 1,032**	**$ 1,228**	**$ 182**	**$ 47**	**$ 271**	**$ 9**	**$ 1**	**$ 2,770**
Ending balance: individually evaluated for impairment	**$ 69**	**$ 23**	**$ 138**	**$ 21**	**$ -**	**$ -**	**$ -**	**$ 251**
Ending balance: collectively evaluated for impairment	**$ 963**	**$ 1,205**	**$ 44**	**$ 26**	**$ 271**	**$ 9**	**$ 1**	**$ 2,519**
Financing receivables:								
Ending balance	**$ 38,433**	**$ 166,223**	**$ 7,965**	**$ 5,145**	**$ 19,728**	**$ 634**		**$ 238,128**
Ending balance: individually evaluated for impairment	**$ 887**	**$ 1,562**	**$ 490**	**$ 165**	**$ -**	**$ -**		**$ 3,104**
Ending balance: collectively evaluated for impairment	**$ 37,546**	**$ 164,661**	**$ 7,475**	**$ 4,980**	**$ 19,728**	**$ 634**		**$ 235,024**

	Commercial	Commercial Real Estate	Construction	Residental Real Estate	Home Equity	Consumer	Unallocated	Total
Allowance for credit losses:								
Beginning Balance 1/1/13	$ 942	$ 1,132	$ 187	$ 173	$ 185	$ 11	$ -	$ 2,630
Charge-offs	(596)	-	-	-	(166)	-	-	(762)
Recoveries	1	-	-	-	-	1	-	2
Provisions	6	417	100	21	174	(4)	13	727
Ending balance 12/31/13	$ 353	$ 1,549	$ 287	$ 194	$ 193	$ 8	$ 13	$ 2,597
Ending balance: individually evaluated for impairment	$ 52	$ 119	$ 266	$ 169	$ -	$ -	$ -	$ 606
Ending balance: collectively evaluated for impairment	$ 301	$ 1,430	$ 21	$ 25	$ 193	$ 8	$ 13	$ 1,991
Financing receivables:								
Ending balance	$ 29,990	$ 135,033	$ 3,386	$ 6,362	$ 17,091	$ 268		$ 192,130
Ending balance: individually evaluated for impairment	$ 634	$ 1,990	$ 1,590	$ 559	$ -	$ -		$ 4,773
Ending balance: collectively evaluated for impairment	$ 29,356	$ 133,043	$ 1,796	$ 5,803	$ 17,091	$ 268		$ 187,357

Note 4 - Loans Receivable (Continued)

The following tables present the classes of the commercial loan portfolio summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Company's internal risk rating system and the classes of the consumer loan portfolio by credit risk based on payment activity as of December 31, 2014 and 2013:

	Commercial	Commercial	**Commercial Real Estate**	Commercial Real Estate	**Construction**	Construction
	12/31/2014	12/31/2013	**12/31/2014**	12/31/2013	**12/31/2014**	12/31/2013
Pass	**$ 37,420**	$ 29,356	**$ 164,011**	$ 133,043	**$ 7,475**	$ 1,796
Special Mention	**149**	24	**650**	-	**-**	-
Substandard	**864**	610	**1,562**	1,990	**490**	1,590
Doubtful	**-**	-	**-**	-		
Total	**$ 38,433**	$ 29,990	**$ 166,223**	$ 135,033	**$ 7,965**	$ 3,386

Consumer Credit Exposure
Credit Risk Profile Based on Payment Activity

	Residential Real Estate	Residential Real Estate	**Home Equity**	Home Equity	**Consumer**	**Consumer**
	12/31/2014	12/31/2013	**12/31/2014**	12/31/2013	**12/31/2014**	**12/31/2013**
Performing	**$ 4,980**	$ 5,699	**$ 19,411**	$ 16,795	**$ 628**	$ 256
Nonperforming	**165**	663	**317**	296	**6**	12
Total	**$ 5,145**	$ 6,362	**$ 19,728**	$ 17,091	**$ 634**	$ 268

Note 4 - Loans Receivable (Continued)

The following tables summarize information in regards to impaired loans by loan portfolio class as of December 31, 2014 and 2013:

December 31, 2014	**Recorded Investment**	**Unpaid Principal Balance**	**Related Allowance**	**Average Recorded Investment**	**Interest Income Recognized**
			(In Thousands)		
With no related allowance recorded:					
Commercial	**$ -**	**$ -**	**$ -**	**$ -**	**$ -**
Commercial real estate	**41**	**46**	**-**	**43**	**-**
Commercial construction	**-**	**-**	**-**	**-**	**-**
Residential mortgage	**-**	**-**	**-**	**-**	**-**
With an allowance recorded:					
Commercial	**$ 887**	**$ 887**	**$ 69**	**$ 780**	**$ 22**
Commercial real estate	**1,520**	**1,663**	**23**	**1,649**	**24**
Commercial construction	**490**	**490**	**138**	**1,066**	**-**
Residential mortgage	**165**	**171**	**21**	**457**	**6**
Total:					
Commercial	**$ 887**	**$ 887**	**$ 69**	**$ 780**	**$ 22**
Commercial real estate	**1,561**	**1,709**	**23**	**1,692**	**24**
Commercial construction	**490**	**490**	**138**	**1,066**	**-**
Residential mortgage	**165**	**171**	**21**	**457**	**6**

December 31, 2013	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
			(In Thousands)		
With no related allowance recorded:					
Commercial	$ -	$ -	$ -	$ -	$ -
Commercial real estate	-	-	-	-	-
Commercial construction	-	-	-	-	-
Residential mortgage	-	-	-	-	-
With an allowance recorded:					
Commercial	$ 634	$ 749	$ 52	$ 1,083	$ 7
Commercial real estate	1,990	2,097	119	2,009	21
Commercial construction	1,590	1,590	266	1,873	-
Residential mortgage	559	562	169	559	-
Total:					
Commercial	$ 634	$ 749	$ 52	$ 1,083	$ 7
Commercial real estate	1,990	2,097	119	2,009	21
Commercial construction	1,590	1,590	266	1,873	-
Residential mortgage	559	562	169	559	-

Note 4 - Loans Receivable (Continued)

The following table presents nonaccrual loans by classes of the loan portfolio as of December 31, 2014 and 2013:

	2014	2013
	(In Thousands)	
Commercial	**$ 618**	$ 348
Commercial real estate	**1,079**	1,508
Commercial construction	**490**	1,590
Residential mortgage	**165**	663
Home equity	**201**	296
Consumer, other	**6**	4
	$ 2,559	$ 4,409

The performance and credit quality of the loan portfolio is also monitored by analyzing the age of the loans receivable as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the past due status as of December 31, 2014 and 2013:

December 31, 2014	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	**Total Loans Receivable**	Recorded Investment > 90 Days and Accruing
Commercial	$ 520	$ 92	$ 618	$ 1,230	$ 37,203	**$ 38,433**	$ -
Commercial real estate	2,017	1,294	394	3,705	162,518	**166,223**	
Commercial construction	40	-	450	490	7,475	**7,965**	-
Residential mortgage	165	-	-	165	4,980	**5,145**	-
Home equity	51	-	62	113	19,615	**19,728**	-
Consumer, other	-	-	5	5	629	**634**	-
Total	$ 2,793	$ 1,386	$ 1,529	$ 5,708	$ 232,420	**$ 238,128**	$ -

December 31, 2013	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	**Total Loans Receivable**	Recorded Investment > 90 Days and Accruing
Commercial	$ -	$ -	$ 348	$ 348	$ 29,642	**$ 29,990**	$ -
Commercial real estate	487	231	790	1,508	133,525	**135,033**	
Commercial construction	-	-	1,590	1,590	1,796	**3,386**	-
Residential mortgage	-	-	663	663	5,699	**6,362**	-
Home equity	45	19	187	251	16,840	**17,091**	-
Consumer, other	-	107	-	107	161	**268**	-
Total	$ 532	$ 357	$ 3,578	$ 4,467	$ 187,663	**$ 192,130**	$ -

Note 4 - Loans Receivable (Continued)

At December 31, 2014, the Company had six loans classified as TDRs with a combined balance of $1.2 million. At December 31, 2013 the Company had six loans classified as TDRs with combined balances of $1.7 million. Based upon the borrower's unique situations, certain modifications were made to the original loans interest rate, maturity date or loan terms that resulted in these loans being classified as TDRs. The following table reflects information regarding the Company's troubled debt restructurings for the years ended December 31, 2014 and 2013:

Troubled Debt Restructurings for the year ended December 31, 2014:

	Number of Contracts	**Pre-Modification Outstanding Recorded Investments**	**Post-Modification Outstanding Recorded Investments**	**Modification**
		(In Thousands)		
Home Equity	**1**	**$ 134**	**$ 134**	**Reduced interest rate**

Troubled Debt Restructurings for the year ended December 31, 2013:

	Number of Contracts	Pre-Modification Outstanding Recorded Investments	Post-Modification Outstanding Recorded Investments	Modification
		(In Thousands)		
Commercial	1	$ 269	$ 262	Reduced interest rate and extended the term
Home Equity	1	$ 107	$ 109	Reduced interest rate
Consumer other	1	$ 8	$ 7	Reduced interest rate

During 2014 and 2013, no TDRs defaulted.

Note 5 - Financial Instruments with Off-Balance Sheet Risk

The Company is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and letters of credit. Such commitments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the financial statements.

The Company's exposure to credit loss from nonperformance by the other party to the financial instruments for commitments to extend credit and letters of credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Note 5 - Financial Instruments with Off-Balance Sheet Risk (Continued)

The contract or notional amounts of financial instruments where contract amounts represent credit risk at December 31, 2014 and 2013 are as follows:

	December 31, 2014	December 31, 2013
	(In Thousands)	
Outstanding loan and credit line commitments	**$79,821**	$60,301
Outstanding letters of credit	**1,267**	877

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by management upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include personal or commercial real estate, accounts receivable, inventory and equipment.

Outstanding letters of credit written are conditional commitments issued to guarantee the performance of a customer to a third party. These standby letters of credit expire within the next twelve months. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending other loan commitments. The Company requires collateral supporting these letters of credit as deemed necessary. Outstanding letters of credit at December 31, 2014 were $1,267,000, all of which were secured by collateral. Outstanding letters of credit at December 31, 2013 were $877,000, all of which were secured by collateral. The current amount of the liability as of December 31, 2014 and 2013 for guarantees under standby letters of credit is not material.

Note 6 - Premises and Equipment

The components of premises and equipment at December 31, 2014 and 2013 are as follows:

	Estimated Useful Lives	2014	2013
		(In Thousands)	
Land		**$ 302**	$ 301
Building	40 years	**645**	640
Building improvements	40 years	**371**	131
Leasehold improvements	2 - 10 years	**1,875**	1,648
Furniture, fixtures and equipment	5 - 10 years	**1,368**	877
Computer equipment and data processing software	3 - 5 years	**891**	680
		5,452	4,277
Accumulated depreciation		**(2,575)**	(2,127)
		$2,877	$ 2,150

Note 7 – Deposits

The components of deposits at December 31, 2014 and 2013 are as follows:

	2014	2013
	(In Thousands)	
Demand, non-interest bearing	**$ 51,338**	$ 42,926
Demand interest bearing	**23,580**	19,435
Money market accounts	**34,344**	27,407
Savings	**39,570**	41,191
Time, $100,000 and over	**71,692**	56,840
Time, other	**13,848**	8,315
	$234,372	$196,114

Note 7 – Deposits (Continued)

At December 31, 2014, the scheduled maturities of time deposits are as follows:

	(In Thousands)
2015	**$ 21,551**
2016	**19,633**
2017	**21,944**
2018	**14,375**
2019	**7,786**
Thereafter	**250**
	$85,539

Note 8 - Lease Commitments

The Company leases its banking facilities under operating lease agreements expiring through 2021. The Company is also required to pay a monthly fee for its portion of certain operating expenses, including real estate taxes, insurance, utilities, maintenance and repairs in addition to the base rent. Rent expense for the years ended December 31, 2014 and 2013 totaled $474,000 and $398,000, respectively.

Two of the lease agreements are with related parties. In 2005, the Company entered into a ten-year operating lease agreement with this related party for its main banking office. Total rent expense paid to the related party under this lease agreement was $180,000 and $174,000 for the years ended December 31, 2014 and 2013, respectively. In 2013, the Company signed a one-year lease agreement for additional office space located next door to its main banking office with a second related party, and in 2015 the Company leased additional office space in this same location, renewing the lease for both areas for an additional five years. Total rent expense paid to the related party under this lease agreement was $19,000 and $16,000 for the years ended December 31, 2014 and 2013, respectively. The lease terms of the related party leases are comparable to similarly outfitted office space in the Company's market.

Future minimum lease payments by year and in the aggregate under these lease agreements are as follows:

	(In Thousands)
2015	**$ 714**
2016	**507**
2017	**309**
2018	**314**
2019	**203**
Thereafter	**231**
	$2,278

Note 9 - Borrowings

The components of borrowings outstanding at December 31, 2014 and 2013 are as follows:

	2014	2013
	(In Thousands)	
Subordinated debt due May 16, 2024	**$ 5,000**	$ -
Federal funds line of credit	**3,500**	1,853
Warehouse line of credit	**4,416**	-
Federal Home Loan Bank short-term borrowings	-	2,000
	$ 12,916	$ 3,853

In May 2014 the Company completed a $5,000,000 private placement of subordinated debt, the proceeds of which the Company uses for increased capital for strategic growth and as supplement the Bank's regulatory capital levels. The Note bears an interest rate of 8.00% with quarterly interest payments, and matures May 16, 2024. Upon receipt of the proceeds, $4,000,000 was down streamed to the Bank as additional Tier 1 capital.

The Company has a $5,000,000 unsecured line of credit with Atlantic Central Bankers Bank (ACBB) for federal funds purchased of which $0 and $1,853,000 was outstanding at December 31, 2014 and 2013, respectively. The line of credit expires June 30, 2015. In 2014, the Company also established a $4,500,000 unsecured line of credit with Zions Bank for federal funds purchased of which $3,500,000 was outstanding at December 31, 2014. This line of credit has no expiration date but requires the Company to maintain a demand deposit account balance at Zions Bank as specified in the Fed Funds Line Agreement.

The Company also has borrowing capabilities with the Federal Home Loan Bank of New York (FHLB) which are secured under terms of a blanket collateral agreement by pledges of qualifying collateral. At December 31, 2014 and 2013, outstanding borrowings were $0 and $2,000,000, respectively. The 2013 borrowings had a weighted average interest rate of 2.67% and matured in 2014.

The Bank's subsidiary, Secure Lending Solutions, Inc. has a $5,000,000 mortgage loan warehousing agreement revolving line established with First Constitution Bank, which it uses to fund mortgage loans. This line is secured by pledging the underlying mortgage collateral, and had a balance outstanding at December 31, 2014 of $4,416,000. This credit line expires July 31, 2015.

Note 10 - Preferred Stock

On May 8, 2009, the Bank issued to the United States Treasury Department (the "Treasury") 3,091 shares of Series 2009A Preferred Stock and a warrant to purchase 155 shares of the Bank's Series 2009B Preferred Stock for an aggregate purchase price of $3,091,000 in cash ("TARP funds"). The warrant was exercised as a cashless exercise on May 8, 2009 and 155 shares of Series 2009B Preferred Stock were issued. Both series of preferred stock qualified as a Tier 1 capital. On December 22, 2009, the Bank consummated a second financing with the Treasury under the Capital Purchase Program for Small Banks pursuant to which the Bank issued to the Treasury

Note 10 - Preferred Stock (Continued)

an additional 2,359 shares of Series 2009A Preferred Stock for total proceeds of $2,359,000. The Series 2009A Preferred Stock paid non-cumulative dividends of 5% per annum for the first five years and 9% per annum thereafter. Series 2009B Preferred Stock paid non-cumulative dividends of 9% per annum.

Upon consummation of the holding company reorganization on August 31, 2010, the Company assumed all of the Bank's obligations under the preferred stock, and issued to the Treasury shares of the Company's preferred stock in exchange for the outstanding shares of Bank preferred stock.

On September 22, 2011, the Company entered into a Securities Purchase Agreement (the "Purchase Agreement") with the Secretary of the Treasury (the "Treasury"), pursuant to which the Company issued and sold to the Treasury 6,853 shares of its Senior Non-Cumulative Perpetual Preferred Stock, Series C (the "Series C Preferred Stock"), having a liquidation preference of $1,000 per share (the "Liquidation Amount"), for proceeds of $6,853,000. The Purchase Agreement was entered into, and the Series C Preferred Stock was issued, pursuant to the Treasury's SBLF program, a $30 billion fund established under the Small Business Jobs Act of 2010 that encourages lending to small businesses by providing capital to qualified community banks with assets of less than $10 billion. The proceeds were used to redeem the Series 2009A and 2009B preferred stock previously issued to the U.S. Treasury under the Capital Purchase Program, and to further enhance the Bank's business lending efforts.

The Series C Preferred Stock qualifies as Tier 1 capital for the Company. Non-cumulative dividends are payable quarterly on the Series C Preferred Stock, beginning January 1, 2012. The dividend rate is calculated as a percentage of the aggregate Liquidation Amount of the outstanding Series C Preferred Stock and is based on changes in the level of "Qualified Small Business Lending" or "QSBL" (as defined in the Purchase Agreement) by the Bank. Based upon the increase in the Bank's level of QSBL over the baseline level calculated under the terms of the Purchase Agreement, the dividend rate for the initial dividend period, which is from the date of issuance through December 31, 2011, was set at 1.65%. For the 2nd through 10th calendar quarters, the annual dividend rate may be adjusted to between 1% and 5%, to reflect the amount of change in the Banks' level of QSBL. For the 11th calendar quarter through 4.5 years after issuance, the dividend rate will be fixed at between 1% and 7% based upon the increase in QSBL as compared to the baseline. After 4.5 years from issuance, the dividend rate will increase to 9%. The actual dividend payments made during 2014 and 2013 reflected a rate of 1.00%.

The Series C preferred shares are non-voting, other than class voting rights on matters that could adversely affect the shares. The preferred shares are redeemable at any time, with Treasury, Federal Reserve and FDIC approval. Apart from the Series C shares, no other shares of the Company's preferred stock are currently outstanding.

Note 11 - Federal Income Taxes

The components of income tax expense (benefit) for the years ended December 31, 2014 and 2013 were as follows:

	2014	2013
	(In Thousands)	
Current taxes	**$ 50**	$ 55
Deferred taxes	**403**	334
Reversal of valuation allowance	**-**	(1,699)
	$ 453	$ (1,310)

The effective income tax rate for 2014 and 2013 was different than the applicable statutory Federal income tax rate of 34% as follows:

	2014	2013
	(In Thousands)	
Federal income taxes at statutory rate	**$ 388**	$ 326
State taxes net of federal benefit	**77**	44
Incentive stock options	**10**	10
Change in valuation allowance	**-**	(1,699)
Other	**(22)**	9
	$ 453	$ (1,310)

Note 11 - Federal Income Taxes (Continued)

The components of the net deferred tax asset (liability) at December 31, 2014 and 2013 are as follows:

	2014	2013
	(In Thousands)	
Deferred tax assets:		
Organization and start-up costs	**$ 89**	$ 104
Net operating loss carryforwards	**1,052**	1,210
AMT credit carryforward	**45**	45
Allowance for loan losses	**731**	817
Non-accrual interest	**27**	141
Non-qualified stock option compensation	**113**	96
Unrealized loss on securities available for sale	**-**	89
Other	**170**	141
Total Deferred Tax Assets	**2,227**	2,643
Deferred tax liabilities:		
Cash basis conversion	**(38)**	(47)
Depreciation	**(107)**	(22)
Unrealized gain on securities available for sale	**(2)**	-
Total Deferred Tax Liabilities	**(147)**	(69)
Net Deferred Tax Asset	**$ 2,080**	$ 2,574

During 2013, the Bank reversed the remaining $1,699,000 valuation allowance on the net deferred tax asset. US GAAP requires a valuation allowance against deferred tax assets if, based upon the weight of available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized. The full realization of the tax benefits associated with the carryforwards depends predominately upon the recognition of ordinary income during the carryforward period. Management had concluded that there was no valuation allowance for deferred tax assets required for December 31, 2013, and a valuation allowance of $1,699,000 was required at December 31, 2012. The Bank reversed the valuation allowance in 2013, as the Bank has achieved consistent profitability and there is no longer a more likely than not chance that some or all of the deferred tax assets will not be realized.

At December 31, 2014, the Company had available unused net operating loss carryforwards for federal income tax purposes of approximately $3,094,000 which start to expire in 2025. The Company has no unused net operating loss carryforwards remaining for state purposes. At December 31, 2013, the Company had available unused net operating loss carryforwards for federal and state income tax purposes of approximately $3,589,000 and $172,000, respectively.

Note 12 - Transactions with Executive Officers, Directors, and Principal Stockholders

The Bank has had, and may be expected to have in the future, banking transactions in the ordinary course of business with its executive officers, directors, principal stockholders, their immediate families and affiliated companies (commonly referred to as related parties), on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with others. Deposits of related parties totaled $14,592,000 and $12,564,000 at December 31, 2014 and 2013, respectively. Activity with respect to loans to related parties for the year ended December 31, 2014 is as follows:

	2014
	(In Thousands)
Balance, beginning	**$ 12,853**
Loans originated	**6,272**
Collection of principal	**(5,282)**
Persons no longer associated with the Company	**(551)**
Balance, ending	**$ 13,292**

The Company leases the Bank's main office from a real estate company controlled and majority owned by three of its directors (see Note 8), and additional office space near the main office from a company owned by one director.

Note 13 - Stock Option Plans

In 2006, the Board of Directors adopted three stock related compensation plans: the Highlands State Bank 2006 Nonstatutory Stock Option Plan, the Highlands State Bank 2006 Incentive Stock Option Plan and the Highlands State Bank 2006 Nonemployee Directors Stock Option Plan (2006 Plans), which were approved by the stockholders at the 2006 annual meeting in April 2006. These plans were adopted by the Company as part of the holding company reorganization.

The 2006 Plans enable the Board of Directors to grant stock options to executives, other key employees and nonemployee directors. The Company has reserved 150,000 shares of common stock for issuance upon the exercise of options granted under the 2006 Plans. Such shares may be issued from authorized but unissued shares or previously issued shares that the Company may hereafter reacquire (treasury stock). The 2006 Plans will terminate ten years from stockholder approval. Options may not be granted with an exercise price that is less than 1) 100% of the fair market value of the Company's common stock on the date of grant or 2) the par value of the common stock or 3) $10.00 for any option granted before January 1, 2009. Options may not be granted with a term longer than 10 years. Stock options granted under the Incentive Plan are subject to limitations under Section 422 of the Internal Revenue Code. The Incentive Plan also has special terms for individuals that own more than 10% of the Company's common stock. Vesting, exercisability, and other conditions related to an option will be waived in the event of a "change in control" of the Company, as defined in the 2006 Plans. The number of shares available under the 2006 Plans, the number of shares subject to outstanding options and the

Note 13 - Stock Option Plans (Continued)

exercise price of outstanding options will be adjusted to reflect any stock dividend, stock split, merger, reorganization or other event generally affecting the number of the Company's outstanding shares. At December 31, 2014, there were 26,000 shares available for grant under the 2006 Plans.

In 2011, the Board of Directors adopted the Highlands Bancorp, Inc. 2011 Equity Compensation Plan ("2011 Plan") which was approved by the stockholders at the 2011 annual meeting in May 2011. This Plan authorizes the Company to issue stock options or restricted stock to eligible participants. The Company has reserved 136,000 shares of the Company's common stock, which may be granted as incentive stock options, non-qualified stock options and restricted stock awards to eligible employees, officers, non-employee directors, advisory board members, and other service providers to the Company under this Plan. The options under this Plan will have a maximum term of ten years, subject to earlier termination of the options as provided by the 2011 Plan. Options granted under the Plan as ISO's are to be granted at an exercise price of not less than 100% of the fair market value of the Company's common stock on the date of the grant. However, if the optionee owns stock possessing more than 10% of the total combined voting power of all classes of the Company 's common stock, the purchase price per share of common stock deliverable upon the exercise of each option shall not be less than 110% of the fair market value of the common stock on the date of grant or the par value of the common stock, whichever is greater. All non-qualified options must have an exercise price of at least 100% of fair market value on the date of grant. Fair market value is to be determined by the Board of Directors in good faith.

No options or restricted stock awards may be granted under the Plan more than ten (10) years after adoption by the shareholders, but options or restricted stock awards previously granted may extend beyond that date. Awards under the Plan will be made to eligible Participants at the discretion of the Board of Directors, who may at any time amend, suspend or terminate the Plan.

In 2013, the Board of Directors awarded stock options to certain members of the Board of Directors and certain employees of the Company and/or its wholly-owned subsidiary, Highlands State Bank under the Highlands Bancorp, Inc. 2011 Equity Compensation Plan. The Company's board of directors authorized and approved the granting of 55,000 stock options to certain board members, and 71,000 stock options to certain employees relating to the Company's 2011 Equity Compensation Plan. These grants of options have an exercise price of $3.55, the fair market value for the common stock based upon the close of trading, are subject to a vesting period of two years, and have a maximum term of ten years from the date of grant.

The Bank accounts for stock-based compensation in accordance with Financial Accounting Standards Board ("FASB") ASC 718 "Compensation-Stock Options" which requires compensation costs related to share-based payment transactions to be recognized in the financial statements over the period that an employee provides service in exchange for the award. Share-based compensation expense of $73,000 is included in the accompanying statement of income for the both years ended December 31, 2014 and 2013. For the year ended December 31, 2013 there was $17,474 in related tax benefits on stock compensation expense recognized.

Note 13 - Stock Option Plans (Continued)

The following is a summary of the Company's stock option activity and related information for its 2006 and 2011 Plans for the years ended December 31, 2014 and 2013:

	Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at December 31, 2012	124,000	$ 10.00		
Options granted during 2013	126,000	3.55		
Outstanding at December 31, 2013	250,000	6.75		
Outstanding at December 31, 2014	250,000	6.75	5.1 years	$ 427,000
Exercisable at December 31, 2014	208,000	$ 7.40	4.3 years	$ 285,000

The following is a summary of the Company's stock options outstanding at December 31, 2014:

	Options Outstanding			Options Exercisable	
Exercise Prices	Number of Options Outstanding	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Number of Options Exercisable	Weighted Average Exercise Price
$3.55	126,000	8.8	$3.55	84,000	$3.55
10.00	124,000	1.3	10.00	124,000	10.00
$3.55 - $10.00	250,000	5.1	$6.75	208,000	$7.40

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions for grants in 2013: dividend yield of 0%, risk-free interest rate of 1.00%, expected life of 6.0 years, and expected volatility of 32%. The volatility percentage was based on the average expected volatility of similar public financial institutions in the Bank's market area. The weighted average fair value of options granted in 2013 was $1.16. There were no stock options granted in 2014.

Note 14 - Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet the 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 financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's

Note 14 - Regulatory Matters (Continued)

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 Bank to maintain minimum amounts and ratios (set forth below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets and of Tier 1 capital to average assets. Management believes, as of December 31, 2014, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2014, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category.

The Bank's actual capital amounts and ratios at December 31, 2014 and 2013 are presented below:

	Actual		For Capital Adequacy Purposes		To be Well Capitalized under Prompt Corrective Action Provisions	
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
			(Dollar Amounts in Thousands)			
December 31, 2014						
Total capital (to risk-weighted assets)	**$27,116**	**11.5 %**	**$≥18,891**	**≥8.0 %**	**$≥23,614**	**≥10.0 %**
Tier 1 capital (to risk-weighted assets)	**24,346**	**10.3**	**≥ 9,446**	**≥4.0**	**≥ 14,168**	**≥ 6.0**
Tier 1 capital (to adjusted average assets)	**24,346**	**9.5**	**≥ 10,259**	**≥4.0**	**≥ 12,824**	**≥ 5.0**
December 31, 2013						
Total capital (to risk-weighted assets)	$22,155	10.5 %	$≥16,837	≥8.0 %	$≥21,047	≥10.0 %
Tier 1 capital (to risk-weighted assets)	19,558	9.3	≥ 8,419	≥4.0	≥ 12,628	≥ 6.0
Tier 1 capital (to adjusted average assets)	19,558	9.2	≥ 8,548	≥4.0	≥ 10,684	≥ 5.0

The Bank is subject to certain restrictions on the amount of dividends that it may declare due to regulatory considerations. Although the Company is not subject to these same restrictions, unless the Company expands its operations, the operations of the Bank will be the only source of cash dividends for shareholders of the Company. Therefore, as a practical matter, the ability of the Company to pay cash dividends is subject to any restrictions on the Bank's ability to pay dividends to the Company.

Note 15 - Fair Value Measurements and Fair Values of Financial Instruments

Management uses its best judgment in estimating the fair value of the Company's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Company could have realized in a

Note 15 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

sale transaction on the dates indicated. The estimated fair value amounts have been measured as of year end and have not been re-evaluated or updated for purposes of these financial statements subsequent to year end. As such, the estimated fair values of these financial instruments subsequent to the period-end reporting dates may be different than the amounts reported at year end.

The Company follows the provisions of FASB ASC 820, *Fair Value Measurements and Disclosures*. This guidance, which defines fair value, establishes a framework for measuring fair value under GAAP, expands disclosures about fair value measurements and applies to other accounting pronouncements that require or permit fair value measurements. Fair value is defined as the price that would be received to sell the asset or transfer the liability in an orderly transaction (that is not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions.

The fair value guidance establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported with little or no market activity).

An asset or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

Note 15 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2014 and 2013 are as follows:

	Total	(Level 1) Quoted Prices in Active Markets for Indentical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
		(In Thousands)		
December 31, 2014:				
U.S. Treasuries	**$ 2,471**	**$ 2,471**	**$ -**	**$ -**
U.S. Government agencies and sponsored agencies	**6,430**	**-**	**6,430**	**-**
U.S. Government sponsored enterprises (GSEs) - mortgage-backed securities	**1,278**	**-**	**1,278**	**-**
Other	**698**	**-**	**698**	**-**
	$ 10,877	**$ 2,471**	**$ 8,406**	**$ -**
December 31, 2013:				
U.S. Treasuries	$ 1,352	$ 1,352	$ -	$ -
U.S. Government agencies and sponsored agencies	9,720	-	9,720	-
U.S. Government sponsored enterprises (GSEs) - mortgage-backed securities	2,777	-	2,777	-
Other	809	-	809	-
	$ 14,658	$ 1,352	$ 13,306	$ -

Note 15 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2014 and 2013 are as follows:

Description	**December 31, 2014**	**(Level 1) Quoted Prices in Active Markets for Indentical Assets**	**(Level 2) Significant Other Observable Inputs**	**(Level 3) Significant Unobservable Inputs**
		(In Thousands)		
Impaired loans	**$ 2,811**	**$ -**	**$ -**	**$ 2,811**
Foreclosed assets	**$ 273**	**$ -**	**$ -**	**$ 273**

Description	December 31, 2013	(Level 1) Quoted Prices in Active Markets for Indentical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
		(In Thousands)		
Impaired loans	$ 4,774	$ -	$ -	$ 4,774
Foreclosed assets	$ 328	$ -	$ -	$ 328

Real estate properties acquired through, or in lieu of, foreclosure are to be sold and are carried at fair value less estimated cost to sell. Fair value is based upon independent market prices or appraised value of the property. These assets are included in Level 3 fair value based upon the lowest level of input that is significant to the fair value measurement.

Note 15 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

The following table presents additional qualitative information about assets measured at fair value on a nonrecurring basis and for which the Company has utilized Level 3 inputs to determine fair value:

	Quantitative Information about Level 3 Fair Value Measurements			
(In Thousands)	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range (Weighted Average)
December 31, 2014				
Impaired loans	$ 2,811	Appraisal of collateral (1)	Appraisal adjustments (2)	0% to -30% (0%)
			Liquidation expenses (2)	-5% to -10% (-5.29%)
Foreclosed assets	$ 273	Appraisal of collateral (1)	Appraisal adjustments (2)	-25% to -8% (-5.29%)
			Liquidation expenses (2)	-9.47% (-9.47%)
December 31, 2013				
Impaired loans	$ 4,774	Appraisal of collateral (1)	Appraisal adjustments (2)	0% to -30% (-8.24%)
			Liquidation expenses (2)	-5% to -10% (-7.10%)
Foreclosed assets	$ 328	Appraisal of collateral (1)	Appraisal adjustments (2)	-35.51% (-35.51%)
			Liquidation expenses (2)	-9.85% (-9.85%)

(1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various Level 3 inputs which are not identifiable.

(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range and weighted average of liquidation expenses and other appraisal adjustments are presented as a percentage of the appraisal.

Below is management’s estimate of the fair value of all financial instruments, whether carried at cost or fair value on the Company’s balance sheet. The following information should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only provided for a limited portion of the Company’s assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Company’s disclosures and those of other companies may not be meaningful.

Note 15 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

The following methods and assumptions were used to estimate the fair values of the Company's financial instruments at December 31, 2014 and 2013:

Cash and Cash Equivalents (Carried at Cost)

The carrying amounts reported in the balance sheet for cash and short-term instruments approximate those assets' fair values.

Time Deposits in Other Banks (Carried at Cost)

Fair values for fixed-rate time certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits. The Company generally purchases amounts below the insured limit, limiting the amount of credit risk on these time deposits.

Securities Available for Sale (Carried at Fair Value)

The fair value of securities available for sale are determined by obtaining quoted market prices or nationally recognized exchanges (Level 1) or by matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. For these Level 2 securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the security's terms and conditions, among other things.

Loans Held For Sale (Carried at Fair Value)

The fair values of loans held for sale is determined, when possible, using quoted secondary-market prices. If no such quoted prices exist, the fair value of a loan is determined using quoted prices for a similar loan or loans, adjusted for the specific attributes of that loan. The Company did not write down any loans held for sale during the years ended December 31, 2014 and 2013.

Loans Receivable (Carried at Cost)

The fair values of loans are estimated using discounted cash flow analyses, using market rates at the balance sheet date that reflect the credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. Generally, for variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values.

Impaired Loans (Generally Carried at Fair Value)

Impaired loans are those in which management has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements.

Note 15 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

Restricted Investment in Bank Stock (Carried at Cost)

The carrying amount of restricted investment in bank stock approximates fair value, and considers the limited marketability of such securities.

Accrued Interest Receivable and Payable (Carried at Cost)

The carrying amount of accrued interest receivable and accrued interest payable approximates its fair value.

Deposit Liabilities (Carried at Cost)

The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings and money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Borrowings (Carried at Cost)

Fair values of FHLB advances are estimated using discounted cash flow analysis, based on quoted prices for new FHLB advances with similar credit risk characteristics, terms and remaining maturity. These prices obtained from this active market represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party.

Off-Balance Sheet Financial Instruments (Disclosed at Cost)

Fair values for off-balance sheet financial instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account, the remaining terms of the agreements and the counterparties' credit standing.

Note 15 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

The estimated fair values of the Company's financial instruments are summarized below:

December 31, 2014	**Carrying or Notional Amount**	**Fair Value**	**(Level 1) Quoted Prices in Active Markets for Identical Assets**	**(Level 2) Significant Other Observable Inputs**	**(Level 3) Significant Unobservable Inputs**
			(In Thousands)		
Financial Assets:					
Cash and cash equivalents	**$ 9,492**	**$ 9,492**	**$ 9,492**	**$ -**	**$ -**
Time deposits in other banks	**3,479**	**3,479**	**-**	**3,479**	**-**
Securities available for sale	**10,877**	**10,877**	**2,471**	**8,406**	**-**
Loans held for sale	**4,456**	**4,456**	**-**	**-**	**4,456**
Loans receivable, net	**235,146**	**236,266**	**-**	**-**	**236,266**
Restricted investment in bank stock	**343**	**343**	**-**	**343**	**-**
Accrued interest receivable	**792**	**792**	**-**	**792**	**-**
Financial Liabilities:					
Demand and savings deposits	**148,833**	**148,833**	**-**	**148,833**	**-**
Time deposits	**85,539**	**85,309**	**-**	**-**	**85,309**
Borrowings	**12,916**	**12,915**	**-**	**12,915**	**-**
Accrued interest payable	**82**	**82**	**-**	**82**	**-**
Off-Balance Financial Instruments:					
Commitments to extend credit	-	-	-	-	-
Letters of credit	-	-	-	-	-

December 31, 2013	Carrying or Notional Amount	Fair Value	(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
			(In Thousands)		
Financial Assets:					
Cash and cash equivalents	$ 2,853	$ 2,853	$ 2,853	$ -	$ -
Time deposits in other banks	8,660	8,660	-	8,660	-
Securities available for sale	14,658	14,658	1,352	13,306	-
Loans receivable, net	189,346	185,596	-	-	185,596
Restricted investment in bank stock	452	452	-	452	-
Accrued interest receivable	658	658	-	658	-
Financial Liabilities:					
Demand and savings deposits	130,959	130,959	-	130,959	-
Time deposits	65,155	64,755	-	-	64,755
Borrowings	3,853	3,853	-	3,853	-
Accrued interest payable	48	48	-	48	-
Off-Balance Financial Instruments:					
Commitments to extend credit	-	-	-	-	-
Letters of credit	-	-	-	-	-

Note 16 - Contingencies

In the normal course of business, the Company is subject to various lawsuits involving matters generally incidental to its business. Management is of the opinion that the ultimate liability, if any, resulting from any pending actions or proceedings will not have a material effect on the financial position or results of operations of the Company.

NOTES

NOTES

Board of Directors

George E. Irwin
Chairman of the Board of Highlands State Bank
and Highlands Bancorp, Inc.

Bruce D. Zaretsky
Vice Chairman of the Board, Highlands State Bank
and Highlands Bancorp, Inc.
Owner & President, Glenwood Homes, Inc.

Jeffrey M. Parrott
Sussex County Clerk
President, Parr Homes Inc.

Steven C. Ackmann
President and CEO, of Highlands State Bank
and Highlands Bancorp, Inc.

John V. Bosma
Owner & President, Boz Electrical Contractors, Inc.

E. Jane Brown
Chief Financial Officer, Pope John XXIII High School
and The Catholic Academy of Sussex County

Andrew J. Mulvihill
Owner & President, Mountain Resort Properties
CEO, Mountain Creek

Steven V. Oroho
NJ State Senator, District 24
Financial Advisor, Stonebridge Capital Management

Dov Perlysky
Managing Member, Nesher, LLC

Michael Halpin
Retired Banker

Charles H. Shotmeyer
President, Shotmeyer Bros. Petroleum Corp.

Martin Theobald
Owner, Heaven Hill Farm

Douglas Verduin
Certified Public Accountant, Berry, Verduin & Koch, LLC

Officers

Steven C. Ackmann
President and CEO, Highlands State Bank

Patrick W. Smith
Executive Vice President & Senior Loan Officer

Eileen D. Piersa
Senior Vice President,
Chief Financial Officer & Treasurer

Josephine Bartman
Senior Vice President

Donald E. Estes
Senior Vice President

Robert L. Heigl
Senior Vice President

Edward G. Poolas
Senior Vice President

Joanne E. Sagaas
Senior Vice President, Operations

Julianne Depue
Vice President

Carol J. Hults
Vice President & Corporate Secretary

Donna M. Jemas
Vice President

Monica A. McGee
Vice President

Paula L. McKowen
Vice President

Alexis Schoerner
Vice President

Mary Alexander
Assistant Vice President

Sharon L. Sofia
Assistant Vice President

Jason Rivera
Assistant Treasurer

Secure Lending Solutions, Inc.

(a wholly owned subsidiary of Highlands State Bank)

Michele C. Luff
President & CEO

JoAnn Gross
Senior Vice President, Secondary Marketing & Accounting

Marion R. Gulli
Senior Vice President, Operations

Joseph L. Ennis, Jr.
Vice President, Production

Helen O. Wyche
Vice President, Operations

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