FORESIGHT.

Always in your best interest.

HERITAGE
BANKSHARES, INC.

Annual Report 2013

HERITAGE BANK
CITIES SERVED



FORESIGHT.

At Heritage Bank, we use our banking knowledge and experience to structure our client relationships for the future with flexibility for growth and with precision to anticipate and provide for future recessionary pressures.

During the Great Recession, we did not have a so-called “special assets” department or even a single “special assets” officer. We did not need one. Our loans were structured properly for the best interest of our clients and our Bank.

If you are thinking about the future for your business, you need to talk to Heritage Bank now.

HERITAGE BANK

Always in your best interest.

PRESIDENT'S REPORT TO STOCKHOLDERS

Each year, I try to bring some insights into our Company and community banking rather than simply reciting our financial results for the prior year. In the pages that follow this Report, you can read our financial results for yourselves.

Suffice it to say, in 2013 we had record net income, continued to have excellent asset quality, and continued to lower our noninterest expense year over year. Furthermore, the overall skill level of our employees has never been higher.

We have nearly completed the restructuring of our administrative areas and our branches. With these initiatives behind us, for 2014, it is time to move forward with the more basic objectives of growing our loans and deposits. To that end, I undertook the additional role of interim Chief Lending Officer on September 1, 2013 so that I could provide our clients and prospects with even more direct input in the initial structuring of their new loan and deposit requests. There may not be many benefits to being my age, but one significant benefit is business experience that can help our clients.

Moving beyond the obligatory part of my Report on our results from last year and our plans for this year, I now want to turn my thoughts to community bank stocks as investments for the future. Most stockholders make their investments in a community bank with the idea, and indeed the expectation, that at some point in time there will be a change in control of the bank and a resulting substantial immediate increase in the stock price. Often, the management and directors of a community bank proclaim the importance of remaining independent for the best interests of the bank's stockholders, customers, employees and community right up until the day when the bank announces that it has been sold. This is just the way it works in community banking, and everyone seems to understand the game.

This underlying premise that eventually all community banks will sell for substantial premiums was a mainstay of pricing support for community bank stocks for many years prior to the onset of the Great Recession. This basic premise was shattered in the Great Recession, but many believe that it is now back in play, albeit at lower takeover premiums. Speculation is rampant about the inevitability of rapid consolidation in the community banking industry but, so far, actual merger deal flow does not support this viewpoint.

Before I give you some of my thoughts on community bank consolidation, I must make a disclaimer. I do not purport to be an expert on this subject. When I arrived at the Company in 2005, I explained to our Board of Directors the importance of maintaining an "open door" policy to listen to investment bankers, bank stock research analysts, and other community bankers when they ask to meet with us. Whether they are trying to convince us to raise capital, to return capital to our stockholders, to expand into other markets, to offer new services, or to merge with another bank, they provide me with information to consider. It is from my own research and consideration of information from these other sources that I have formed certain opinions about the future of community bank consolidation.

First, let's deal with the easy part. In my opinion, consolidation among small community banks in rural and small metropolitan areas will be more frequent than among community banks in large metropolitan areas. Many of these rural banks are quite small and ever increasing regulatory burdens drive operational expenses higher each day. In the absence of expectations for meaningful economic growth, earnings per share growth for these banks will come primarily from decreasing costs and increasing efficiency. This is generally much easier and much quicker to achieve through consolidation as compared to internal restructuring, so, consolidation it will be.

Motivations for acquirers of community banks in large metropolitan areas, on the other hand, will likely be much more diverse. Certainly, cost savings and efficiency are substantial drivers for in-market consolidation in larger markets. Beyond this, acquirers from outside a market focus on many more factors such as potential for growth in the market, asset quality, management, loan portfolio composition, deposit base composition, and the location and deposit size of branches. Another important factor is the number of branches because, in many cases, fewer branches is more desirable as physical facilities become less important in this age of electronic banking. Also, many acquirers only want to acquire banks serving primarily business customers because competing against established large banks and credit unions for retail and consumer business in a new market is cost prohibitive. In short, a bank acquirer looking to enter a large market often has a very specific set of criteria for an acquisition and finding just the right bank in a particular market may be challenging.

If community bank consolidation does not accelerate as predicted by the "experts," I have my doubts that in the future many community banks will continue to enjoy implicit presumptions of change of control premiums in their stock prices. If that is so, those banks without that presumption may see their stock prices fall even as their earnings per share, asset quality and efficiency all improve. In other words, while earnings are rising, price-earnings multiples for community bank stocks could be falling. With this in mind, it seems to me that the future of community banks as investments is less than clear.

What does all of this mean for Heritage? Our business plan has been and remains to increase our efficiency, to lower our cost structure, to preserve our asset quality, and to focus our loan and deposit growth on businesses rather than consumers. We recently closed two poorly performing consumer branches in poor locations. We operate modern branch facilities in major business corridors. We have highly trained employees who perform multiple functions.

We believe that over time these initiatives will improve our earnings per share safely and consistently and will increase our capacity to pay dividends. Coincidentally or not, these same initiatives may also preserve and may even enhance our franchise value to potential new entrants into our local market. We cannot predict the future, and I do not purport to do so here. However, as always, the best interest of our stockholders remains in the forefront of our thinking.



Michael S. Ives
President and CEO
April 2, 2014

FORWARD-LOOKING STATEMENTS.

Statements contained in this report that are not historical facts are forward-looking statements, as that term is defined in the Private Securities Litigation Reform Act of 1995. Such forward-looking statements may be identified by the use of such words as "may," "will," "believe," "expect," "anticipate," "should," "could," "planned," "opinion," "estimated" and "potential," among others, though these words are not the exclusive means of identifying such forward-looking statements. These forward-looking statements relate to, among other things, expectations regarding the business environment in which we operate, projections of future performance and perceived opportunities in the market, including opportunities for community bank consolidation, and they are based on management's current beliefs, assumptions and expectations. Such forward-looking statements are subject to risks and uncertainties which could cause actual results to differ materially from the expectations of future results, performance, financial condition or opportunities that we may express or imply in any forward-looking statements.

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*Heritage Bankshares Director only

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elliott davis

Independent Auditor's Report

The Board of Directors and Stockholders
Heritage Bankshares, Inc.
Norfolk, Virginia

Report on the Financial Statements
We have audited the accompanying consolidated financial statements of Heritage Bankshares, Inc. and subsidiaries which comprise the consolidated balance sheets as of December 31, 2013 and 2012, 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 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 as of and for the year ended December 31, 2013, in accordance with auditing standards generally accepted in the United States of America. We conducted our audits as of and for the year ended December 31, 2012, in accordance with standards of the Public Company Accounting Oversight Board (United States). 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. These procedures include examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the 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.

Auditor's Responsibility
In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Heritage Bankshares, Inc. and its subsidiaries as of December 31, 2013 and 2012, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Elliott Davis LLC

Richmond, Virginia
February 28, 2014

HERITAGE BANKSHARES, INC.
CONSOLIDATED BALANCE SHEETS

	At December 31,	
	2013	2012
	(in thousands except share data)	
ASSETS		
Cash and due from banks	$ 4,897	$ 5,746
Interest-bearing deposits in other banks	5,919	32,717
Federal funds sold	110	25
Total cash and cash equivalents	10,926	38,488
Certificates of deposit in other banks	48,767	35,892
Securities available for sale, at fair value	10,287	21,162
Securities held to maturity, at cost, (fair value $3,099)	3,358	-
Loans, held for investment, net of allowance for loan losses of $1,930 and $2,075, respectively	216,412	220,962
Accrued interest receivable	517	624
Stock in Federal Reserve Bank, at cost	597	594
Stock in Federal Home Loan Bank of Atlanta, at cost	582	440
Premises and equipment, net	9,325	10,602
Other real estate owned	743	210
Bank-owned life insurance	5,757	5,690
Other assets	1,690	1,954
Total assets	$ 308,961	$ 336,618
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Deposits		
Noninterest-bearing	$ 99,322	$ 111,518
Interest-bearing	164,270	183,628
Total deposits	263,592	295,146
Federal Home Loan Bank Advances	4,000	-
Securities sold under agreements to repurchase	511	2,605
Other borrowings	135	465
Accrued interest payable	21	33
Other liabilities	1,817	1,695
Total liabilities	270,076	299,944
Commitments and contingencies – Note 14	-	-
Stockholders' equity		
Preferred stock, no par value - 1,000,000 shares authorized:		
Senior non-cumulative perpetual preferred stock, Series C, 7,800 shares issued and outstanding	7,800	7,800
Common stock, $5 par value - 6,000,000 shares authorized; 2,274,507 shares and 2,275,891 shares issued and outstanding at December 31, 2013 and December 31, 2012, respectively	11,373	11,380
Additional paid-in capital	6,792	6,761
Retained earnings	12,995	10,625
Accumulated other comprehensive income, net	(75)	108
Total stockholders' equity	38,885	36,674
Total liabilities and stockholders' equity	$ 308,961	$ 336,618

See accompanying notes to consolidated financial statements.

HERITAGE BANKSHARES, INC.
CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31,	
	2013	2012
	(in thousands except share and per share data)	
Interest income		
Interest income and fees on loans	$ 9,171	$ 10,166
Interest on taxable investment securities	335	824
Other interest and dividend income	663	231
Total interest income	10,169	11,221
Interest expense		
Deposits	860	943
Borrowings	17	29
Total interest expense	877	972
Net interest income	9,292	10,249
Provision for loan losses	-	35
Net interest income after provision for loan losses	9,292	10,214
Noninterest income		
Service charges on deposit accounts	191	252
Late charges and other fees on loans	320	98
Gain(loss) on sale of investment securities	(8)	284
Gain on sale of other assets	190	30
Gain(loss) on sale of other real estate owned	349	(70)
Income from bank-owned life insurance	194	203
Other	282	318
Total noninterest income	1,518	1,115
Noninterest expense		
Compensation	3,843	4,151
Data processing	437	630
Occupancy	774	887
Furniture and equipment	570	579
Taxes and licenses	269	318
Professional fees	268	373
FDIC assessment	164	155
Loss on disposal of fixed assets	142	-
Other	852	987
Total noninterest expense	7,319	8,080
Income before provision for income taxes	3,491	3,249
Provision for income taxes	970	921
Net income	$ 2,521	$ 2,328
Preferred stock dividend and accretion of discount	(105)	(137)
Net income available to common stockholders	$ 2,416	$ 2,191
Earnings per common share		
Basic	$ 1.06	$ 0.96
Diluted	$ 1.04	$ 0.94
Dividends per common share	$ -	$ 0.60
Weighted average common shares outstanding - basic	2,275,779	2,290,533
Effect of dilutive equity awards	57,639	50,201
Weighted average common shares outstanding - diluted	2,333,418	2,340,734

See accompanying notes to consolidated financial statements.

HERITAGE BANKSHARES, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Years Ended December 31,	
	2013	2012
	(in thousands)	
Net income	$ 2,521	$ 2,328
Other comprehensive loss:		
Change in unrealized holding gains on securities available for sale	(285)	(221)
Change in tax effect on unrealized gains	97	75
Realized losses(gains) on sales of available for sale securities	8	(284)
Tax effect on realized (losses)gains	(3)	97
Total other comprehensive loss	(183)	(333)
Total comprehensive income	$ 2,338	$ 1,995

See accompanying notes to consolidated financial statements.

HERITAGE BANKSHARES, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
YEARS ENDED DECEMBER 31, 2013 AND 2012

	Preferred Shares		Common Stock		Additional Paid-in	Retained	Accumulated Other Comprehensive	
	Shares	Amount	Shares	Amount	Capital	Earnings	Income	Total
				(in thousands except share data)				
Balance, December 31, 2011	7,800	$ 7,800	2,304,965	$ 11,525	$ 6,704	$ 9,967	$ 441	$ 36,437
Total comprehensive income	-	-	-	-	-	2,328	(333)	1,995
Exercise of stock options and related tax benefits of $1	-	-	1,000	5	4	-	-	9
Repurchase of common shares	-	-	(30,074)	(150)	(54)	(164)	-	(368)
Equity-based compensation expense	-	-	-	-	107	-	-	107
Cash dividends on preferred stock	-	-	-	-	-	(137)	-	(137)
Cash dividends on common stock ($0.60 per share)	-	-	-	-	-	(1,369)	-	(1,369)
Balance, December 31, 2012	7,800	7,800	2,275,891	11,380	6,761	10,625	108	36,674
Total comprehensive income	-	-	-	-	-	2,521	(183)	2,338
Issuance of restricted stock and related tax benefits of $2	-	-	8,720	44	(42)	-	-	2
Repurchase of common shares	-	-	(10,104)	(51)	(29)	(46)	-	(126)
Equity-based compensation expense	-	-	-	-	102	-	-	102
Cash dividends on preferred stock	-	-	-	-	-	(105)	-	(105)
Balance, December 31, 2013	7,800	$ 7,800	2,274,507	$ 11,373	$ 6,792	$ 12,995	$ (75)	$ 38,885

See accompanying notes to consolidated financial statements.

HERITAGE BANKSHARES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the Years Ended December 31, 2013	2012
	(in thousands)	
Cash flows from operating activities:		
Net income	$ 2,521	$ 2,328
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan loss	-	35
Amortization of loan yield adjustments, net	414	298
Depreciation, amortization and accretion, net	518	603
Stock based compensation	102	107
Deferred compensation	43	77
Tax benefit from stock based compensation plan issuances	2	1
Net (gains) losses on:		
Sale of securities	8	(284)
Sale, disposal, or impairment of premises and equipment	142	-
Sale of other long lived assets	(190)	(30)
Sale or impairment of other real estate owned	(349)	70
Net income on bank owned life insurance	(194)	(203)
Changes in assets/liabilities, net:		
Decrease(increase) in interest receivable and other assets	793	(47)
Increase(decrease) in interest payable and other liabilities	85	(291)
Net cash provided by operating activities	3,895	2,664
Cash flows from investing activities:		
Proceeds from maturities and principal repayments of securities available for sale	9,000	28,200
Purchases of securities available for sale	(8,400)	(18,996)
Proceeds from sales of securities available for sale	9,988	14,696
Proceeds from maturities and principal repayments of securities held to maturity	55	-
Purchases of securities held to maturity	(3,427)	-
Net proceeds from sale of other real estate owned	719	1,535
Net increase in certificates of deposit in other banks	(12,875)	(35,892)
Net decrease(increase) in loans held for investment	4,326	(8,208)
Purchases of Federal Home Loan Bank stock and Federal Reserve Bank stock	(2,721)	(59)
Redemption of FHLB stock and Federal Reserve Bank stock	2,576	450
Purchases of premises and equipment	(487)	(173)
Proceeds from sale of premises and equipment	9	-
Proceeds from sale of other long lived assets	-	40
Purchases of and premiums paid for bank-owned life insurance	(11)	(12)
Proceeds from death benefits of bank-owned life insurance	-	141
Net cash used for investing activities	(1,248)	(18,278)
Cash flows from financing activities:		
Proceeds from exercise of stock options	-	8
Net increase(decrease) in deposits	(31,554)	45,168
Net increase(decrease) in Federal Home Loan Bank advances	4,000	(4,000)
Net increase(decrease) in securities sold under agreements to repurchase	(2,094)	1,103
Net decrease in other borrowings	(330)	(317)
Retirement of common stock	(126)	(368)
Cash dividends paid	(105)	(1,506)
Net cash provided by(used for) financing activities	(30,209)	40,088
Increase(decrease) in cash and cash equivalents	(27,562)	24,474
Cash and cash equivalents, beginning of period	38,488	14,014
Cash and cash equivalents, end of period	$ 10,926	$ 38,488
Supplemental disclosure:		
Interest paid	$ 889	$ 1,022
Income taxes paid	$ 710	$ 1,099
Noncash financing activities:		
Transfer of other real estate owned to loans	$ 190	$ 96
Transfer of restricted stock to additional paid in capital	$ 42	$ -
Transfer of fixed assets to other real estate owned	$ 1,081	$ -
Transfer of real estate commissions to accounts payable	$ 12	$ -

See accompanying notes to consolidated financial statements.

HERITAGE BANKSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of Heritage Bankshares, Inc. and its wholly-owned subsidiary, Heritage Bank. All significant intercompany balances and transactions have been eliminated in consolidation.

Nature of Operations

Heritage Bankshares, Inc. (the "Company") is a bank holding company incorporated under the laws of the Commonwealth of Virginia in 1983, and at December 31, 2013 the Company serves as the holding company for its wholly-owned subsidiary, Heritage Bank.

Heritage Bank (the "Bank") is a wholly-owned subsidiary of the Company and is a state banking corporation engaged in the general commercial and retail banking business. The Bank is a full-service bank conducting a general commercial banking business with its customers located throughout the Hampton Roads area of Virginia. The Bank has one wholly-owned subsidiary, Sentinel Financial Group, Inc. ("Sentinel Financial"). During the year ended December 31, 2013, Sentinel Financial sold its interest in Bankers Insurance, LLC, providers of various insurance and products, recording a receivable for gain on sale based on the cost method of accounting for investments.

Use of 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 periods presented. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for losses on loans, the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans, and the valuation of deferred tax assets.

Significant Group Concentrations of Credit Risk

The Company invests in a variety of securities, principally obligations of the United States, U.S. government sponsored enterprises, mortgage-backed securities and obligations of states and political subdivisions. Note 3 presents the Company's investment activities. Substantially all of the Company's lending activities are with customers located in southeastern Virginia. Note 4 presents the Company's lending activities. The Company does not have any significant concentrations of loans in any one industry or customer.

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold and overnight investments with Federal Home Loan Bank.

Certificates of Deposit in Other Banks

The Company invests in certificates of deposit at other financial institutions with original maturity dates up to ten years.

Investment Securities

Investment securities are classified in three categories and accounted for as follows:

- Debt securities that the Company has the positive intent and ability to hold to maturity are classified as held to maturity securities and reported at amortized cost.
- Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings.
- Debt and equity securities not classified as either held to maturity or trading securities are classified as available for sale securities and reported at fair value, with unrealized gains and losses excluded from earnings and reported as other comprehensive income, a separate component of stockholders' equity.

Gains and losses on sales of securities are computed based on specific identification of the adjusted cost of each security and included in other income. Amortization of premiums and accretion of discounts are computed by the effective yield method and recognized in interest income.

Declines in the fair value of individual held-to-maturity and available-for-sale securities below their cost that are other than temporary would result in write-downs of the individual securities to fair value. These write-downs would be included in the Company's calculation of earnings as realized losses.

Loans

Loans are reported at their principal outstanding balance, net of charge-offs, deferred loan fees and costs on originated loans, unearned income, and unamortized premiums or discounts, if any, on purchased loans. Interest income is generally recognized when

income is earned using the interest method. Loan origination fees and certain direct loan origination costs are deferred and the net amounts are amortized as an adjustment to yield on the respective loans.

Loans Held For Sale

Mortgage loans originated and intended for sale in the secondary market, if any, are carried at cost. Loans held for sale are pre-committed to secondary market investors and, subsequent to being closed, are held for short holding periods pending receipt of loan documents.

Allowance For Loan Losses

The Bank maintains an allowance for loan losses at a level which, in management's judgment, is adequate to absorb estimated credit losses on existing loans. The amount of the allowance is affected by: (1) loan charge-offs, which decrease the allowance, (2) recoveries on loans previously charged-off, which increase the allowance, and (3) the provision for loan losses charged to income, which increases the allowance.

The Bank analyzes its loan portfolio through ongoing credit review processes and constructs a comprehensive allowance analysis for its loan portfolio at least quarterly. This analysis includes two basic elements: (1) specific allowances for individual loans, and (2) general allowances for loan portfolio segments, which factor in historical loan loss experience and delinquency rates for the Bank and the banking industry and numerous other environmental factors.

The Bank evaluates various loans individually for impairment based on guidance for receivables. An evaluation is based upon either discounted cash flows or collateral evaluations. If the evaluation shows that a particular loan is impaired, then a specific reserve is established, or a charge-off is made, for the amount of any impairment.

For loans without an individual measure of impairment, the Bank makes estimates of losses for groups of loans as provided by guidance for contingencies. As part of the loan loss reserve methodology, loans are placed into one of four major categories or segments of loans: (1) commercial and industrial loans, (2) consumer loans, (3) 1-4 family residential loans (including home equity loans and lines), and (4) multi-family and other commercial real estate loans.

The Bank then considers the impact of various bank, industry, economic and other environmental factors and documents which factors are used in the analysis.

The Bank's allowance for loan losses is divided into four distinct portions: (1) Historical – an amount based on the Bank's actual net charge-offs; (2) Impaired Loans – an amount for specific allocations on significant individual credits as prescribed by generally accepted accounting principles related to receivables; (3) Loan Segments – an amount to adjust the historical allocation for the four loan segments based on environmental factors as provided by guidance on contingencies; and (4) Unallocated – an amount to reflect the imprecision inherent in these calculations.

Income Recognition on Nonaccrual Loans

Loans are generally classified as nonaccrual if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-secured and in the process of collection. If a loan or a portion of a loan is classified as doubtful, or is partially charged off, the loan is generally classified as nonaccrual. Loans that are on a current payment status or past due less than 90 days may also be classified as nonaccrual if repayment in full of principal and/or interest is in doubt.

Loans may be returned to accrual status when all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within an acceptable period of time and there is a sustained period of repayment performance by the borrower.

While a loan is classified as nonaccrual, and the future collectability of the recorded loan balance is doubtful, collections of interest and principal are generally applied as a reduction to principal outstanding. When the future collectability of the recorded loan balance is expected, interest income may be recognized on a cash basis.

Other Real Estate Owned

Other real estate owned is comprised of real estate acquired through foreclosure, acceptance of a deed in lieu of foreclosure or loans in which the Company receives physical possession of the debtor's real estate or change of management's intent towards its own property. Other real estate owned is carried at the lower of the recorded investment in the loan or the fair value of the real estate. Net operating income of such properties, exclusive of depreciation, is included in other income and related depreciation expense is included in other expense.

Restructured Loans

Loans are considered troubled debt restructurings if, for economic or legal reasons, a concession has been granted to the borrower related to the borrower's financial difficulties that the Company would not have otherwise considered. The Company restructures certain loans in instances where a determination is made that greater economic value will be realized under new terms rather than through foreclosure, liquidation or other disposition. The terms of the renegotiation generally involve some or all of the following characteristics: a reduction in the interest pay rate to reflect actual operating income, an extension of the loan maturity date to allow time for stabilization of operating income, and/or partial forgiveness of principal and interest.

The carrying value of a restructured loan is reduced by the fair value of assets or equity interest received from the borrower, if any. The Company generally continues to classify restructured nonaccrual loans as nonaccrual until such time as the loans demonstrate performance. The accrual of interest resumes when such loans can demonstrate performance, generally evidenced by six months of pre- or post-restructuring payment performance in accordance with the restructured terms, or by the presence of other significant factors. In addition, at the time of restructuring, loans are classified as impaired.

Off Balance Sheet Credit Related Financial Instruments

In the ordinary course of business, the Company enters into commitments to extend credit and issue standby letters of credit. Such financial instruments are recorded when they are funded.

Sale of Loans

Transfers of loans are accounted for as sales when control over the loans has been surrendered. Control over transferred loans is deemed to be surrendered when (1) the loans 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 loans, and (3) the Company does not maintain effective control over the transferred loans through an agreement to repurchase them before their maturity. In addition, participated loans sold by the Bank with disproportionate cash flows to the buyer are considered to be incomplete transfers because risk is not proportionate. Generally accepted accounting principles require that this type of participation be classified as a borrowing with the entire loan balance reported in loans held for investment and not reduced for the participation.

Premises and Equipment

Land is carried at cost. Buildings, leasehold improvements and equipment are carried at cost, less accumulated depreciation computed on the straight-line method over the estimated useful lives of the assets, ranging from two years to 40 years.

Federal Reserve Bank Stock and Federal Home Loan Bank Stock

As a member of the Federal Reserve Bank, the Company is required to hold shares of FRB capital stock, $100 par value, in an amount equal to 6% of the Bank's total common stock and capital surplus.

As a member of the Federal Home Loan Bank of Atlanta, the Company is required to hold shares of capital stock in the FHLB in an amount equal to 0.12% of total assets plus 4.50% of borrowings from the FHLB. The Bank, as a member institution, is required to own certain stock investments in the Federal Home Loan Bank of Atlanta and the Federal Reserve Bank. Additional stock at FHLB must be purchased as a percentage of borrowings and is generally pledged against these borrowings. No ready market exists for the FHLB stock and it has no quoted market value. However, redemption of this stock has historically been at par value.

Income Taxes

The Company files a consolidated tax return. Provisions for income taxes reflect tax expense incurred as a consolidated group. Tax expense is allocated among the members of the consolidated group in accordance with an intercompany agreement for tax expense. Income taxes are provided for the tax effects of the transactions reported in the financial statements and consist of taxes currently due plus deferred taxes related primarily to differences between the basis of investment securities, deferred loan fees, allowance for loan losses, allowance for losses on foreclosed real estate, premises and equipment and deferred compensation for financial and income tax reporting. The deferred tax assets and liabilities represent the future tax return consequences of those differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled. An allowance is provided if it is more likely than not that the Company will not realize the benefits of a deferred tax asset. Through December 31, 2013, no valuation allowance has been provided against the Company's deferred tax asset.

The Company analyzes tax positions taken or expected to be taken on its tax returns to determine if it has any liability related to uncertain tax positions in accordance with guidance on income taxes. Liabilities, if any, resulting from this evaluation are recorded in the current period.

Deferred Compensation Plans

The Company maintains deferred compensation agreements with certain current and former directors and the beneficiary of its former chief executive officer, as well as a Supplemental Executive Retirement Plan with its current Chief Executive Officer. The Company's policy is to accrue the present value of estimated amounts to be paid under the contracts over the required service period to the date the participant is fully eligible to receive the benefits. At December 31, 2013, the discount rate the Company utilized to determine the deferred compensation liability under such plans was determined by computing the average of the last three year-end periods' AA corporate bond yield, whose approximate maturity corresponded to the approximate time remaining to pay out the expected benefits for each participant.

Bank-Owned Life Insurance

The Company has purchased life insurance policies on certain current and former employees and directors. Company-owned life insurance is recorded at its cash surrender value, or the amount that can be realized.

Stock Compensation Plans

At December 31, 2013, the Company has one stock-based compensation plan, the Heritage 2006 Equity Incentive Plan, as amended and restated effective January 28, 2009, and as subsequently amended in 2012 (the "2006 Incentive Plan"). The Company has adopted accounting guidance related to share-based payments, which requires that the fair value of equity instruments, such as stock options, be recognized as an expense in the issuing entity's financial statements as services are performed.

On January 25, 2012, the Company's Board of Directors granted, effective February 1, 2012, 43,600 shares of restricted stock to certain executives under the 2006 Equity Incentive Plan. The shares vest at a rate of 20% over a five year period beginning on February 1, 2013 and on each February 1 thereafter. In the event of a change of control of the Company, all then-unvested shares shall vest upon the occurrence of the change of control. In the event of a termination of service of the executive by reason of death or permanent disability, all then-unvested shares shall vest upon such termination of service.

As defined in the 2006 Incentive Plan, as amended, fair value of the shares is measured by the price of the last sale of a share of the Company's common stock on the OTC Markets Group occurring prior to the grant of the applicable award or, if inapplicable, the fair market value as determined in good faith by the Board. In addition, to the extent the share-recipients are not entitled to dividends

until the shares vest, the grant date fair value of the award is reduced by the present value of the dividends expected to be paid on the underlying shares during the service period, discounted at the appropriate risk-free interest rate.

Earnings Per Common Share

Basic earnings per common share represent income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate to outstanding stock options and are determined using the treasury stock method.

Comprehensive Income

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

Business Segments

The Company currently reports its activities as a single business segment. In determining appropriate segment definition and reporting, the Company considers components of the business about which financial information relating to performance and resource allocation is available and regularly evaluated by management. Management determines components for which it will implement performance and resource measurement procedures based upon criteria of relative importance and materiality to the organization.

Reclassifications

Certain reclassifications have been made to prior year financial statements to conform them to the current year presentation.

Recent Accounting Pronouncements

The following is a summary of recent authoritative pronouncements:

On December 23, 2013, the FASB issued ASU 2013-12, *Definition of a Public Business Entity, An Addition to the Master Glossary*, to minimize the inconsistency and complexity of having multiple definitions of, or a diversity in practice as to what constitutes, a nonpublic entity and public entity within U.S. GAAP. The ASU amends the Master Glossary of the Codification for future use in U.S. GAAP, however, the amendment does not affect existing requirements. That definition will be used by the FASB, the Private Company Council ("PCC"), and the Emerging Issues Task Force ("EITF") in specifying the scope of future financial accounting and reporting guidance. There is no actual effective date for the amendment in this ASU. However, the term public business entity will be used in future ASUs issued by the FASB. The Company does not expect this amendment to have any material impact on its financial statements.

On February 5, 2013, the FASB issued ASU No. 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. The amendments in the ASU do not change the current requirements for reporting net income or other comprehensive income in financial statements. All of the information that this Update requires already is required to be disclosed elsewhere in the financial statements under U.S. GAAP.

The amendments require an organization to:

- Present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of AOCI–but only if the item reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period
- Cross-reference to other disclosures currently required under U.S. GAAP for other reclassification items (that are not required under U.S. GAAP) to be reclassified directly to net income in their entirety in the same reporting period.

The amendments apply to all public and private companies that report items of other comprehensive income and are required for all reporting periods (interim and annual). For public entities, the amendments were effective prospectively for reporting periods beginning after December 15, 2012. For nonpublic entities, the amendments are effective prospectively for reporting periods beginning after December 15, 2013. Early adoption is permitted. The Company does not expect this amendment to have any material impact on its financial statements.

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

Subsequent Events

In accordance with accounting guidance, the Company evaluated events and transactions for potential recognition or disclosure in our financial statements through February 28, 2014, the date the financial statements were available to be issued.

NOTE 2 – RESTRICTIONS ON CASH AND DUE FROM BANKS

The Bank is required to maintain average balances on hand or with the Federal Reserve Bank. At December 31, 2013 and 2012, these required reserve balances amounted to $685,000 and $0, respectively.

NOTE 3 - SECURITIES

The tables below present amortized cost, unrealized gains and losses, and fair value of the Company's investments in securities at December 31, 2013 and December 31, 2012.

	At December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(in thousands)		
Securities available for sale				
U.S. Treasury notes	$ 2,000	$ 5	$ -	$ 2,005
U.S. government sponsored enterprises	5,000	-	(66)	4,934
Corporate floating rate notes	3,400	-	(52)	3,348
Total securities available for sale	10,400	5	(118)	10,287
Securities held to maturity				
Mortgage backed securities	3,358	-	(259)	3,099
Total securities held to maturity	3,358	-	(259)	3,099
Total securities	$ 13,758	$ 5	$ (377)	$ 13,386

	At December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(in thousands)		
Securities available for sale				
U.S. Treasury Notes	$ 2,002	$ 23	$ -	$ 2,025
U.S. government sponsored enterprises	18,996	141	-	19,137
Total securities available for sale (1)	$ 20,998	$ 164	$ -	$ 21,162

(1) At December 31, 2012, the Company held no securities classified as held to maturity.

Investment securities having an amortized cost of $8,358,000 and $10,000,000 at December 31, 2013 and 2012, respectively, were made available for retail repurchase agreements. The estimated fair values of these securities were $8,033,000 and $10,105,000 at December 31, 2013 and 2012, respectively.

The following tables show gross unrealized losses and fair value on investment securities, aggregated by investment category and length of time that individual securities have been in a continuous realized loss position, at December 31, 2013 and 2012. Current year unrealized losses on investment securities are a result of changes in interest rates during the periods. Unrealized losses on investment securities are considered by management to be temporary given the credit ratings on these investment securities and the short duration of any unrealized loss due to credit quality.

	At December 31, 2013					
	Less than 12 months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
			(in thousands)			
Securities available for sale						
U.S. government sponsored enterprises	$ 4,934	$ 66	$ -	$ -	$ 4,934	$ 66
Corporate floating rate notes	3,348	52	-	-	3,348	52
Total securities available for sale	8,282	118	-	-	8,282	118
Securities held to maturity						
Mortgage backed securities	3,099	259	-	-	3,099	259
Total securities held to maturity	3,099	259	-	-	3,099	259
Total securities	$ 11,381	$ 377	$ -	$ -	$ 11,381	$ 377

There were no securities with unrealized losses at December 31, 2012.

The amortized cost and fair value of investment securities at December 31, 2013, by contractual maturity, are reflected below. Actual maturities will differ from contractual maturities because some securities may be called or prepaid prior to their contractual maturity.

	At December 31, 2013	
	Amortized Cost	Fair Value
	(in thousands)	
Securities available for sale		
Due in one year or less	$ 2,000	$ 2,005
Due after one year through five years	-	-
Due after five years through ten years	8,400	8,282
Due after ten years	-	-
Total securities available for sale	10,400	10,287
Securities held to maturity		
Due in one year or less	-	-
Due after one year through five years	-	-
Due after five years through ten years	-	-
Due after ten years	3,358	3,099
Total securities held to maturity	3,358	3,099
Total securities	$ 13,758	$ 13,386

Gross proceeds from sales of securities available for sale were $9,988,000 for 2013 and $14,696,000 for 2012. Gross realized losses and gains associated with these sales were a $12,000 loss for 2013 and a $284,000 gain for 2012, respectively. Gross proceeds from the call or maturity of investment securities were $9,000,000 for 2013 and $28,200,000 for 2012. Gross gains associated with the call or maturities of these securities were $4,000 in 2013 and $0 in 2012. Gains and losses on the sale of investment securities are recorded as of the trade date and are determined using the specific identification method.

NOTE 4 – LOANS HELD FOR INVESTMENT, NET

Loans at the dates indicated consisted of the following:

	At December 31,	
	2013	2012
	(in thousands)	
Commercial	$ 36,953	$ 39,904
Real estate-commercial	129,614	131,078
Real estate-construction and land	9,274	4,832
Real estate-residential 1-4	40,797	45,418
Consumer	1,704	1,805
Total loans	218,342	223,037
Allowance for loan losses	(1,930)	(2,075)
Total loans, net	$ 216,412	$ 220,962

All loan amounts are presented net of unearned fees and costs for December 31, 2013 and December 31, 2012.

Nonperforming assets at the dates indicated were:

	At December 31,	
	2013	2012
	(in thousands)	
Nonperforming loans	$ -	$ 489
Real estate owned	743	210
Total nonperforming assets	$ 743	$ 699

A summary of the activity in the allowance for loan losses account for the periods indicated is as follows:

	At December 31,	
	2013	2012
	(in thousands)	
Balance, beginning of year	$ 2,075	$ 2,091
Provision for loan losses	-	35
Loans charged-off		
Commercial	-	(7)
Real estate-commercial	-	-
Real estate-construction and land	-	-
Real estate-residential 1-4	(148)	(63)
Consumer	-	(1)
Total loans charged-off	(148)	(71)
Loans recovered		
Commercial	-	-
Real estate-commercial	-	-
Real estate-construction and land	3	20
Real estate-residential 1-4	-	-
Consumer	-	-
Total loans recovered	3	20
Net recoveries (charge-offs)	(145)	(51)
Balance, end of period	$ 1,930	$ 2,075

The following table presents the aging analysis of the Company's loan portfolio at December 31, 2013:

	30-59 days past due	60-89 days past due	90 days or more past due	Total past due	Current	Total loans outstanding	Loans 90 days past due and accruing
				(in thousands)			
Commercial	$ -	$ -	$ -	$ -	$ 36,953	$ 36,953	$ -
Real estate-commercial	-	-	-	-	129,614	129,614	-
Real estate-construction and land	-	-	-	-	9,274	9,274	-
Real estate-residential 1-4	-	-	-	-	40,797	40,797	-
Consumer	-	-	-	-	1,704	1,704	-
Total loans	$ -	$ -	$ -	$ -	$ 218,342	$ 218,342	$ -

The following table presents the aging analysis of the Company's loan portfolio at December 31, 2012:

	30-59 days past due	60-89 days past due	90 days or more past due	Total past due	Current	Total loans outstanding	Loans 90 days past due and accruing
				(in thousands)			
Commercial	$ -	$ -	$ -	$ -	$ 39,904	$ 39,904	$ -
Real estate-commercial	-	-	-	-	131,078	131,078	-
Real estate-construction and land	-	-	-	-	4,832	4,832	-
Real estate-residential 1-4	-	-	489	489	44,929	45,418	489
Consumer	-	-	-	-	1,805	1,805	-
Total loans	$ -	$ -	$ 489	$ 489	$ 222,548	$ 223,037	$ 489

The Bank utilizes an internal system based on payment history as its primary credit indicator on its commercial and commercial real estate loan portfolios. Loans that consistently meet an established historical payment schedule are not given further scrutiny other than that given in the ordinary course of business. Any loan that misses its normal payment date falls into a category of heightened scrutiny to determine whether a potential weakness exists. Based upon the collection and analysis of certain data, if there is a determination that no weakness exists, the loan will be given no further heightened scrutiny. If, however, current financial information indicates a potential weakness, aggressive investigation will begin into collateral values and borrower ability to pay to determine loss potential to the Bank. If loss potential is small, the loan is placed into a category of continued monitoring. If loss potential is high, the process of collateral realization may begin.

The following table is a summary of credit quality indicators related to the Bank's commercial, commercial real estate and construction real estate loans at December 31, 2013:

	Commercial	Real Estate Commercial	Real Estate Construction and Land	Total
		(in thousands)		
Category:				
Normal review	$ 36,953	$ 128,845	$ 9,095	$ 174,893
Closely monitored	-	769	179	948
In collection	-	-	-	-
Total	$ 36,953	$ 129,614	$ 9,274	$ 175,841

The following table is a summary of credit quality indicators related to the Bank's commercial, commercial real estate and construction real estate loans at December 31, 2012.

	Commercial	Real Estate Commercial	Real Estate Construction and Land	Total
		(in thousands)		
Category:				
Normal review	$ 39,904	$ 130,288	$ 4,536	$ 174,728
Closely monitored	-	790	296	1,086
In collection	-	-	-	-
Total	$ 39,904	$ 131,078	$ 4,832	$ 175,814

For regulatory purposes, the Bank utilizes an internal credit classification system to manage the credit quality of its commercial and real estate loan portfolios. Loans classified as "substandard" have well-defined weaknesses and typically have experienced a degradation in either the current value of the pledged collateral or of the paying capacity of the borrower; these loans carry a distinct possibility that the Bank could sustain some loss unless the weakness is corrected. Loans classified as "doubtful" have uncorrected weaknesses that have a high possibility of loss; a loan may reside in this classification temporarily until a currently unquantifiable expected loss can be determined with a greater degree of accuracy. Any loan classified in the "loss" risk class is considered uncollectible and is to be charged-off within 30 days or less.

The following table presents a summary of commercial, commercial real estate, and construction real estate loans classified by this internal credit classification at December 31, 2013:

	Commercial	Real Estate Commercial	Real Estate Construction and Land	Total
		(in thousands)		
Category:				
Not classified	$ 36,633	$ 128,845	$ 9,005	$ 174,483
Substandard	320	769	269	1,358
Doubtful	-	-	-	-
Total	$ 36,953	$ 129,614	$ 9,274	$ 175,841

The following table presents a summary of commercial, commercial real estate, and construction real estate loans classified by this internal credit classification at December 31, 2012:

	Commercial	Real Estate Commercial	Real Estate Construction and Land	Total
		(in thousands)		
Category:				
Not classified	$ 39,578	$ 130,288	$ 3,078	$ 172,944
Substandard	326	790	1,754	2,870
Doubtful	-	-	-	-
Total	$ 39,904	$ 131,078	$ 4,832	$ 175,814

The Bank utilizes delinquency status in its evaluation of credit exposure for residential 1-4 and consumer loans, which include both revolving and closed-end mortgages as well as installment and personal loans. These loans are considered to be nonperforming when severely delinquent, defined as 90 days or more past due.

The following table represents the credit risk profile for the consumer portfolio at December 31, 2013:

	Real Estate Residential 1-4	Consumer	Total
		(in thousands)	
Category:			
Performing	$ 40,797	$ 1,704	$ 42,501
Nonperforming	-	-	-
Total	$ 40,797	$ 1,704	$ 42,501

The following table represents the credit risk profile for the consumer portfolio at December 31, 2012:

	Real Estate Residential 1-4	Consumer	Total
		(in thousands)	
Category:			
Performing	$ 44,929	$ 1,805	$ 46,734
Nonperforming	489	-	489
Total	$ 45,418	$ 1,805	$ 47,223

The following tables present an allocation of the Company's allowance for loan losses and the respective loans evaluated based on its allowance methodology at December 31, 2013:

	Commercial	Real Estate Commercial	Real Estate Construction and Land	Real Estate Residential 1-4	Consumer	Unallocated	Total
				(in thousands)			
Allowance for loan losses:							
Ending balance: Individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Ending balance: Collectively evaluated for impairment	282	987	71	331	13	246	1,930
Total Ending Balance	$ 282	$ 987	$ 71	$ 331	$ 13	$ 246	$ 1,930

	Commercial	Real Estate Commercial	Real Estate Construction and Land	Real Estate Residential 1-4	Consumer	Total
				(in thousands)		
Total loans:						
Ending balance: Individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ -
Ending balance: Collectively evaluated for impairment	36,953	129,614	9,274	40,797	1,704	218,342
Total Ending Balance	$ 36,953	$ 129,614	$ 9,274	$ 40,797	$ 1,704	$ 218,342

The following tables present an allocation of the Company's allowance for loan losses and the respective loans evaluated based on its allowance methodology at December 31, 2012:

	Commercial	Real Estate Commercial	Real Estate Construction and Land	Real Estate Residential 1-4	Consumer	Unallocated	Total
				(in thousands)			
Allowance for loan losses:							
Ending balance: Individually evaluated for impairment [1]	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Ending balance: Collectively evaluated for impairment	339	1,110	39	404	15	168	2,075
Total Ending Balance	$ 339	$ 1,110	$ 39	$ 404	$ 15	$ 168	$ 2,075

	Commercial	Real Estate Commercial	Real Estate Construction and Land	Real Estate Residential 1-4	Consumer	Total
				(in thousands)		
Total loans:						
Ending balance: Individually evaluated for impairment	$ -	$ 790	$ 296	$ -	$ -	$ 1,086
Ending balance: Collectively evaluated for impairment	39,904	130,288	4,536	45,418	1,805	221,951
Total Ending Balance	$ 39,904	$ 131,078	$ 4,832	$ 45,418	$ 1,805	$ 223,037

[1] Certain loans were evaluated for impairment at December 31, 2012. Based on this evaluation process, it was determined that no specific allowance was required.

The following table reflects the recorded investment as well as the average daily recorded investment in impaired loans as of December 31, 2013 and interest income recognized on those loans for the year ending December 31, 2013:

	(1) Recorded Investment	Unpaid Principal Balance	Specific Related Allowance	Average Daily Recorded Investment	Interest Income Recognized
			(in thousands)		
With no allowance recorded:					
Commercial	$ -	$ -	$ -	$ -	$ -
Real estate - commercial	-	-	-	-	-
Real estate - construction and land	179	179	-	251	8
Real estate - residential 1-4	-	-	-	-	-
Consumer	-	-	-	-	-
Total	$ 179	$ 179	$ -	$ 251	$ 8
With an allowance recorded:					
Commercial	$ -	$ -	$ -	$ -	$ -
Real estate - commercial	-	-	-	-	-
Real estate - construction and land	-	-	-	-	-
Real estate - residential 1-4	-	-	-	-	-
Consumer	-	-	-	-	-
Total	$ -	$ -	$ -	$ -	$ -
Total:					
Commercial	$ -	$ -	$ -	$ -	$ -
Real estate - commercial	-	-	-	-	-
Real estate - construction and land	179	179	-	251	8
Real estate - residential 1-4	-	-	-	-	-
Consumer	-	-	-	-	-
Total	$ 179	$ 179	$ -	$ 251	$ 8

(1) Recorded investment is net of unearned deferred fees and costs.

The following table reflects the recorded investment as well as the average daily recorded investment in impaired loans as of December 31, 2012 and interest income on those loans for the year ending December 31, 2012.

	(1) Recorded Investment	Unpaid Principal Balance	Specific Related Allowance	Average Daily Recorded Investment	Interest Income Recognized
			(in thousands)		
With no allowance recorded:					
Commercial	$ -	$ -	$ -	$ -	$ -
Real estate - commercial	790	787	-	768	30
Real estate - construction and land	387	385	-	838	29
Real estate - residential 1-4	-	-	-	32	-
Consumer	-	-	-	-	-
Total	$ 1,177	$ 1,172	$ -	$ 1,638	$ 59
With an allowance recorded:					
Commercial	$ -	$ -	$ -	$ -	$ -
Real estate - commercial	-	-	-	-	-
Real estate - construction and land	-	-	-	-	-
Real estate - residential 1-4	-	-	-	-	-
Consumer	-	-	-	-	-
Total	$ -	$ -	$ -	$ -	$ -
Total:					
Commercial	$ -	$ -	$ -	$ -	$ -
Real estate - commercial	790	787	-	768	30
Real estate - construction and land	387	385	-	838	29
Real estate - residential 1-4	-	-	-	32	-
Consumer	-	-	-	-	-
Total	$ 1,177	$ 1,172	$ -	$ 1,638	$ 59

(1) Recorded investment is net of unearned deferred fees and costs.

No loans were restructured during the year ending December 31, 2013. During the year ending December 31, 2012, two loans to one borrower were restructured in which both concessions on interest rate and extensions of payment terms were granted. The pre-modification recorded investment was $1,118,000 for a real estate construction loan and $560,000 for a commercial real estate loan. Post-modification recorded investments in these two loans were $879,000 for the real estate construction loan and $805,000 for the commercial real estate loan. Because the commercial real estate loan carries a market rate, has met all contractual terms during the year, and was only considered for impairment as a result of the restructuring, this loan is no longer considered to be impaired at December 31, 2013.

During the year ended December 31, 2013, no loans that had been restructured during the prior twelve months went into default.

At the time of restructuring, loans that are considered troubled are evaluated for impairment allowances based on collateral value, expected cash flows and/or financial strength of the borrower. Any such loan deemed impaired may be assigned a specific allowance in the calculation of allowance for loan losses. If there are subsequent payment defaults on troubled debt restructured loans, additional evaluations are conducted to determine impairment levels. No impairment allowance was deemed necessary at December 31, 2013.

NOTE 5 – PREMISES AND EQUIPMENT

Premises and equipment consist of the following:

	At December 31,	
	2013	2012
	(in thousands)	
Land and improvements	$ 3,260	$ 3,745
Buildings and improvements	4,318	5,424
Leasehold improvements	1,745	1,767
Equipment, furniture and fixtures	2,876	3,678
Fixed assets not in service	63	-
	12,262	14,614
Less - accumulated depreciation	(2,937)	(4,012)
Total premises and equipment	$ 9,325	$ 10,602

Depreciation expense for the years ended December 31, 2013 and 2012 was $532,000 and $600,000, respectively. The Company incurred losses on disposal and impairment charges related to equipment of $142,000 in 2013 from the closure of two Bank branches that would no longer be utilized.

The Company leases approximately 12,000 square feet of office space for executive and operating offices and a branch in Norfolk and an additional 3,766 square feet of office space for a branch in Chesapeake.

The initial lease term for the Norfolk facility, which began in 2007, is for ten years expiring in 2017 with four renewal options of five years each. The Company pays a minimum rent plus annual adjustments based on a CPI index. Total rent expense for the Norfolk facility during years ended December 31, 2013 and 2012 amounted to $222,000 and $223,000, respectively.

The initial lease term for the Chesapeake branch, which began in 2011, is for five years expiring in 2016 with three renewal options of five years each. The Company pays a base rent for the first three years with 3% increases in each of the next two years during the initial lease term. Total rent expense for the Chesapeake branch during each of the years ended 2013 and 2012 was $84,000.

Future minimum lease payments, by year and in the aggregate, under non-cancelable leases with remaining terms of one year or more at December 31, 2013 were as follows:

	Amount
	(in thousands)
2014	$ 342
2015	350
2016	313
2017	113
2018	-
Total	$ 1,118

NOTE 6 – DEPOSITS

Interest-bearing deposits consist of the following at the dates indicated:

	At December 31,	
	2013	2012
	(in thousands)	
Money Market and NOW	$ 143,062	$ 156,046
Savings	4,541	3,904
Certificates of deposit $100,000 and over	-	100
Other time deposits	16,667	23,578
Total interest-bearing deposits	$ 164,270	$ 183,628

At December 31, 2013, the scheduled maturities of time deposits are as follows:

	Amount
	(in thousands)
Past Maturity	$ 20
2014	15,211
2015	705
2016	309
2017 and thereafter	422
Total time deposits	16,667

In both years ending December 31, 2013 and 2012, the Bank had no brokered deposits.

NOTE 7 – SECURITIES SOLD TO CUSTOMERS UNDER AGREEMENTS TO REPURCHASE AND OTHER BORROWINGS

Investment securities having an amortized cost of $8,358,000 and $10,000,000 and fair values of $8,033,000 and $10,105,000 were made available to secure retail repurchase agreements at December 31, 2013 and 2012, respectively. Information concerning securities sold to customers under agreements to repurchase is summarized as follows:

	As of and for the years ended December 31,	
	2013	2012
	(in thousands)	
Balance at end of year	$ 511	$ 2,605
Average balance during the year	$ 1,673	$ 1,465
Weighted average interest rate during the year	0.19%	0.19%
Interest expense during the year	$ 3	$ 3
Maximum month-end balance during the year	$ 2,617	$ 2,605

The Bank is a member of the FHLB of Atlanta, which had established, at December 31, 2013, a credit availability for the Bank in an amount equal to 25% of the Bank's total assets. At December 31, 2013, the Bank had $4.0 million in outstanding advances under the FHLB credit line. Borrowings from the Federal Home Loan Bank are secured by a blanket collateral agreement on a pledged portion of the Bank's 1-4 family residential real estate loans, home equity lines of credit, multifamily mortgage loans, and commercial real estate loans. Information concerning advances from the FHLB is summarized as follows:

	As of and for the years ended December 31,	
	2013	2012
	(in thousands)	
Balance at end of year	$ 4,000	$ -
Average balance during the year	$ 780	$ 1,372
Weighted average interest rate during the year	0.37%	0.19%
Interest expense during the year	$ 3	$ 3
Maximum month-end balance during the year	$ 5,950	$ 7,300

Other borrowings consist of participated loans sold by the Bank with disproportionate cash flows to the buyer. Generally accepted accounting principles consider these loans to be incomplete transfers because risk is not proportionate and require that this type of participation be classified as a borrowing. Because of this treatment, the entire loan balance is reported in loans held for investment and not reduced for the participation. At December 31, 2013 and 2012, the outstanding balance for other borrowings was $135,000 and $465,000, respectively.

NOTE 8 – EARNINGS PER SHARE RECONCILIATION

The Company calculates its basic and diluted earnings per common share ("EPS") in accordance with generally accepted accounting principles related to earnings per share. EPS is calculated after giving effect to payments made and other obligations in respect of the Company's outstanding shares of preferred stock, and the components of the Company's EPS calculations are as follows:

	Years Ended December 31,	
	2013	2012
	(in thousands except share and per share data)	
Net income available to common stockholders (numerator, basic and diluted)	$ 2,416	$ 2,191
Weighted average common shares outstanding (denominator)	2,275,779	2,290,533
Earnings per common share - basic	$ 1.06	$ 0.96
Effect of dilutive securities		
Weighted average common shares outstanding during the period	$ 2,275,779	$ 2,290,533
Effect of dilutive equity awards	57,639	50,201
Weighted diluted average common shares outstanding (denominator) during the period	$ 2,333,418	$ 2,340,734
Earnings per common share - assuming dilution	$ 1.04	$ 0.94

Basic earnings per common share are calculated by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per common share are calculated by applying the treasury stock method. Under the treasury stock method, the exercise of dilutive stock options is assumed. The sum of the assumed proceeds of (a) the stock option exercises, (b) the amount of any tax benefits that would be credited to additional paid-in capital assuming exercise of the options, and (c) the unamortized compensation expense on in-the-money options not yet recognized pursuant to generally accepted accounting principles for share-based payments (see "Note 9 – Employee and Director Benefit Plans – Stock Compensation Plans") are assumed to be used to purchase common stock at the average market price during the period. The incremental shares (the difference between the number of shares assumed issued and the number of shares assumed purchased), if any, are included in the denominator of the diluted earnings per share calculation.

Any difference in the number of shares used for basic earnings per common share and diluted earnings per common share for each of the two years results solely from the dilutive effect of equity awards. Options on an average of 57,200 shares and 84,525 shares were not included in computing diluted earnings per share for the years ended December 31, 2013 and December 31, 2012, respectively, because the effects of the corresponding stock options were antidilutive.

NOTE 9 – EMPLOYEE AND DIRECTOR BENEFIT PLANS

Stock Compensation Plans

Under the Heritage 2006 Equity Incentive Plan, as amended and restated effective January 28, 2009, and subsequently amended in 2012 ("2006 Incentive Plan"), the Board of Directors may grant up to 250,000 stock options, stock appreciation rights, restricted stock and certain other equity awards, in the aggregate, to officers and nonemployee directors of the Company and the Bank. The Board of Directors may approve the grant of non-statutory stock options and options qualifying as incentive stock options, and the option price of both a non-statutory stock option and an incentive stock option will be the Fair Market Value of the Company's common stock on the date of grant. Prior to January 28, 2009, "Fair Market Value" under the 2006 Incentive Plan was defined generally as the weighted average (based on daily trading volume) during the thirty (30) day period next preceding the date of grant of the "last sale" prices of a share of the Company's common stock on the five (5) days nearest preceding the date of grant on which at least 300 shares were traded. On January 28, 2009, the Board amended the definition of "Fair Market Value" to mean the following: (i) the closing price of a share of the Company's common stock on the OTC Bulletin Board on the grant date of the applicable award, if the grant date is a trading day; or (ii) if shares of the Company's common stock are not traded on the grant date of the applicable award, then the closing price of a share of the Company's common stock on the OTC Bulletin Board on the next preceding date on which a trade occurred; or (iii) if (i) and (ii) are inapplicable, the fair market value as determined in good faith by the Board. On August 22, 2012, the Board further amended the definition of "Fair Market Value" to mean (i) the price of the last sale of a share of common stock on the OTC Markets Group (or successor system) occurring prior to the grant of the applicable award under the plan; or (ii) if inapplicable, the fair market value as determined in good faith by the Board.

A total of 202,000 options and 30,000 options were outstanding under the 2006 Incentive Plan and other incentive stock plans that have since been terminated, respectively, at December 31, 2013. For purposes of determining the "fair value", as prescribed by accounting guidance for share-based payments, of options granted under the 2006 Incentive Plan, the measurement date is the date of grant. The fair value of each stock option award is estimated on the measurement date using a Black-Scholes valuation model that uses assumptions described below. Expected volatility is based on the historical volatility of the Company's stock, using weekly price observations over the expected term of the stock options. The expected term represents the period of time that stock options granted are expected to be outstanding and is estimated based on management's business plan and provisions of the grant including the contractual term and vesting schedule. The expected dividend yield is based on recent dividend history. The risk-free interest rate is the U.S. Treasury zero coupon yield curve in effect at the measurement date for the period corresponding to the expected life of the option.

All options granted will become exercisable earlier upon a change in control (as defined in the 2006 Incentive Plan) of the Company, subject to any limitations under applicable law. The options may also become exercisable earlier upon the optionee's retirement, disability or death, and in the case of an optionee who is an employee, the optionee's termination without cause or resignation for good reason, again subject to any limitations under applicable law. No option may be exercised after ten (10) years from the date of grant.

No options were granted or modified in 2013 or 2012.

The following table presents a summary of stock option activity during 2013 and 2012:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Term (years)	Aggregate Intrinsic Value *(in thousands)*
Outstanding at January 1, 2013	232,000	$ 12.68		
Granted	-	-		
Exercised	-	-		
Forfeited/expired	-	-		
Outstanding at December 31, 2013	232,000	$ 12.68	2.7	$ 320
Exercisable at December 31, 2013	232,000	$ 12.68	2.7	$ 320

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Term (years)	Aggregate Intrinsic Value *(in thousands)*
Outstanding at January 1, 2012	235,800	$ 12.65		
Granted	-	-		
Exercised	(1,000)	(7.50)		
Forfeited/expired	(2,800)	(12.06)		
Outstanding at December 31, 2012	232,000	$ 12.68	3.7	$ 123
Exercisable at December 31, 2012	230,400	$ 12.71	3.7	$ 117

The aggregate intrinsic value in the previous table represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading day of the quarter and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on December 31, 2013. The amount changes based on the fair market value of the Company's common stock, as reflected by stock market prices. The Company's current policy is to issue new shares of common stock to satisfy option exercises.

There were no options exercised during the year ended December 31, 2013. The aggregate intrinsic value of options exercised during the year ended December 31, 2012 was $3,700. Cash received from exercises of options during the year of 2012 was $7,500. The total fair value of shares underlying options that vested during the years ending December 31, 2013 and 2012 was $4,000 and $37,000, respectively.

Stock option awards granted under the 2006 Incentive Plan provide for accelerated vesting under certain circumstances as defined in the Plan, such as a change of control with respect to the Company, the optionee's retirement, death, permanent disability and, if the optionee is an employee of the Company, resignation for good reason or termination without cause, subject to any limitations under applicable law. Occurrence of these events may cause the requisite service period to be less than reflected in the schedule above and unamortized stock-based compensation expense recognized at that time.

On January 25, 2012, the Company's Board of Directors granted, effective February 1, 2012, 43,600 shares of restricted stock to certain executives under the Heritage 2006 Equity Incentive Plan. The shares vest at a rate of 20% over a five year period beginning on February 1, 2013 and on each February 1 thereafter. In the event of a change of control of the Company, all then-unvested shares shall vest upon the occurrence of the change of control. In the event of a termination of service of the executive by reason of death or permanent disability, all then-unvested shares shall vest upon such termination of service.

As defined in the 2006 Incentive Plan as amended, fair value of the shares was measured by the price the last sale of a share of the Company's common stock on the OTC Markets Group, Inc. reporting system occurring prior to the grant date of the applicable award. In addition, because the share-recipients are not entitled to dividends until the shares vest, the grant date fair value of the award was reduced by the present value of the dividends expected to be paid on the underlying shares during the service period, discounted at the appropriate risk-free interest rate.

The following table presents a summary of restricted stock award activity for the year ending December 31, 2013.

	Shares	Fair Value at Grant Date	Weighted Average Remaining Term (years)	Aggregate Intrinsic Value *(in thousands)*
Outstanding at January 1, 2013	43,600	$ 11.28		
Granted	-	-		
Vested and issued	8,720	11.28		
Forfeited/expired	-	-		
Outstanding at December 31, 2013	34,880	$ 11.28	3.1	$ 58

The following table presents a summary of restricted stock award activity for the period of January 1, 2012 to December 31, 2012.

	Shares	Fair Value at Grant Date
Outstanding at January 1, 2012	-	-
Granted	43,600	$ 11.28
Vested	-	-
Forfeited/expired	-	-
Outstanding at December 31, 2012	43,600	$ 11.28

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading day of the quarter and the fair value at grant date price, multiplied by the number of outstanding restricted stock shares) that would have been received by the grant holders had all grant holders received their stock on December 31, 2013. The amount changes based on the fair market value of the Company's common stock, as reflected by stock market prices. The Company's current policy is to issue new shares of common stock to satisfy the restricted stock grant.

The aggregate intrinsic value of grants issued during the year ended December 31, 2013 was $4,300. The total fair value of shares that vested during the years ending December 31, 2013 was $98,000.

The amount charged against income, before income tax benefit of $33,000, in relation to stock-based payment arrangements was $102,000 for the year ended December 31, 2013. The amount charged against income, before income tax benefit of $31,000, in relation to stock-based payment arrangements was $107,000 for the year ended December 31, 2012. At December 31, 2013, unrecognized compensation expense, net of estimated forfeitures, related to unvested stock option and restricted stock grants was $303,000 and is currently expected to be recognized over a weighted average period of 1.6 years as follows:

At December 31, 2013:	Stock-Based Compensation Expense
	(in thousands)
2014	$ 98
2015	98
2016	99
2017	8
2018	-
Total	$ 303

Deferred Compensation Plans

In 1985, the Company entered into a deferred compensation and retirement arrangement with certain directors and subsequently with one officer.

The Company is a party to a Supplemental Executive Retirement Plan ("SERP") with Michael S. Ives, President & Chief Executive Officer of the Company and the Bank, that provides for an immediately accrued retirement benefit of $25,000 for Mr. Ives. Under the SERP, Mr. Ives will be paid $25,000 each year for ten years, in equal monthly installments, in accordance with the terms and on the schedule set forth in the SERP.

In addition, under his Executive Deferred Compensation Agreement effective February 1, 2010, Mr. Ives may (but is not obligated to) elect to defer a portion of his annual base salary each calendar year (an "Elective Deferral"), pursuant to an advance election process that complies with Internal Revenue Code Section 409A. The Elective Deferrals and related investment earnings are nominally funded through a grantor Deferred Compensation Plan Trust (i.e., a "Rabbi Trust"), where the Company is the grantor for income tax purposes and pursuant to which assets of the Company are maintained as reserves against the Company's obligations under the Executive Deferred Compensation Agreement. The Elective Deferrals are 100% vested at all times, and the Elective Deferrals and any related investment earnings are payable (in a lump sum and/or installments) at separation from service, a change in control of the Company, a specified date, death and/or disability, as specified by Mr. Ives with respect to each Elective Deferral.

The Company's policy for these deferred compensation plans is to accrue the present value of estimated amounts to be paid under the applicable agreements over the required service period to the date the participant is fully eligible to receive the benefit. At December 31, 2013 and 2012, other liabilities included $1,144,000 and $1,060,000, respectively, related to these plans. Compensation expense related to these plans was $43,000 and $77,000 for the years ended December 31, 2013 and 2012, respectively.

Employee Stock Bonus Plan

The Board of Directors adopted a stock bonus plan (the "ESOP") effective January 1, 1998. The ESOP covered substantially all employees after they met eligibility requirements, and funds contributed to the ESOP were used to purchase outstanding common stock of the Company. The Company last made a contribution to the ESOP for the year ended December 31, 2005, and as a result no employees became entitled to allocations of ESOP contributions after that date. During 2011, the Board of Directors adopted resolutions terminating the ESOP, effective as of November 1, 2011. The Company has obtained approval from the Internal Revenue Service for the termination of the ESOP, including the distribution of all remaining account balances to participants and beneficiaries entitled to them.

The Company recognized no compensation expense related to the ESOP for the years ended December 31, 2013 or 2012. Dividends received by the ESOP are used for administrative expenses of the plan. At December 31, 2013 and 2012, the ESOP owned 20 shares and 7,244 shares, respectively, of common stock of the Company. There were no contributions to the ESOP for the years ended December 31, 2013 or 2012. During the year ending 2013, a total of 7,224 shares were disbursed from the ESOP. Of this amount, 5,114 shares were distributed to plan participants, a group that contains both current and terminated employees, and 2,110 shares were repurchased by the Company. A total of 346 shares were purchased by the ESOP during 2012 and a total of 1,272 shares were distributed from the ESOP to terminated employees during 2012. At December 31, 2013 and 2012, the fair market value of the shares held by the ESOP totaled $259 and $85,000, respectively.

401(k) Retirement Program

Effective January 1, 1993, the Board of Directors adopted a 401(k) Retirement Program (the "401(k) Plan"). Eligible employees who have completed the required months of service are eligible to participate and make contributions to the 401(k) Plan. The Company makes employer matching contributions. The Company expensed $88,000 and $98,000 for 401(k) Plan matching contributions during the years ended December 31, 2013 and December 31, 2012, respectively.

Key Man Life Insurance

The Company maintains a key man life insurance policy on its Chief Executive Officer in the amount of $2 million. The policy has no cash surrender value and the Company is the sole beneficiary.

NOTE 10 – OTHER REAL ESTATE OWNED

At December 31, 2013, the Company had other real estate owned of $743,000 representing a Bank branch that will no longer be utilized. During the year ending December 31, 2013, the Bank closed two branches, one of which was sold late in the fourth quarter of 2013. At December 31, 2012, the Company had other real estate owned in the amount of $210,000, representing a Bank branch site that was sold late in the fourth quarter of 2013. The net cash proceeds from these two sales were $897,000, which included net cash of $719,000 and a net note receivable of $178,000. The resulting gain was $349,000.

NOTE 11 – OTHER NONINTEREST INCOME AND EXPENSE

The components of other noninterest income for the periods indicated are as follows:

	Years Ended December 31,	
	2013	2012
	(in thousands)	
Noninterest income		
ATM transaction fees	$ 131	$ 151
Other	151	167
Total noninterest income	$ 282	$ 318

The components of other noninterest expense for the periods indicated are as follows:

	Years Ended December 31,	
	2013	2012
	(in thousands)	
Noninterest expense		
Marketing	$ 74	$ 109
Telephone	123	127
ATM expense	98	137
Other miscellaneous	557	614
Total noninterest income	$ 852	$ 987

NOTE 12 – INCOME TAXES

The principal components of income tax expense for the periods indicated are as follows:

	Years Ended December 31,	
	2013	2012
	(in thousands)	
Federal income tax expense - current	$ 905	$ 924
Deferred federal income tax liability	65	(3)
Income tax expense	$ 970	$ 921

A reconciliation of income tax expense calculated at the federal statutory rate and that shown in the statements of income is summarized as follows for the periods indicated:

	Years Ended December 31,	
	2013	2012
	(in thousands)	
Federal income tax expense (at 34% statutory rate)	$ 1,187	$ 1,105
Effect of tax-exempt interest	(141)	(144)
Effect of life insurance proceeds, premiums, and increases in value, net	(63)	(67)
Effect of equity based compensation	1	6
Other	(14)	21
Income tax expense	$ 970	$ 921

A cumulative net deferred tax asset is included in other assets at December 31, 2013 and 2012. The components of the asset are as follows:

	As of December 31,	
	2013	2012
	(in thousands)	
Deferred Tax Assets		
Deferred compensation	$ 339	$ 343
Allowance for loan losses	585	634
Non-qualifying options	184	150
Investment in partnerships	-	48
Total Deferred Tax Assets	1,108	1,175
Deferred Tax Liabilities		
Deferred loan costs, net	271	275
Net appreciation(depreciation) on available for sale securities	(38)	56
Depreciation on premises and equipment	246	275
Total Deferred Tax Liabilities	479	606
Net Deferred Tax Assets	$ 629	$ 569

The Company has analyzed the tax positions taken or expected to be taken in its tax returns and has concluded it has no liability related to uncertain tax positions in accordance with generally accepted accounting standards for income tax purposes. Tax returns for 2010 and subsequent years are subject to examination by taxing authorities.

NOTE 13 – RELATED PARTY TRANSACTIONS

The Bank has loan and deposit transactions with certain of its executive officers and directors, and with companies in which the officers and directors have a financial interest.

A summary of related party loan activity for the Bank during the periods indicated is set forth in the following table:

	2013	2012
	(in thousands)	
Balance, January 1	$ 12,548	$ 15,419
Originations	3,525	1,241
Repayments	(1,724)	(4,112)
Balance, December 31	$ 14,349	$ 12,548

In the opinion of management, such related party loans are made in the ordinary course of business on substantially the same terms, including interest rate and collateral, as those prevailing at the same time for comparable loans to unrelated persons and did not involve more than the normal risk of collectability or present other unfavorable features.

Commitments to extend credit and letters of credit to such related parties amounted to $3,323,000 and $2,281,000 at December 31, 2013 and 2012, respectively.

NOTE 14 – COMMITMENTS AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET CREDIT RISK

The Company is a party to financial instruments with off-balance sheet credit risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit in the form of loans or loans approved but not yet funded, standby letters of credit, and commitments to sell loans. These instruments involve, to varying degrees, elements of risk which have not been recognized in the Company's consolidated balance sheets.

Loan commitments are agreements to extend credit to a customer so long as there are no violations of the applicable contract terms prior to the funding. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee by the customer. Because certain of the commitments are expected to be withdrawn or expire unused, the total commitment amount does not necessarily represent future cash requirements. Standby letters of credit are written unconditional commitments to guarantee the performance of a Bank customer to a third party.

The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. Unless otherwise noted, the Company requires collateral or other security to support financial instruments with credit risk. Contractual amounts for financial instruments whose contract amounts represent credit risk at December 31, 2013 and 2012 are set forth in the following table:

	At December 31,	
	2013	2012
	(in thousands)	
Commitments to extend credit	$ 42,403	$ 36,259
Standby letters of credit	304	228
Total Commitments	$ 42,707	$ 36,487

As of December 31, 2013, the Company had $42.5 million in deposits in financial institutions in excess of amounts insured by the FDIC.

NOTE 15 – REGULATORY MATTERS

The Bank is subject to various regulatory capital requirements administered by federal and state banking agencies. Failure to meet minimum capital requirements may result in 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 capital amounts and classification are also subject to qualitative judgments by the regulators about components (such as interest rate risk), risk weighting and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum capital amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to average assets (as defined). Management believes that, as of December 31, 2013, the Company and the Bank meet all capital adequacy requirements to which they are subject; further, the Bank is "well capitalized" under the applicable regulatory framework. To be categorized as well capitalized, the Bank must maintain the minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios set forth in the table below. At December 31, 2013, the Company's total risk-based capital, Tier 1 risk-based capital, and Tier 1 capital (leverage) ratios were 16.38%, 15.61% and 12.31%, respectively, all in excess of the minimum requirements. There are no conditions or events that management believes have changed the Bank's categorization.

The capital amounts and ratios for the Company (consolidated) and the Bank as of December 31, 2013 and 2012 are presented in the following table:

	Actual		For Capital Adequacy Purposes		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(dollars in thousands)			
At December 31, 2013						
Total Capital (to Risk-Weighted Assets)						
Consolidated Company	$ 40,890	16.38 %	$ 19,967	8.00 %	N/A	N/A
Bank	$ 36,622	14.71 %	$ 19,922	8.00 %	$ 24,902	10.00 %
Tier 1 Capital (to Risk-Weighted Assets)						
Consolidated Company	$ 38,959	15.61 %	$ 9,984	4.00 %	N/A	N/A
Bank	$ 34,692	13.93 %	$ 9,961	4.00 %	$ 14,941	6.00 %
Tier 1 Capital (to Average Assets)						
Consolidated Company	$ 38,959	12.31 %	$ 12,656	4.00 %	N/A	N/A
Bank	$ 34,692	11.09 %	$ 12,518	4.00 %	$ 15,648	5.00 %
At December 31, 2012						
Total Capital (to Risk-Weighted Assets)						
Consolidated Company	$ 38,640	15.54 %	$ 19,892	8.00 %	N/A	N/A
Bank	$ 36,478	14.70 %	$ 19,852	8.00 %	$ 24,815	10.00 %
Tier 1 Capital (to Risk-Weighted Assets)						
Consolidated Company	$ 36,566	14.71 %	$ 9,946	4.00 %	N/A	N/A
Bank	$ 34,403	13.86 %	$ 9,926	4.00 %	$ 14,889	6.00 %
Tier 1 Capital (to Average Assets)						
Consolidated Company	$ 36,566	10.91 %	$ 13,400	4.00 %	N/A	N/A
Bank	$ 34,403	10.33 %	$ 13,323	4.00 %	$ 16,653	5.00 %

Federal and state banking regulations place certain restrictions on dividends paid and loans or advances made by the Bank to the Company. The amount of dividends the Bank may pay to the Company, without prior approval, is limited to current year earnings plus retained net profits for the two preceding years. Loans or advances are limited to 10.0% of the Bank's stockholders' equity.

NOTE 16 – DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

The following summary presents the methodologies and assumptions used to estimate the fair value of the Company's financial instruments presented below. Because there is no readily available active market for a portion of the Company's financial instruments, fair values of some financial instruments are based on estimates using present value and other valuation techniques. Much of the information used to determine fair value is highly subjective in nature and therefore the results may not be precise. The subjective factors include, among other things, estimates of cash flows, risk characteristics, credit quality and interest rates, all of which are subject to change. Accordingly, the amounts that will actually be realized or paid upon settlement or maturity of the various instruments could be significantly different from the estimated fair value.

Cash, Due From Banks, Interest-bearing Deposits at Other Banks and Federal Funds Sold

For cash, due from banks, interest-bearing deposits at other banks and federal funds sold, the carrying amount is a reasonable estimate of fair value.

Certificates of Deposit in Other Banks

The carrying value of certificates of deposit in other banks approximates fair value.

Investment Securities

Fair values of investment securities are based on quoted market prices, where available. For unquoted securities, the fair value is estimated by the Company on the basis of available financial and other information. Securities available for sale are recorded at fair value.

Loans

The fair value of loans is estimated by discounting the future estimated scheduled cash flows using the current rates at which similar loans

would be made to borrowers with similar credit ratings and significant core deposit relationships. The fair value of loans does not include the value of the customer relationship or the right to fees generated by the account.

Accrued Interest Receivable

The carrying amount of accrued interest receivable approximates fair value.

Stock in Federal Reserve Bank and Federal Home Loan Bank

The carrying value for FRB stock and FHLB stock approximates fair value.

Bank-Owned Life Insurance

The carrying value of bank-owned life insurance approximates fair value, as this investment is carried at cash surrender value.

Other Financial Assets

Other financial assets includes a deferred compensation plan trust (i.e. rabbi trust) maintained for the benefit of the Company's Chief Executive Officer. Because the carrying value of other financial assets is based on market prices, carrying value is a reasonable estimate of fair value.

Deposit Liabilities

The fair value of fixed-maturity certificates of deposit is estimated using a discounted cash flow model based on the rates offered for deposits of similar remaining maturities. Weighted average rates paid and posted rates were used for December 2013 and 2012.

The fair value of deposits with no stated maturities (which includes demand deposits, savings accounts and money market deposits) is the amount payable on demand at the reporting date. Deposit liabilities with no stated maturity are reported at the amount payable on demand without regard for the inherent funding value of these instruments. The Company believes that significant value exists in this funding source. The fair value of deposits does not include the value of the customer relationship or the rights to fees generated by the account.

Federal Home Loan Bank Advances

The fair value of FHLB advances is estimated using discounted cash flow analysis based on rates offered at the reporting date for borrowings of similar remaining maturities.

Other Borrowings and Securities Sold Under Agreements to Repurchase

The fair value of other borrowings is estimated using discounted cash flow analysis based on rates offered at the reporting date for borrowings of similar remaining maturities. The carrying amount for securities sold under agreements to repurchase is a reasonable estimate of fair value.

Accrued Interest Payable

The carrying value of accrued interest payable is a reasonable estimate of fair value.

Loan Commitments and Standby Letters of Credit

The carrying value of notional principal amounts of loan commitments and standby letters of credit are reasonable estimates of fair value.

The carrying amounts and fair value of the Company's financial instruments that differ from financial statement presentation at December 31, 2013 and 2012 are presented in the following table.

	At December 31, 2013				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
			(in thousands)		
Financial Assets:					
Loans held for investment	$ 216,412	$ 218,129	$ -	$ -	$ 218,129
Financial liabilities:					
Deposits	$ 263,592	$ 263,614	$ -	$ 263,614	$ -
Other borrowings	135	140	-	-	140

	At December 31, 2012				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
			(in thousands)		
Financial Assets:					
Loans held for investment	$ 220,962	$ 225,598	$ -	$ -	$ 225,598
Financial liabilities:					
Deposits	$ 295,146	$ 295,194	$ -	$ 295,194	$ -
Other borrowings	465	492	-	-	492

Fair Value Hierarchy

"Fair Value Measurements and Disclosures" establishes three levels of inputs that may be used to measure fair value:

Level 1: Valuation is based on quoted prices in active markets for identical assets or liabilities.

Level 2: Valuation is based on observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include debt securities with quoted prices that are traded less frequently than exchange-traded instruments and derivative contracts whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data.

Level 3: Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

Investment Securities Available for Sale

Investment securities available for sale are recorded at fair value on a recurring basis. Fair value is measured by quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 2 securities include Treasury notes and bills, mortgage-backed securities issued by government sponsored entities, municipal bonds and other securities issued by government sponsored agencies.

Loans

The Company does not record loans at fair value on a recurring basis. Fair value is measured using modeling software that incorporates various assumptions based on observable market data such as interest rate fluctuations and cash flow data. From time to time, a loan is considered impaired. Loans that are deemed to be impaired are valued in accordance with guidance related to receivables. The fair value of impaired loans is estimated using one of several methods, including collateral value, liquidation value and discounted cash flows.

When the fair value of collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as Level 2. If the fair value of the loan is based on criteria other than observable market prices or current appraised value, the loan is recorded as Level 3.

Other Real Estate Owned

Foreclosed assets are adjusted to fair value upon transfer of the loans to foreclosed assets. Foreclosed assets are carried at the lower of the carrying value or fair value. Once management's intentions change regarding the utilization of its own property, that property is transferred to other real estate owned at fair value. Fair value is based upon independent observable market prices or appraised values of the collateral, which the Company considers to be Level 2 inputs. The Company may, from time to time, revise its evaluation of the fair value of a property and provide an allowance based on subjective criteria such as declines in assessed value, which the Company considers to be Level 3 inputs.

Other Financial Assets

Other financial assets are recorded at fair value on a recurring basis. Fair value is based on quoted market prices which are considered to be Level 2 inputs.

General

The Company has no liabilities carried at fair value or measured at fair value on a recurring or nonrecurring basis.

Assets Recorded at Fair Value on a Recurring Basis

	At December 31, 2013			
	Total	**Level 1**	**Level 2**	**Level 3**
		(in thousands)		
Investment in securities available for sale:				
U.S. Treasury notes	$ 2,005	$ -	$ 2,005	$ -
U.S. government sponsored enterprises	4,934	-	4,934	-
Corporate floating rate notes	3,348	-	3,348	-
Other financial assets	380	-	380	-
Total assets at fair value	$ 10,667	$ -	$ 10,667	$ -

	At December 31, 2012			
	Total	**Level 1**	**Level 2**	**Level 3**
		(in thousands)		
Investment in securities available for sale:				
U.S. Treasury notes	$ 2,025	$ -	$ 2,025	$ -
U.S. government sponsored enterprises	19,137	-	19,137	-
Other financial assets	285	-	285	-
Total assets at fair value	$ 21,447	$ -	$ 21,447	$ -

Assets Recorded at Fair Value on a Non-Recurring Basis

	At December 31, 2013			
	Total	**Level 1**	**Level 2**	**Level 3**
		(in thousands)		
Other real estate owned	$ 743	$ -	$ 743	$ -
Total assets at fair value	$ 743	$ -	$ 743	$ -

	At December 31, 2012			
	Total	**Level 1**	**Level 2**	**Level 3**
		(in thousands)		
Other real estate owned	$ 210	$ -	$ 210	$ -
Total assets at fair value	$ 210	$ -	$ 210	$ -

NOTE 17 - PARTICIPATION IN SMALL BUSINESS LOAN FUND PROGRAM

On August 11, 2011, the Company entered into and consummated the transactions contemplated by a Securities Purchase Agreement (the "Securities Purchase Agreement") with the Secretary of the Treasury (the "Secretary") under the Small Business Lending Fund program (the "SBLF Program"), a $30 billion fund established under the Small Business Jobs Act of 2010 designed to encourage lending to small businesses by providing capital to qualified community banks with assets of less than $10 billion. Under the Securities Purchase Agreement, the Company issued to the Secretary a total of 7,800 shares of the Company's Senior Non-Cumulative Perpetual Preferred Stock, Series C (the "SBLF Preferred Stock"), having a liquidation value of $1,000 per share, for total proceeds of $7,800,000.

The SBLF Preferred Stock qualifies as Tier 1 capital. Non-cumulative dividends are payable quarterly on the SBLF Preferred Stock, and the dividend rate is calculated as a percentage of the aggregate liquidation value of the outstanding SBLF Preferred Stock and is based on changes in the Bank's level of "Qualified Small Business Lending" or "QSBL" (as defined in the Securities Purchase Agreement), as compared to the Bank's baseline QSBL level of approximately $70 million.

For the initial 2.5 years of the SBLF Program, the Company's dividend rate has fluctuated between 1% and 5% to reflect changes in the Bank's level of QSBL compared to the initial baseline. More specifically, if the Bank's QSBL at the end of a quarter has increased as compared to the baseline, then the dividend rate payable on the SBLF Preferred Stock have changed as follows:

Relative Increase in QSBL to Baseline	Dividend Rate
less than 2.5%	5%
between 2.5% and 5.0%	4%
between 5.0% and 7.5%	3%
between 7.5% and 10.0%	2%
10% or more	1%

During the year ended December 31, 2013, the Company declared $105,000 in SBLF Preferred Stock dividends, a dividend rate of 1.34%. Based on the Bank's latest measured levels of QSBL, the dividend rate on the SBLF Preferred Stock is 1.00% for the remaining quarters of 2014. The Company expects to pay corresponding dividends of $19,500 on or about April 1, 2014, $19,500 on or about July 1, 2014, and $19,500 on or about October 1, 2014.

After the initial 2.5 years of the SBLF Program and continuing through 4.5 years after the SBLF Program transaction closing, the dividend rate on the SBLF Preferred Stock will be fixed at between 1% and 7% based on the level of QSBL at that time, as compared to the baseline; however, the dividend rate will increase to 7% only if the Bank's rate of small business lending has stayed the same or decreased relative to the baseline. If any SBLF Preferred Stock remains outstanding after 4.5 years, the dividend rate will increase to 9%. Having achieved the required QSBL levels as compared to the baseline at September 30, 2013, the Company's SBLF dividend rate was fixed at 1% through the quarter ending December 31, 2015.

The SBLF Preferred Stock is generally non-voting, except in limited circumstances that could impact the SBLF investment, such as (i) authorization of senior stock, (ii) charter amendments adversely affecting the SBLF Preferred Stock and (iii) extraordinary transactions such as mergers, asset sales, share exchanges and the like (unless the SBLF Preferred Stock remains outstanding and the rights and preferences are not impaired by the transaction).

If the Company misses five dividend payments, whether or not consecutive, the holder of the SBLF Preferred Stock will have the right to appoint an "observer" on the Company's Board of Directors.

The SBLF Preferred Stock is not convertible to common stock or any other securities. Distributions upon any liquidation of the Company must be paid on the SBLF Preferred Stock up to the aggregate liquidation value, plus accrued dividends, before any other shareholder distributions can be made.

The SBLF Preferred Stock may be redeemed (repurchased) by the Company at any time, at a redemption price of $1,000 per share plus accrued but unpaid dividends to the date of redemption, subject to the approval of the Company's federal banking regulator. The SBLF Preferred Stock may be redeemed in whole or in part, subject to a minimum redemption of at least 25% of the original SBLF investment (i.e., a minimum redemption of about $1.95 million).

The SBLF Preferred Stock was issued in a private placement transaction exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended. The Company has agreed to register the SBLF Preferred Stock under applicable securities laws upon the request of the Secretary, as further described in the Securities Purchase Agreement. The SBLF Preferred Stock is not subject to any contractual restrictions on transfer and thus the Secretary may sell, transfer, exchange or enter into other transactions with respect to the SBLF Preferred Stock without the Company's consent.

NOTE 18 – CONDENSED FINANCIAL INFORMATION OF HERITAGE BANKSHARES, INC.

(Parent Company Only)

The following condensed financial statements of Heritage Bankshares, Inc. are presented below on a parent company only basis for the years indicated.

	As of December 31,	
	2013	**2012**
	(in thousands)	
Condensed Balance Sheets		
Assets		
Cash and interest-bearing deposits in other banks	$ 4,204	$ 1,934
Investment in subsidiary bank	34,617	34,511
Other assets	91	287
Total Assets	$ 38,912	$ 36,732
Liabilities and Stockholders' Equity		
Other liabilities	$ 27	$ 58
Total liabilities	27	58
Preferred stock	7,800	7,800
Common stock	11,373	11,380
Additional paid-in capital	6,792	6,761
Retained earnings	12,995	10,625
Accumulated other comprehensive income(loss)	(75)	108
Stockholders' equity	38,885	36,674
Total Liabilities and Stockholders' Equity	$ 38,912	$ 36,732

	Years ended December 31,	
	2013	**2012**
	(in thousands)	
Condensed Statements of Income		
Dividends from subsidiary bank	$ 2,428	$ 2,478
Equity in undistributed net income of subsidiaries	187	-
Interest income	4	4
Other expenses	(145)	(219)
Income before income taxes	2,474	2,263
Income tax benefit	47	65
Net Income	2,521	2,328
Preferred stock dividends and accretion of discount	(105)	(137)
Net income available to common stockholders	$ 2,416	$ 2,191

Certain restrictions exist regarding the ability of the Bank to transfer funds to the Company in the form of cash dividends, loans or advances. Pursuant to federal regulations, dividends are generally restricted to net profits, as defined, for the current year plus retained net profits for the previous two years. The maximum amount available for transfer from the Bank to the Company in the form of loans and advances is 10.0% of the Bank's stockholders' equity.

	Years ended December 31,	
	2013	2012
	(in thousands)	
Condensed Statement of Cash Flows		
Cash flows from operating activities		
Net income	$ 2,521	$ 2,328
Add (deduct) items not affecting cash during the year		
Stock-based compensation	102	107
Undistributed net income of subsidiaries	(187)	-
Restricted stock issuance tax benefit	2	1
Changes in assets/liabilities, net		
Decrease(increase) in other assets	94	(184)
Increase(decrease) in other liabilities	(31)	17
Net cash provided by operating activities	2,501	2,269
Cash flows from investing activities		
Net cash provided by investing activities	-	-
Cash flows from financing activities		
Proceeds from exercise of stock options	-	8
Repurchase of common stock	(126)	(368)
Cash dividends paid	(105)	(1,506)
Net cash used for financing activities	(231)	(1,866)
Increase(decrease) in cash and cash equivalents	2,270	403
Cash and cash equivalents at beginning of year	1,934	1,531
Cash and cash equivalents at end of year	$ 4,204	$ 1,934
Non-cash financing activities		
Perpetual preferred stock dividends accrued but not paid	$ 20	$ 51

STOCKHOLDER INFORMATION

CORPORATE HEADQUARTERS

Heritage Bankshares, Inc.
150 Granby Street
Norfolk, Virginia 23510
757-648-1700

STOCK TRADING

Heritage Bankshares, Inc. common stock is currently quoted on the OTCBB and OTCQB over-the-counter markets under the symbol "HBKS."

FINANCIAL INFORMATION

To obtain financial information on Heritage Bankshares, Inc., contact:

Anne F. Vanderberry, Senior Vice President
& Chief Financial Officer
Heritage Bankshares, Inc.
150 Granby Street
Norfolk, VA 23510

FOR INFORMATION ONLINE, VISIT HERITAGEBANKVA.COM

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