RELIABLE.

Always in your best interest.

HERITAGE
BANKSHARES, INC.

Annual Report 2014

HERITAGE BANK
CITIES SERVED



RELIABLE.

Every business needs a reliable bank.

A reliable bank will protect its business clients by:

1. Having consistent lending policies throughout all phases of the business cycle;
2. Structuring loans to withstand economic and regulatory pressures;
3. Rewarding improvements in your businesses with better rates and terms;
4. Providing consistently excellent service through knowledgeable bankers trained in multiple banking services; and
5. Running the bank's business in an honest and exemplary fashion to protect you from your bank's problems making problems for you.

Heritage Bank is a reliable bank for its clients.

Is your bank a reliable bank?

HERITAGE BANK

Always in your best interest.

PRESIDENT'S REPORT TO STOCKHOLDERS

Some say that the definition of insanity is doing the same thing over and over again and expecting a different result. Whether this is the correct definition, I do not know. Unfortunately, it does describe the mindset of many community bankers and community bank investors. Let's call it being overly optimistic rather than outright insanity.

What do I mean by this? When the same bankers make the same types of loans to the same types of borrowers, why should they expect things to be different in the next major recession? Why should they expect credit losses to be much less in the next major recession compared to what we had in this past recession?

Before I delve into credit issues more deeply, I need to reference our results from 2014. As usual, we had another solid year for earnings and asset quality. We completed the reorganization of our lending and deposit banking operations. Our core operating expenses remained stable. Just what you expect from us.

For 2015, our primary objective is to grow our loan portfolio safely. If you ask any other community banker, he or she will probably say the same thing. He or she probably said the same thing in 2004, 2005, 2006 and 2007. In other words, poor asset quality is not an intention problem; it is a memory and discipline problem.

I still can recall with amusement what was said about me in my first five years at Heritage. In 2005 and 2006, we limited our exposure to real estate lending because of the substantial overvaluation of real estate compared to historical norms. Some folks said at that time that I did not know how to run a bank because Heritage was not participating in the easy asset growth and "profits" from real estate lending. Several years later, many of those same folks told me how clever I had been. The truth of the matter is that I was neither incompetent nor clever. I just had a good memory and relied on my memory of past recessions to avoid mistakes that seem so obvious now but not so obvious back then.

Why am I talking about all of this now? The economy continues to grow at a moderate pace. The Federal Reserve Open Market Committee (the "FOMC") is only talking about slowly increasing the Fed Funds Rate to more normal levels over time. Furthermore, it does not appear from current bond rates and the forward yield curves that the projected increases in the Fed Funds Rate will have any dramatic impact on longer term interest rates. Inflation remains low. The overall unemployment rate is falling but wage growth remains tepid as the large number of part-time workers seeking full-time employment provides employers with flexibility on wages. The majority economic view seems to be either accelerating growth or continuing moderate growth at worst.

Now is when a good memory is one of the most important assets of a community banker. There is no authoritative warning before a recession begins. Things are good until they become bad. We cannot point to a peak in real estate values until after they decline. We may hope and act like recessions will not happen, but a good memory tells us that they will. It will not be different this time.

You may be thinking that these thoughts are premature because the "real" business expansion has yet to occur. Statistically, the current economic expansion, however weak, is already of average duration on a historical basis. Furthermore, there is no "money-back" guaranty on loans that there will be a "real" business expansion before the next recession.

From my standpoint, there are signs of hidden slippage in credit standards for community banks. Exhausted borrowers who survived the recession with little in the way of reserves are receiving additional credit because of their payment histories during the recession. This is the typical confusion of willingness to repay with capacity to repay in the future. These borrowers simply lack the capacity to withstand the next recession.

An exacerbating factor for credit weakness is coming from bank regulators warning community bankers about interest rate risks. As a result, community bankers are now trying to make commercial real estate loans with shorter maturities based on loan-to-value ratios from inflated appraised values. These values are driven upward by low capitalization rates derived from the current ultra-low interest rates. These loans look good in theory from an asset-liability standpoint, but may well be "underwater" when they mature in three to five years if interest rates have risen appreciably.

A floating interest rate for a loan provides many community bankers with a false sense of security from interest rate risks. A floating rate hides the practical interest rate ceiling on a loan stemming from the borrower's actual capacity to pay higher rates. Assumptions about vacancy rates and lease rates for real estate loans in a future recession tend to be overly optimistic. Competition and the need to grow loans may cause bankers to minimize these assumptions until it is too late.

Let me give a specific example of interest rate risk on a real estate loan. Assume that a commercial real estate property currently has an annual net income before debt service of $100,000 after providing for currently appropriate reserves for vacancies and repairs. Further assume this property has a valuation of $1,250,000 against which many banks would loan the traditional 80% of value, or $1,000,000, for a term of five years. The annual payment on this loan at a 4% interest rate amortized over 20 years would be $73,098 creating a "safe" debt service coverage ratio of 137%. However, the FOMC has said that the "normal" Fed Funds Rate is more than 300 basis points above the current 25 basis points and that the FOMC wants to bring the Fed Funds Rate back to "normal" over time. So, assuming that intermediate term interest rates would move in parallel with an increase in the Fed Funds Rate of 300 basis points, the market interest rate at the renewal of the loan for a new five year term would

increase to 7%. This would increase the annual payment to $93,796. This increase in rate would lower the debt service coverage ratio on the loan to 107% if the borrower had been unable to increase his leasing rates. This does not even account for any additional vacancies and/or decreases in leasing rates that might arise during a recession. At this point, if the borrower does not have substantial liquidity, the loan could quickly become a problem.

A floating interest rate might create this credit problem well before the maturity of this loan. If the FOMC were to increase the Fed Funds Rate by 300 basis points over a relatively short period of time and the interest rate on the loan was floating at the Prime Rate plus 1%, the interest rate on the loan would become 7.25%. In this case, the bank's apparent interest rate risk mitigant of a floating rate creates a more immediate credit risk than a term loan because the borrower may not have had time to adjust the rents on the leases for the underlying property to offset the rising interest rates. If unexpected vacancies and/or expenses were to occur and the borrower lacked sufficient liquidity to deal with these problems, the loan could quickly become a problem, well before its maturity in five years.

At Heritage, we try to think about interest rate risk in our loan portfolio as part of credit risk. For the typical community bank, a high degree of theoretical interest rate risk is a threat to earnings but a high degree of credit risk, which includes an interest rate risk component, is a threat to solvency. Community bankers have only dim memories of the credit risks associated with higher interest rates arising from fixed-rate loans resetting to much higher rates at their maturities and from floating-rate loans with interest rates that increase quickly beyond the borrowers' capacities to pay.

My memory tells me that the current economic expansion, regardless of how weak it might be, is now at least average in length. There is no guaranty that this expansion will accelerate before it decelerates. Rising interest rates can create net interest income risk for the typical community bank, but that risk can be ameliorated quickly by changes in the composition of the bank's assets and liabilities and/or by the use of financial derivatives such as interest rate swaps and caps. Above all, interest rate risk is more dangerous and more difficult to detect as actual credit risk than as theoretical financial risk. Awareness of this type of interest rate risk often comes too late to prevent deteriorating credit quality.

Some might argue that my concerns about a combination of interest rate risk and credit risk in a recession is misplaced. This argument means that the FOMC would automatically act to reduce interest rates to alleviate the impact of recessionary forces. This may or may not be the case depending on the level of inflationary pressures existing at that time.

In years past, we faced the dilemma of strong inflationary pressures and a slow economy, the combination of which was called "stagflation." How did the FOMC react? The FOMC raised interest rates dramatically to combat inflation with the accompanying negative impact on the economy. Obviously, a severe recession followed almost immediately.

We have a saying at Heritage that "Nothing is ever easy." Our excellent asset quality is a function of memory and discipline and not happenstance. This means declining to make a lower quality loan that other community banks are pursuing eagerly. This means foregoing a higher interest rate on a new loan to negotiate a more conservative loan structure to preserve the asset quality of that loan in a future recession.

Making loans is easy; making high quality loans is hard. At Heritage, we do what is right for our stockholders and not what is easy for management.

Some may be calling me out of touch or too conservative just like they did ten years ago. We are not structuring loans to "manage" our interest rate risk. We do not ignore the future credit risk from rising rates and a slow economy that could just as easily deteriorate as it could improve. My memory tells me that before too long, public perception of our business plan will once again move from out of touch to clever.

Thank you.



Michael S. Ives

President & CEO

April 8, 2015

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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elliott davis

Independent Auditor's Report

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

Report on the Consolidated 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, 2014 and 2013, and the related consolidated statements of income, comprehensive income, stockholders' equity and cash flows for the years then ended and the related notes to the financial statements.

Management's Responsibility for the Consolidated 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, 2014, in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. 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.

Opinion

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, 2014 and 2013, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Elliott Davis Decosimo, LLC

Richmond, Virginia
February 25, 2015

HERITAGE BANKSHARES, INC.
CONSOLIDATED BALANCE SHEETS

	At December 31,	
	2014	2013
	(in thousands except share data)	
ASSETS		
Cash and due from banks	$ 3,677	$ 4,897
Interest-bearing deposits in other banks	6,437	5,919
Federal funds sold	27	110
Total cash and cash equivalents	10,141	10,926
Certificates of deposit in other banks	57,982	48,767
Securities available for sale, at fair value	27,855	10,287
Securities held to maturity, at cost, (fair value $3,024 and $3,099, respectively)	3,090	3,358
Loans, held for investment, net of allowance for loan losses of $1,943 and $1,930, respectively	224,651	216,412
Accrued interest receivable	553	517
Stock in Federal Reserve Bank, at cost	600	597
Stock in Federal Home Loan Bank of Atlanta, at cost	1,780	582
Premises and equipment, net	9,085	9,325
Other real estate owned	743	743
Bank-owned life insurance	5,494	5,757
Other assets	1,496	1,690
Total assets	$ 343,470	$ 308,961
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Deposits		
Noninterest-bearing	$ 101,576	$ 99,322
Interest-bearing	165,320	164,270
Total deposits	266,896	263,592
Federal Home Loan Bank Advances	33,450	4,000
Customer repurchase agreements	351	511
Other borrowings	-	135
Accrued interest payable	25	21
Other liabilities	1,991	1,817
Total liabilities	302,713	270,076
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; 2,287,509 shares and 2,274,507 shares issued and outstanding at December 31, 2014 and December 31, 2013, respectively	11,438	11,373
Additional paid-in capital	7,005	6,792
Retained earnings	14,487	12,995
Accumulated other comprehensive income (loss), net	27	(75)
Total stockholders' equity	40,757	38,885
Total liabilities and stockholders' equity	$ 343,470	$ 308,961

See accompanying notes to consolidated financial statements.

HERITAGE BANKSHARES, INC.
CONSOLIDATED STATEMENTS OF INCOME

	Years Ended December 31,	
	2014	2013
	(in thousands except share and per share data)	
Interest income		
Interest income and fees on loans	$ 8,766	$ 9,171
Interest on taxable investment securities	528	335
Other interest and dividend income	858	663
Total interest income	10,152	10,169
Interest expense		
Deposits	835	860
Borrowings	49	17
Total interest expense	884	877
Net interest income	9,268	9,292
Provision for loan losses	-	-
Net interest income after provision for loan losses	9,268	9,292
Noninterest income		
Service charges on deposit accounts	160	191
Late charges and other fees on loans	78	320
Gain(loss) on sale of investment securities	197	(8)
Gain on sale of other assets	1	190
Gain on sale of other real estate owned	-	349
Income from bank-owned life insurance	866	194
Other	240	282
Total noninterest income	1,542	1,518
Noninterest expense		
Compensation	3,674	3,843
Data processing	436	437
Occupancy	757	774
Furniture and equipment	578	570
Taxes and licenses	335	269
Professional fees	250	268
FDIC assessment	165	164
Loss on disposal of fixed assets	22	142
Other	843	852
Total noninterest expense	7,060	7,319
Income before provision for income taxes	3,750	3,491
Provision for income taxes	878	970
Net income	$ 2,872	$ 2,521
Preferred stock dividend	(78)	(105)
Net income available to common stockholders	$ 2,794	$ 2,416
Earnings per common share		
Basic	$ 1.23	$ 1.06
Diluted	$ 1.19	$ 1.04
Dividends per common share	$ 0.48	$ -
Weighted average common shares outstanding - basic	2,281,187	2,275,779
Effect of dilutive equity awards	60,674	57,639
Weighted average common shares outstanding - diluted	2,341,861	2,333,418

See accompanying notes to consolidated financial statements.

	Years Ended December 31,	
	2014	2013
	(in thousands)	
Net income	$ 2,872	$ 2,521
Other comprehensive gain(loss):		
Change in unrealized holding gains(losses) on securities available for sale	352	(285)
Change in tax effect on unrealized gains(losses)	(120)	97
Realized losses(gains) on sales of available for sale securities	(197)	8
Tax effect on realized (gains)losses	67	(3)
Total other comprehensive gain(loss)	102	(183)
Total comprehensive income	$ 2,974	$ 2,338

See accompanying notes to consolidated financial statements.

HERITAGE BANKSHARES, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
YEARS ENDED DECEMBER 31, 2014 AND 2013

	Preferred Shares		Common Stock		Additional Paid-in	Retained	Accumulated Other Comprehensive	
	Shares	Amount	Shares	Amount	Capital	Earnings	Income (loss)	Total
				(in thousands except share data)				
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
Vested and issued 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
Total comprehensive income	-	-	-	-	-	2,872	102	2,974
Vested and issued restricted stock and related tax benefits of $10	-	-	11,720	59	(49)	-	-	10
Exercise of stock options and related tax benefits of $44	-	-	30,400	152	227	-	-	379
Repurchase of common shares	-	-	(29,118)	(146)	(87)	(207)	-	(440)
Equity-based compensation expense	-	-	-	-	122	-	-	122
Cash dividends on preferred stock	-	-	-	-	-	(78)	-	(78)
Cash dividends on common stock ($0.48 per share)	-	-	-	-	-	(1,095)	-	(1,095)
Balance, December 31, 2014	7,800	$ 7,800	2,287,509	$ 11,438	$ 7,005	$ 14,487	$ 27	$ 40,757

See accompanying notes to consolidated financial statements.

	For the Years Ended December 31,	
	2014	2013
	(in thousands)	
Cash flows from operating activities:		
Net income	$ 2,872	$ 2,521
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of loan yield adjustments, net	408	414
Depreciation, amortization and accretion, net	565	518
Stock based compensation	122	102
Deferred compensation	33	43
Tax benefit from stock based compensation plan issuances	54	2
Net (gains)losses on:		
Sale of securities	(197)	8
Sale, disposal, or impairment of premises and equipment	22	142
Sale of other long lived assets	(1)	(190)
Sale or impairment of other real estate owned	-	(349)
Net income on bank owned life insurance	(866)	(194)
Changes in assets/liabilities, net:		
Decrease in interest receivable and other assets	106	793
Increase in interest payable and other liabilities	181	85
Net cash provided by operating activities	3,299	3,895
Cash flows from investing activities:		
Proceeds from maturities and principal repayments of securities available for sale	7,991	9,000
Purchases of securities available for sale	(40,368)	(8,400)
Proceeds from sales of securities available for sale	15,105	9,988
Proceeds from maturities and principal repayments of securities held to maturity	250	55
Purchases of securities held to maturity	-	(3,427)
Net proceeds from sale of other real estate owned	-	719
Net increase in certificates of deposit in other banks	(9,215)	(12,875)
Net decrease(increase) in loans held for investment	(8,647)	4,326
Purchases of Federal Home Loan Bank stock and Federal Reserve Bank stock	(11,361)	(2,721)
Redemption of FHLB stock and Federal Reserve Bank stock	10,160	2,576
Purchases of premises and equipment	(309)	(487)
Proceeds from sale of premises and equipment	-	9
Purchases of and premiums paid for bank-owned life insurance	(8)	(11)
Proceeds from death benefits of bank-owned life insurance	1,137	-
Net cash used for investing activities	(35,265)	(1,248)
Cash flows from financing activities:		
Proceeds from exercise of stock options	336	-
Net increase(decrease) in deposits	3,304	(31,554)
Net increase in Federal Home Loan Bank advances	29,450	4,000
Net decrease in customer repurchase agreements	(160)	(2,094)
Net decrease in other borrowings	(135)	(330)
Retirement of common stock	(441)	(126)
Preferred stock cash dividends paid	(78)	(105)
Common stock cash dividends paid	(1,095)	-
Net cash provided by(used for) financing activities	31,181	(30,209)
Decrease in cash and cash equivalents	(785)	(27,562)
Cash and cash equivalents, beginning of period	10,926	38,488
Cash and cash equivalents, end of period	$ 10,141	$ 10,926
Supplemental disclosure:		
Interest paid	$ 880	$ 889
Income taxes paid	$ 817	$ 710
Noncash financing activities:		
Transfer of other real estate owned to loans	$ -	$ 190
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, 2014 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 investment products, recording a $303,000 receivable based on the cost method of accounting for investments. This receivable is to be paid in equal annual installments over a ten year period beginning in December 2014 and including interest at the ten year U.S. Treasury note rate.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities 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. The Company does have a concentration of real estate collateral supporting its commercial real estate portfolio.

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 or are secured by a 1-4 residential property. 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 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 2 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 0.09% 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, 2014, 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, 2014, 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, 2014, 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 that are determined using the treasury stock method, and other non-vested unissued stock awards.

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:

In January 2014, the FASB amended Receivables topic of the Accounting Standards Codification. The amendments are intended to resolve diversity in practice with respect to when a creditor should reclassify a collateralized consumer mortgage loan to other real estate owned (OREO). In addition, the amendments require a creditor reclassify a collateralized consumer mortgage loan to OREO upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. The amendments will be effective for the Company for annual periods, and interim periods within those annual periods beginning after December 15, 2014, with early implementation of the guidance permitted. In implementing this guidance, assets that are reclassified from real estate to loans are measured at the carrying value of the real estate at the date of adoption. Assets reclassified from loans to real estate are measured at the lower of the net amount of the loan receivable or the fair value of the real estate less costs to sell at the date of adoption. The Company will apply the amendments prospectively. The Company does not expect these amendments to have a material effect on its financial statements.

In May 2014, the FASB issued guidance to change the recognition of revenue from contracts with customers. The core principle of the new guidance is that an entity should recognize revenue to reflect the transfer of goods and services to customers in an amount equal to the consideration the entity receives or expects to receive. The guidance will be effective for the Company for reporting periods beginning after December 15, 2016. The Company does not expect these amendments to have a material effect on its financial statements.

In June 2014, the FASB issued guidance which makes limited amendments to the guidance on accounting for certain repurchase agreements. The new guidance (1) requires entities to account for repurchase-to-maturity transactions as secured borrowings (rather than as sales with forward repurchase agreements), (2) eliminates accounting guidance on linked repurchase financing transactions, and (3) expands disclosure requirements related to certain transfers of financial assets that are accounted for as sales and certain transfers (specifically, repos, securities lending transactions, and repurchase-to-maturity transactions) accounted for as secured borrowings. The amendments will be effective for the Company for the first interim or annual period beginning after December 15, 2014. The Company will apply the guidance by making a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. The Company does not expect these amendments to have a material effect on its financial statements.

In August 2014, the FASB issued guidance that is intended to define management's responsibility to evaluate whether there is substantial doubt about an organization's ability to continue as a going concern and to provide related footnote disclosures. In connection with preparing financial statements, management will need to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the organization's ability to continue as a going concern within one year after the date that the financial statements are issued. The amendments will be effective for the Company for annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. The Company does not expect these amendments to have a material effect on its financial statements.

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

Subsequent Events

In accordance with accounting guidance, the Company evaluated events and transactions for potential recognition or disclosure in our financial statements through February 25, 2015, 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, 2014 and 2013, these required reserve balances amounted to $3,760,000 and $685,000, 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, 2014 and December 31, 2013.

	At December 31, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(in thousands)			
Securities available for sale				
U.S. government sponsored enterprises	$ 10,094	$ -	$ (30)	$ 10,064
Mortgage backed securities	14,320	57	-	14,377
Corporate floating rate notes	3,400	24	(10)	3,414
Total securities available for sale	27,814	81	(40)	27,855
Securities held to maturity				
Mortgage backed securities	3,090	-	(66)	3,024
Total securities held to maturity	3,090	-	(66)	3,024
Total securities	$ 30,904	$ 81	$ (106)	$ 30,879

	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

Investment securities having an amortized cost of $6,455,000 and $8,358,000 at December 31, 2014 and 2013, respectively, were made available for customer repurchase agreements. The estimated fair values of these securities were $6,410,000 and $8,033,000 at December 31, 2014 and 2013, 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, 2014 and 2013. 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, 2014					
	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	$ 10,064	$ 30	$ -	$ -	$ 10,064	$ 30
Corporate floating rate notes	-	-	1,690	10	1,690	10
Total securities available for sale	10,064	30	1,690	10	11,754	40
Securities held to maturity						
Mortgage backed securities	-	-	3,024	66	3,024	66
Total securities held to maturity	-	-	3,024	66	3,024	66
Total securities	$ 10,064	$ 30	$ 4,714	$ 76	$ 14,778	$ 106

	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

At December 31, 2014, management anticipates full redemption of its securities with no impairment adjustment required for this portfolio.

The amortized cost and fair value of investment securities at December 31, 2014, 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, 2014	
	Amortized Cost	Fair Value
	(in thousands)	
Securities available for sale		
Due in one year or less	$ -	$ -
Due after one year through five years	10,094	10,064
Due after five years through ten years	17,720	17,791
Due after ten years	-	-
Total securities available for sale	27,814	27,855
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	3,090	3,024
Total securities held to maturity	3,090	3,024
Total securities	$ 30,904	$ 30,879

Gross proceeds from sales of securities available for sale were $15,106,000 for 2014 and $9,988,000 for 2013. Gross realized losses and gains associated with these sales were a $197,000 gain for 2014 and a $12,000 loss for 2013, respectively. Gross proceeds from the call or maturity of investment securities were $7,000,000 for 2014 and $9,000,000 for 2013. There were no gross gains or losses associated with the call or maturities of these securities in 2014 and there was a $4,000 gross gain in 2013. 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,	
	2014	2013
	(in thousands)	
Commercial	$ 40,497	$ 36,953
Real estate-commercial	134,230	129,614
Real estate-construction and land	11,612	9,274
Real estate-residential 1-4	39,518	40,797
Consumer	737	1,704
Total loans	226,594	218,342
Allowance for loan losses	(1,943)	(1,930)
Total loans, net	$ 224,651	$ 216,412

All loan amounts are presented net of unearned fees and costs for December 31, 2014 and December 31, 2013.

Nonperforming assets at the dates indicated were:

	At December 31,	
	2014	2013
	(in thousands)	
Nonperforming loans	$ 188	$ -
Real estate owned	743	743
Total nonperforming assets	$ 931	$ 743

There was one nonperforming loan at December 31, 2014 that was still accruing interest. This loan was secured by a residential 1-4 property.

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

	At December 31,	
	2014	2013
	(in thousands)	
Balance, beginning of year	$ 1,930	$ 2,075
Provision for loan losses	-	-
Loans charged-off		
Commercial	-	-
Real estate-commercial	-	-
Real estate-construction and land	-	-
Real estate-residential 1-4	-	(148)
Consumer	-	-
Total loans charged-off	-	(148)
Loans recovered		
Commercial	-	-
Real estate-commercial	-	-
Real estate-construction and land	13	3
Real estate-residential 1-4	-	-
Consumer	-	-
Total loans recovered	13	3
Net recoveries (charge-offs)	13	(145)
Balance, end of period	$ 1,943	$ 1,930

The following table presents the aging analysis of the Company's loan portfolio at December 31, 2014:

	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	$ -	$ 8	$ -	$ 8	$ 40,489	$ 40,497	$ -
Real estate-commercial	-	-	-	-	134,230	134,230	-
Real estate-construction and land	-	-	-	-	11,612	11,612	-
Real estate-residential 1-4	-	-	188	188	39,330	39,518	188
Consumer	-	-	-	-	737	737	-
Total loans	$ -	$ 8	$ 188	$ 196	$ 226,398	$ 226,594	$ 188

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	$ -

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, 2014:

	Commercial	Real Estate Commercial	Real Estate Construction and Land	Total
Category:		*(in thousands)*		
Not classified	$ 40,169	$ 133,482	$ 11,337	$ 184,988
Substandard	328	748	275	1,351
Doubtful	-	-	-	-
Total	$ 40,497	$ 134,230	$ 11,612	$ 186,339

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 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, 2014:

	Real Estate Residential 1-4	Consumer	Total
		(in thousands)	
Category:			
Performing	$ 39,330	$ 737	$ 40,067
Nonperforming	188	-	188
Total	$ 39,518	$ 737	$ 40,255

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 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, 2014:

	Commercial	Real Estate Commercial	Real Estate Construction and Land	Real Estate Residential 1-4	Consumer	Unallocated	Total
				(in thousands)			
Allowance for loan losses:							
Individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Collectively evaluated for impairment	308	1,021	89	310	6	209	1,943
Total Ending Balance	$ 308	$ 1,021	$ 89	$ 310	$ 6	$ 209	$ 1,943

	Commercial	Real Estate Commercial	Real Estate Construction and Land	Real Estate Residential 1-4	Consumer	Total
				(in thousands)		
Total loans:						
Individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ -
Collectively evaluated for impairment	40,497	134,230	11,612	39,518	737	226,594
Total Ending Balance	$ 40,497	$ 134,230	$ 11,612	$ 39,518	$ 737	$ 226,594

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:							
Individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ -	$ -
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:						
Individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ -
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 table reflects the recorded investment as well as the average daily recorded investment in impaired loans as of December 31, 2014 and interest income recognized on those loans for the year ending December 31, 2014:

	(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	182	179	-	180	6
Real estate - residential 1-4	-	-	-	-	-
Consumer	-	-	-	-	-
Total	$ 182	$ 179	$ -	$ 180	$ 6
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	182	179	-	180	6
Real estate - residential 1-4	-	-	-	-	-
Consumer	-	-	-	-	-
Total	$ 182	$ 179	$ -	$ 180	$ 6

(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, 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.

No loans were restructured during the years ending December 31, 2014 and 2013, and 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, 2014.

NOTE 5 – PREMISES AND EQUIPMENT

Premises and equipment consist of the following:

	At December 31,	
	2014	2013
	(in thousands)	
Land and improvements	$ 3,260	$ 3,260
Buildings and improvements	4,334	4,318
Leasehold improvements	1,806	1,745
Equipment, furniture and fixtures	2,984	2,876
Fixed assets not in service	111	63
	12,495	12,262
Less - accumulated depreciation	(3,410)	(2,937)
Total premises and equipment	$ 9,085	$ 9,325

Depreciation expense for the years ended December 31, 2014 and 2013 was $527,000 and $532,000, respectively. The Company incurred losses on disposal and impairment charges related to equipment of $22,000 in 2014 from the closure of one drive-through facility, and $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 each of the years ended December 31, 2014 and 2013 was $222,000.

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 2014 and 2013 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, 2014 were as follows:

	Amount
	(in thousands)
2015	$ 350
2016	313
2017	113
2018	-
2019	-
Total	$ 776

NOTE 6 – DEPOSITS

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

	At December 31,	
	2014	2013
	(in thousands)	
Money Market and NOW	$ 144,739	$ 143,062
Savings	3,834	4,541
Certificates of deposit $100,000 and over	176	-
Other time deposits	16,571	16,667
Total interest-bearing deposits	$ 165,320	$ 164,270

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

	Amount
	(in thousands)
Past Maturity	$ 19
2015	13,150
2016	687
2017	2,491
2018 and thereafter	400
Total time deposits	$ 16,747

In both years ending December 31, 2014 and 2013, 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 $6,455,000 and $8,358,000 and fair values of $6,410,000 and $8,033,000 were made available to secure customer repurchase agreements at December 31, 2014 and 2013, respectively. Information concerning securities sold to customers under agreements to repurchase is summarized as follows:

	As of and for the years ended December 31,	
	2014	2013
	(in thousands)	
Balance at end of year	$ 351	$ 511
Average balance during the year	$ 1,576	$ 1,673
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	$ 4,545	$ 2,617

The Bank is a member of the FHLB of Atlanta, which had established, at December 31, 2014, a credit availability for the Bank in an amount equal to 25% of the Bank's total assets. At December 31, 2014, the Bank had $33.5 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,	
	2014	2013
	(in thousands)	
Balance at end of year	$ 33,450	$ 4,000
Average balance during the year	$ 17,380	$ 780
Weighted average interest rate during the year	0.26%	0.37%
Interest expense during the year	$ 46	$ 3
Maximum month-end balance during the year	$ 33,450	$ 5,950

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. This other borrowing was fully repaid in May 2014, and had an outstanding balance at December 31, 2013 of $135,000.

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,	
	2014	2013
	(in thousands except share and per share data)	
Net income available to common stockholders (numerator, basic and diluted)	$ 2,794	$ 2,416
Weighted average common shares outstanding (denominator)	2,281,187	2,275,779
Earnings per common share - basic	$ 1.23	$ 1.06
Effect of dilutive securities:		
Weighted average common shares outstanding during the period	2,281,187	2,275,779
Effect of dilutive equity awards	60,674	57,639
Weighted diluted average common shares outstanding (denominator) during the period	2,341,861	2,333,418
Earnings per common share - assuming dilution	$ 1.19	$ 1.04

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. In addition the average outstanding balance of non-vested unissued stock awards are added to 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 were not included in computing diluted earnings per share for either year ended December 31, 2014 or December 31, 2013, 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 201,600 options were outstanding under the 2006 Incentive Plan at December 31, 2014. 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 2014 or 2013.

The following table presents a summary of stock option activity during 2014 and 2013:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Term (years)	Aggregate Intrinsic Value *(in thousands)*
Outstanding at January 1, 2014	232,000	$ 12.68		
Granted	-	-		
Exercised	30,400	11.04		
Forfeited/expired	-	-		
Outstanding at December 31, 2014	201,600	$ 12.92	2.0	$ 559
Exercisable at December 31, 2014	201,600	$ 12.92	2.0	$ 559

	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

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 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, 2014. 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 30,400 options exercised during the year ended December 31, 2014 and no options exercised during the year ended December 31, 2013. The aggregate intrinsic value of options exercised during the year ended December 31, 2014 was $129,000. Cash received from exercises of options during the year of 2014 was $336,000. Because all options were fully vested as of December 31, 2013, there was no total fair value of shares underlying options that vested during the year ending December 31, 2014. The total fair value of shares underlying options that vested during the year ending December 31, 2013 was $4,000.

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, 2014.

	Shares	Fair Value at Grant Date	Weighted Average Remaining Term (years)	Aggregate Intrinsic Value *(in thousands)*
Outstanding at January 1, 2014	34,880	$ 11.28		
Granted	-	-		
Vested and issued	11,720	11.28		
Forfeited/expired	-	-		
Outstanding at December 31, 2014	23,160	$ 11.28	2.1	$ 86

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 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, 2014. 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, 2014 and December 31, 2013 was $30,000 and $4,300, respectively. The total fair value of shares that vested during the year ending December 31, 2014 and December 31, 2013 was $132,000 and $98,000, respectively.

The amount charged against income, before income tax benefit of $41,000, in relation to stock based payment arrangements was $122,000 for the year ended December 31, 2014. 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. At December 31, 2014, unrecognized compensation expense, net of estimated forfeitures, related to unvested stock option and restricted stock grants was $181,000 and is currently expected to be recognized over a weighted average period of 1.1 years as follows:

	Stock-Based Compensation Expense
	(in thousands)
2015	$ 87
2016	87
2017	7
2018	-
Total	$ 181

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, 2014 and 2013, other liabilities included $1,175,000 and $1,144,000, respectively, related to these plans. Compensation expense related to these plans was $33,000 and $43,000 for the years ended December 31, 2014 and 2013, 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.

At December 31, 2014 all distributions of remaining account balances to participants and beneficiaries had been completed. The Company recognized no compensation expense related to the ESOP for the years ended December 31, 2014 or 2013. Dividends received by the ESOP were used for administrative expenses of the plan. There were no contributions to the ESOP for the years ended December 31, 2014 or 2013. During the year ending December 31, 2014, the ESOP sold its 20 remaining shares on the open market to pay administrative expenses, and the Company repurchased 6 shares of common stock that had been disbursed from the ESOP during the year 2013. During the year ending December 31, 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 contained both current and terminated employees, and 2,110 shares were repurchased by the Company. At December 31, 2014 the ESOP owned no shares of common stock of the Company and at December 31, 2013, the ESOP owned 20 shares of common stock of the Company. At December 31, 2013, the fair market value of the shares held by the ESOP totaled $259.

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 $79,000 and $88,000 for 401(k) Plan matching contributions during the years ended December 31, 2014 and December 31, 2013, 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, 2014 and 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. Also, during 2013, the company sold a bank branch site that would not be utilized. 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,	
	2014	2013
	(in thousands)	
Noninterest income:		
ATM transaction fees	$ 95	$ 131
Other	145	151
Total noninterest income	$ 240	$ 282

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

	Years Ended December 31,	
	2014	2013
	(in thousands)	
Noninterest expense:		
Marketing	$ 136	$ 74
Telephone	117	123
ATM expense	66	98
Other miscellaneous	524	557
Total noninterest income	$ 843	$ 852

NOTE 12 – INCOME TAXES

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

	Years Ended December 31,	
	2014	2013
	(in thousands)	
Federal income tax expense - current	$ 923	$ 905
Deferred federal income tax liability	(45)	65
Income tax expense	$ 878	$ 970

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,	
	2014	2013
	(in thousands)	
Federal income tax expense (at 34% statutory rate)	$ 1,275	$ 1,187
Effect of tax-exempt interest	(136)	(141)
Effect of life insurance proceeds, premiums, and increases in value, net	(291)	(63)
Effect of equity based compensation	-	1
Other	30	(14)
Income tax expense	$ 878	$ 970

A cumulative net deferred tax asset is included in other assets at December 31, 2014 and 2013. The components of the asset are as follows:

	As of December 31,	
	2014	2013
	(in thousands)	
Deferred Tax Assets:		
Deferred compensation	$ 333	$ 339
Allowance for loan losses	585	585
Non-qualifying options	147	184
Total Deferred Tax Assets	1,065	1,108
Deferred Tax Liabilities:		
Deferred loan costs, net	272	271
Net appreciation(depreciation) on available for sale securities	14	(38)
Depreciation on premises and equipment	193	246
Total Deferred Tax Liabilities	479	479
Net Deferred Tax Assets	$ 586	$ 629

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 2011 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:

	2014	2013
	(in thousands)	
Balance, January 1	$ 14,349	$ 12,548
Originations	631	3,525
Repayments	(1,649)	(1,724)
Adjustments [(1)]	(1,658)	-
Balance, December 31	$ 11,673	$ 14,349

(1) Adjustments are the result of the resignation of one director and the death of another. The loan amounts attributable to these two former directors should be deducted from the total amount outstanding at the beginning of the year.

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 $2,358,000 and $3,323,000 at December 31, 2014 and 2013, 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, 2014 and 2013 are set forth in the following table:

	At December 31,	
	2014	2013
	(in thousands)	
Commitments to extend credit	$ 41,593	$ 42,403
Standby letters of credit	872	304
Total Commitments	$ 42,465	$ 42,707

As of December 31, 2014, the Company had $49.1 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, 2014, 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, 2014, the Company's total risk based capital, Tier 1 risk based capital, and Tier 1 capital (leverage) ratios were 16.21%, 15.47% and 11.81%, 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, 2014 and 2013 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, 2014						
Total Capital (to Risk-Weighted Assets)						
Consolidated Company	$ 42,673	16.21 %	$ 21,063	8.00 %	N/A	N/A
Bank	$ 36,950	14.08 %	$ 20,995	8.00 %	$ 26,244	10.00 %
Tier 1 Capital (to Risk-Weighted Assets)						
Consolidated Company	$ 40,729	15.47 %	$ 10,531	4.00 %	N/A	N/A
Bank	$ 35,007	13.34 %	$ 10,498	4.00 %	$ 15,746	6.00 %
Tier 1 Capital (to Average Assets)						
Consolidated Company	$ 40,729	11.81 %	$ 13,790	4.00 %	N/A	N/A
Bank	$ 35,007	10.31 %	$ 13,580	4.00 %	$ 16,975	5.00 %
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 %

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 include 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 2014 and 2013.

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 greater than one year 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, 2014 and 2013 are presented in the following table.

	At December 31, 2014				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
			(in thousands)		
Financial Assets:					
Loans held for investment	$ 224,651	$ 225,534	$ -	$ -	$ 225,534
Financial liabilities:					
Deposits	$ 266,896	$ 266,869	$ -	$ 266,869	$ -

	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

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, 2014			
	Total	Level 1	Level 2	Level 3
	(in thousands)			
Investment in securities available for sale:				
U.S. government sponsored enterprises	$ 10,064	$ -	$ 10,064	$ -
Mortgage backed securities	14,377	-	14,377	-
Corporate floating rate notes	3,414	-	3,414	-
Other financial assets	428	-	428	-
Total assets at fair value	$ 28,283	$ -	$ 28,283	$ -

	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	$ -

Assets Recorded at Fair Value on a Non-Recurring Basis

	At December 31, 2014			
	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, 2013			
	Total	Level 1	Level 2	Level 3
	(in thousands)			
Other real estate owned	$ 743	$ -	$ 743	$ -
Total assets at fair value	$ 743	$ -	$ 743	$ -

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 fixed at 1% through December 31, 2015. Thereafter, the dividend rate will be 9%.

During the year ended December 31, 2014, the Company declared $78,000 in SBLF Preferred Stock dividends, a dividend rate of 1.00%. The Company expects to pay corresponding dividends of $19,500 on or about April 1, 2015, $19,500 on or about July 1, 2015, and $19,500 on or about October 1, 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,	
	2014	**2013**
	(in thousands)	
Condensed Balance Sheets		
Assets		
Cash and interest-bearing deposits in other banks	$ 2,155	$ 4,204
Certificates of deposit in other banks	3,530	-
Investment in subsidiary bank	35,034	34,617
Other assets	58	91
Total Assets	$ 40,777	$ 38,912
Liabilities and Stockholders' Equity		
Other liabilities	$ 20	$ 27
Total liabilities	20	27
Preferred stock	7,800	7,800
Common stock	11,438	11,373
Additional paid-in capital	7,005	6,792
Retained earnings	14,487	12,995
Accumulated other comprehensive income(loss)	27	(75)
Stockholders' equity	40,757	38,885
Total Liabilities and Stockholders' Equity	$ 40,777	$ 38,912

	Years ended December 31,	
	2014	**2013**
	(in thousands)	
Condensed Statements of Income		
Dividends from subsidiary bank	$ 2,718	$ 2,428
Equity in undistributed net income of subsidiaries	193	187
Interest income	57	4
Other expenses	(114)	(145)
Income before income taxes	2,854	2,474
Income tax benefit	18	47
Net Income	2,872	2,521
Preferred stock dividends	(78)	(105)
Net income available to common stockholders	$ 2,794	$ 2,416

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,	
	2014	2013
	(in thousands)	
Condensed Statement of Cash Flows		
Cash flows from operating activities		
Net income	$ 2,872	$ 2,521
Add (deduct) items not affecting cash during the year		
Stock-based compensation	122	102
Undistributed net income of subsidiaries	(193)	(187)
Tax benefit from stock based compensation plan issuances	54	2
Changes in assets/liabilities, net		
Decrease(increase) in other assets	(89)	94
Decrease in other liabilities	(7)	(31)
Net cash provided by operating activities	2,759	2,501
Cash flows from investing activities		
Net increase in certificates of deposit at other banks	(3,530)	-
Net cash used for investing activities	(3,530)	-
Cash flows from financing activities		
Proceeds from exercise of stock options	336	-
Retirement of common stock	(441)	(126)
Cash dividends paid	(1,173)	(105)
Net cash used for financing activities	(1,278)	(231)
Increase(decrease) in cash and cash equivalents	(2,049)	2,270
Cash and cash equivalents at beginning of year	4,204	1,934
Cash and cash equivalents at end of year	$ 2,155	$ 4,204
Non-cash financing activities		
Perpetual preferred stock dividends accrued but not paid	$ 20	$ 20

STOCKHOLDER INFORMATION

CORPORATE HEADQUARTERS

Heritage Bankshares, Inc.

150 Granby Street

Norfolk, VA 23510

757-648-1700

STOCK TRADING

Heritage Bankshares, Inc. common stock is currently quoted on the OTCBB and OTCQX 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

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