

Federal Deposit Insurance Corporation  
Washington, D.C. 20439

## FORM 10

**GENERAL FORM FOR REGISTRATION OF SECURITIES**  
Pursuant to Section 12(b) or 12(g) of the Securities Exchange Act of 1934

# Highlands State Bank

(Exact name of registrant as specified in its charter)

New Jersey  
(State or other jurisdiction incorporation or organization)

202017322  
(I.R.S. Employer Identification No.)

310 Route 94  
Vernon, New Jersey 07462  
Address of principal executive office)(zip code)

(973) 764-3200  
(Registrant's telephone number, including area code)

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With Copies to:

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Securities to be registered pursuant to Section 12(b) of the Act: NONE

Securities to be registered pursuant to Section 12(g) of the Act: common stock, par value \$5.00 per share

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if smaller reporting company)

Smaller reporting company

## **Item 1. Business.**

Highlands State Bank (the "Bank") is a New Jersey state chartered commercial bank that commenced operations on October 31, 2005. The Bank's principal office is located at 310 Route 94 in Vernon, NJ 07462. We also operate two additional branch offices at 351 Sparta Ave, Sparta, NJ 07871, New Jersey and at 351 Union Boulevard Totowa, NJ 07512. Our Sparta office was acquired as part of our merger with Noble Community Bank consummated at the end of 2008. See "Acquisition of Nobel Community Bank." Our Totowa office opened in the first quarter of 2009, and was designed to capitalize on the Passaic County contacts of our President and Chief Executive Officer, George E. Irwin. Mr. Irwin served as the President and Chief Executive Officer of Greater Community Bank of Totowa, New Jersey for over 16 years.

The Bank engages in the general business of commercial banking. The Bank offers traditional commercial banking services such as savings and checking accounts and provides commercial, consumer and mortgage loans. Bank deposits are insured by the Federal Deposit Insurance Corporation ("FDIC") up to applicable limits. The Bank provides a wide range of commercial banking products and services, including personal and business checking accounts and time deposits, money market accounts and regular savings accounts. The Bank does not presently have any trust powers and, therefore, does not offer any trust services.

The Bank structures its specific services and fees in a manner designed to attract the business of small and medium-sized businesses and the professional community, as well as that of individuals, in the Sussex County and Passaic County, New Jersey area. The Bank engages in a wide range of lending activities and offers commercial, consumer, mortgage, construction and personal loans. All lending decisions are made primarily on the basis of soundness and in compliance with all applicable laws. The Bank from time to time participates in multi-bank credit arrangements in order to take part in loans for amounts that are in excess of the Bank's legal lending limit. In commercial lending, the Bank offers loans for equipment and working capital needs, as well as for financing of commercial real estate. In consumer lending, the Bank offers personal, automobile, bridge, home equity and home improvement loans. The Bank also makes one-to-four-family residential real estate loans.

The Bank believes it offers competitive rates for its services, thereby enabling consumers and business entities in its service area to avail themselves of the Bank's credit and non-credit services.

Unless otherwise indicated, the terms "us", "we", "our", and the "Bank" refer to Highlands State Bank.

### **Acquisition of Noble Community Bank**

Effective as of the close of business on December 31, 2008, the Bank completed its previously announced merger (the "Merger") with Noble Community Bank ("Noble"), a New Jersey chartered commercial bank headquartered in Sparta, New Jersey, pursuant to the terms of the Bank Merger Agreement dated as of August 5, 2008 (the "Merger Agreement"). At the time of the merger, Noble had approximately \$46.0 million in total assets, \$31.5 million in loans and \$36.9 million in deposits. Noble's former branch, located in Sparta, Sussex County, New Jersey, is now a branch of the Bank.

As a result of the Merger, each outstanding share of Noble common stock was converted to .7953 shares of the Bank's common stock. An aggregate of 693,103 shares of the Bank's common stock (the "Merger Shares") were issued in the merger transaction.

The Bank's Board of Directors was restructured so that the Bank's Board now consists of sixteen members, ten (10) of whom were previously Directors of the Bank and six (6) of whom were previously Directors of Noble.

### **Participation in the Capital Purchase Program**

During the third quarter of 2008, Congress adopted the Emergency Economic Stabilization Act (the "EESA") to address the dysfunctional credit markets. Among the programs implemented under the EESA is the Capital Purchase Program ("the "CPP"), under which the United States Treasury (the "UST") can invest in the preferred stocks of selected insured depository institutions or their holding companies. This program was designed to strengthen the balance sheet of healthy financial institutions, including regional and community banks. The Bank was approved to

participate in the CPP, and on May 8, 2009, the Bank raised \$3.1 in capital through the sale of 3,091 shares of Series A Preferred Stock and 155 shares of Series B Preferred Stock to the UST. The terms of the series A Preferred Stock and the Series B Preferred Stock are almost identical, except with regard to the dividend rate. The Series A Preferred Stock bears a dividend rate of five (5%) percent for the first five (5) years it is outstanding, and the dividend rate increases to nine (9%) percent thereafter if it is not redeemed by the Bank. The Series B Preferred Stock bears a dividend rate of nine (9%) percent from the date of issuance. Participation in the CPP subjects the Bank to various dividend, stock repurchase and executive compensation limitations and imposes additional reporting and corporate governance obligations on the Bank.

The Bank entered into a side letter agreement with Treasury, dated May 8, 2009, which, among other things, clarified that to the extent the terms of any of the Purchase Agreement, the Warrant or the terms of the Series A Preferred Stock or the Series B Preferred Stock are inconsistent with the American Recovery and Reinvestment Act of 2009 (the "ARRA"), as it may be amended from time to time, or any rule or regulation promulgated thereunder, the ARRA and such rules and regulations shall control.

The Company may redeem the Series A Preferred Stock, in whole or in part, at its liquidation preference plus accrued and unpaid dividends at any time as permitted by the ARRA and the rules and regulations promulgated thereunder. The Series B Preferred Stock may not be redeemed until all of the Series A Preferred Stock has been redeemed.

### **Business Strategy**

The Bank was founded by a group of local business persons and professionals on the premise that an essential component of a vibrant local economy is a strong community bank that focuses on serving the financial needs of the individuals, professionals and small to medium size businesses in the communities it serves. As big banks became more and more depersonalized, cut back on services offered to customers, and increased fees in the local markets they had penetrated, the group believed an opportunity arose to offer high quality banking and other financial services with personalized attention. The group was convinced that the communities were under served by these larger institutions, and would therefore welcome an institution that would provide timely and personalized services coupled with timely and direct access to decision makers.

The deposit services offered by the Bank include checking accounts, savings accounts and certificates of deposit for both personal and business use. As of December 31, 2008, the Bank had total deposits of \$96.8 million. The Bank offers commercial, consumer and mortgage related products with particular emphasis on loans that are tailored to meet the needs of small to medium size businesses, professionals and individuals. These products include commercial and residential mortgage, term and working capital loans and home equity credit lines. As of December 31, 2008, the Bank had total loans of \$90.6 million.

The Bank believes that the current trend of consolidation among larger financial institutions results in personnel who are not intimately familiar with the needs of individuals and business in our service areas, a curtailment of services, and increased fees. Highlands State Banks' business strategy is to continue to pursue additional business from those customers who, as a result of these trends, are underserved or undervalued by larger financial institutions. Even in these difficult times, the Bank believes its marketplace remains one of the most desirable banking markets in the entire country. The Bank further believes that by pursuing these undervalued customers, and coupled with the application of sound business principals, it is building a strong customer foundation. Further, by providing a level of service that is customer oriented, including access to the Bank's decision makers, and by expanding our brand into local communities located in the densely populated and affluent northern New Jersey marketplace, the Bank believes it can create value for its shareholders.

### **Lending Activities.**

The Bank engages in a variety of lending activities including commercial, construction, residential real estate and consumer/installment transactions. Lending activities are focused on individuals, professionals and small- to medium-sized businesses by attracting customers with personal service and attractive pricing. The Bank has not engaged in subprime lending.

In managing the growth of the loan portfolio, the Bank has focused on: (1) the application of prudent underwriting criteria; (2) active involvement by senior management and the board of directors in the loan approval process; (3) active monitoring of loans to ensure that repayments are made in a timely manner and to identify potential problem loans; and (4) review of select aspects of the Bank's loan portfolio by independent consultants.

*Commercial and Commercial Real Estate Loans.* The commercial loan portfolio consists primarily of commercial loans to small and medium sized businesses and individuals for general business and real estate uses. Commercial and commercial real estate loans are generally secured by real estate and/or by the guarantees of the principals of the borrowers. Commercial loans that exceed the Bank's legal limits are participated with other commercial banks. At December 31, 2008, the Bank had \$51.0 million in commercial and industrial loans outstanding, representing 56.3% of the total loan portfolio.

Commercial loans are made on a line of credit and fixed basis to finance inventory, equipment or short-term working capital. These loans are generally made on a secured basis with the personal guarantees of the principal owners with occasional policy exceptions. Fixed loans are generally made on a one to five year duration.

Commercial real estate loans are made for the acquisition of new property or the refinancing of existing property. These loans are typically related to commercial businesses and secured by the underlying real estate used in the business or real property of the principals. The Bank makes construction loans on a short-term basis for both residential and non-residential properties. These loans are usually for a term of 12 to 18 months and secured by the underlying land and property as well as other assets of the borrower.

*Real Estate Construction Loans.* Construction loans are generally made to builders, developers and consumers who wish to build their own homes or commercial structures. These loans are secured by the real estate being developed and are generally personally guaranteed by the principals of the borrowers. The duration of construction loans generally is limited to 12 to 18 months, although payments may be structured on a longer amortization basis. Construction loans generally carry a higher degree of risk than long-term financing of existing properties because repayment depends on the ultimate completion of the project and, on some occasions, the sale of the property. As of December 31, 2008, the Bank had \$4.7 million of real estate construction loans outstanding, representing 5.2% of the total loan portfolio.

*Home Equity Loans and Second Mortgages.* The Bank offers both home equity lines of credit and home equity loans. Risks associated with loans secured by residential properties are generally lower than commercial real estate and construction loans and include general economic risks, such as the strength of the job market, employment stability and the strength of the housing market. Since most loans are secured by a primary or secondary residence, the borrower's continued employment is the greatest risk to repayment. As of December 31, 2008, the Bank had \$29.2 million in home equity and second mortgage loans outstanding, representing 32.2% of the total loan portfolio.

*Consumer Loans.* The Bank offers a variety of loans to individuals for personal and household purposes. Consumer loans are generally considered to have greater risk than first or second mortgages on real estate because they may be unsecured, or, if they are secured, the value of the collateral may be difficult to assess and more likely to decrease in value than real estate. At December 31, 2008, the Bank had \$199 thousand in consumer loans outstanding.

## **Competition**

The Bank operates in a highly competitive environment competing for deposits and loans with commercial banks, thrifts, credit unions and other financial institutions, many of which have greater financial resources. In addition, in November 1999, the Gramm-Leach-Bliley Financial Modernization Act of 1999 was passed into law. The Act permits insurance companies and securities firms, among others, to acquire financial institutions and has increased competition within the financial services industry. Certain of the Bank's competitors have significantly higher lending limits and provide services to their customers that the Bank does not offer.

The Bank believes that it is able to compete favorably with its competitors because it provides responsive personalized services through management's knowledge and awareness of its service area, customers and businesses.

## **Service Area**

Primary market areas consist of Sussex County and Passaic County, each in New Jersey, although the extensive banking and business experience of the Bank's management attracts customers in the neighboring counties and throughout New Jersey.

## **Bank Regulation**

Banks are extensively regulated under both federal and state law. These laws and regulations are intended to protect depositors, not shareholders. To the extent that the following information describes statutory and regulatory provisions, it is qualified in its entirety by reference to the particular statutory and regulatory provisions. Any change in the applicable law or regulation may have a material effect on the business and prospects of the Bank.

As a commercial bank organized under the banking laws of the State of New Jersey, the Bank is subject to the regulation, supervision, and control of the New Jersey Department of Banking and Insurance. As an FDIC-insured institution, the Bank is subject to regulation, supervision and control of the FDIC, an agency of the federal government. The regulations of the FDIC and the New Jersey Department of Banking and Insurance impact virtually all of the Bank's activities, including the minimum level of capital it must maintain, the ability to pay dividends and to expand through new branches or acquisitions, and various other matters. The following are highlights of certain of these regulations.

*Insured Deposits.* During the third quarter of 2008, Congress adopted the EESA. Among other things, the EESA authorized a temporary increase in the FDIC insurance limit to \$250 thousand from \$100 thousand per account. In addition, the FDIC implemented a program to insure all deposits held in noninterest-bearing transactional accounts, regardless of amount, at institutions which do not opt out of the program and which pay an additional assessment to the FDIC. The Bank elected not to opt out of this program, and is subject to the required additional assessment. On May 20, 2009 the Helping Families Save Their Homes Acts was passed which extended the temporary increase in the standard maximum deposit insurance amount (SMDIA) of \$250 thousand per depositor through December 31, 2013.

Prior to the fall of 2008, the Bank's deposits were insured up to a maximum of \$100 thousand per depositor (\$250 thousand per IRA account) under the Deposit Insurance Fund of the FDIC. Pursuant to the Federal Deposit Insurance Corporation Improvements Act of 1991 ("FDICIA"), the FDIC has established a risk-based assessment system. Premium assessments under this system are based upon: (i) the probability that the insurance fund will incur a loss with respect to the institution; (ii) the likely amount of the loss; and (iii) the revenue needs of the insurance fund. To effectuate this system, the FDIC has developed a matrix that sets the assessment premium for a particular institution in accordance with its capital level and overall rating by the primary regulator.

The FDIC has significantly increased deposit insurance assessment rates, commencing in the second quarter of 2009. As increased, the adjusted base assessment rates will range from 12 to 77.5 basis points of deposits, a significant increase over premium rates for the past several years. In addition, the Bank will pay a special assessment of 10 basis points of the amount of deposits in excess of \$250,000 held in non-interest bearing transactional accounts under the enhanced insurance program discussed above. Finally, the FDIC has adopted a special assessment on all insured depository institutions equal to five basis points on each institution's assets, minus its Tier 1 capital, as of June 30, 2009. The special assessment will be collected September 30, 2009. Had this assessment been levied against the Bank's assets at March 31, 2009, the Bank would have paid \$57 thousand. The FDIC has also reserved the right to impose one or more additional special assessments if needed to recapitalize the Deposit Insurance Fund.

*Capital Adequacy Guidelines.* The FDIC has promulgated risk-based capital guidelines that are designed to make regulatory capital requirements more sensitive to differences in risk profile among banks, to account for off-balance sheet exposure, and to minimize disincentives for holding liquid assets. Under these guidelines, assets and off-balance sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and off-balance sheet items.

Bank assets are given risk weights of 0%, 20%, 50% and 100%. In addition, certain off-balance sheet items are given similar credit conversion factors to convert them to asset equivalent amounts to which an appropriate risk-weight will apply. Those computations will result in the total risk-weighted assets. Most loans are assigned to the 100% risk category, except for those performing first mortgage loans fully secured by residential property, which carry a 50% risk weighting. Most investment securities (including general obligation claims of states or other political subdivisions of the United States) are assigned to the 20% category, except for municipal or state revenue bonds, which have a 50% risk-weighting, and direct obligations of the U.S. Treasury or obligations backed by the full faith and credit of the U.S. government, which have a 0% risk-weight. In converting off-balance sheet items, direct credit substitutes, including general guarantees and standby letters of credit backing financial obligations, are given a 100% risk weighting. Transaction-related contingencies such as bid bonds, standby letters of credit backing non-financial obligations and undrawn commitments (including credit lines with an initial maturity of more than one year), have a 50% risk weighting.

Short-term commercial letters of credit have a 20% risk weighting, and certain short-term unconditionally cancelable commitments have a 0% risk weighting.

In addition to the risk-based capital guidelines, the FDIC has adopted a minimum Tier 1 capital (leverage) ratio. The minimum required ratio of total capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit) is 8%. At least half of the Bank's total capital is required to be "Tier 1 Capital," consisting of common stockholders' equity less certain goodwill items and other intangible assets. The remainder ("Tier 2 Capital") may consist of (a) the allowance for loan losses of up to 1.25% of risk-weighted assets, (b) excess of qualifying preferred stock, (c) hybrid capital instruments, (d) perpetual debt, (e) mandatory convertible securities, and (f) qualifying subordinated debt and intermediate-term preferred stock up to 50% of Tier 1 Capital. Total capital is the sum of Tier 1 Capital and Tier 2 Capital less reciprocal holdings of other banking organizations' capital instruments, investments in unconsolidated subsidiaries and any other deductions as determined by the FDIC.

*Dividends.* The Bank may pay dividends as declared from time to time by the Board of Directors out of funds legally available, subject to certain restrictions. Under the New Jersey Banking Act of 1948, the Bank may not pay a cash dividend unless, following the payment, the Bank's capital stock will be unimpaired and the Bank will have a surplus of no less than 50% of the Bank capital stock or, if not, the payment of the dividend will reduce the surplus. In addition, the Bank cannot pay dividends in such amounts as would reduce the Bank's capital below regulatory imposed minimums. In addition, under the terms of the CPP, because we have not historically paid cash dividends, we are not permitted to pay cash dividends until we redeem the preferred stock issued to the Treasury under the CPP.

*Community Reinvestment Act.* The Community Reinvestment Act of 1977, as amended (the "CRA"), requires that banks meet the credit needs of all of their assessment area (as established for these purposes in accordance with applicable regulations based principally on the location of branch offices), including those of low income areas and borrowers. The CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with the CRA. The CRA requires the FDIC to assess an institution's record of meeting the credit needs of its community and to take such record into account in the evaluation of certain applications by such institution. The CRA requires public disclosure of an institution's CRA rating and requires that a written evaluation of an institution's performance utilizing a four-tiered descriptive rating system be undertaken. An institution's CRA rating is considered in determining whether to grant charters, branches and other deposit facilities, relocations, mergers, consolidations and acquisitions. Performance less than satisfactory may be the basis for denying an application. The Bank is rated "Satisfactory" in CRA.

*USA PATRIOT Act.* Under the United and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001, financial institutions are subject to prohibitions against specified financial transactions and account relationships as well as enhanced due diligence and "know your customer" standards in their dealings with foreign financial institutions and foreign customers. The USA PATRIOT Act requires financial institutions to establish anti-money laundering programs meeting the minimum standards specified by the Act and implementing regulations. While the Bank does not expect to have any significant international banking relationships, and does not anticipate that the USA PATRIOT Act will have a material effect

on its business or operations, the effect of the compliance burden imposed by the Act on the Bank cannot be predicted with certainty.

*Emergency Economic Stabilization Act.* On October 8, 2008, the Emergency Economic Stabilization Act (the “EESA”) was signed into law. On October 14, 2008, the United States Treasury (the “UST”) announced its Troubled Assets Relief Program (“TARP”) Capital Purchase Program (“CPP”). Under the CPP, the UST will purchase shares of senior preferred stock in insured depository institutions or their holding companies, bearing a dividend rate of 5%. In addition, participating institutions must issue to the UST either common stock purchase warrants, permitting the UST to purchase common stock with a value equal to 15% of the UST’s preferred stock investment or, for institutions that are not deemed to be “publicly traded”, warrants to purchase additional shares of preferred stock with a value equal to 5% of the UST’s investment. These additional shares of preferred stock have a dividend rate of 9%. The EESA, the American Recovery and Reinvestment Act, adopted in February, 2009, and which amended the EESA, and UST regulations promulgated thereunder impose significant dividend, stock repurchase and executive compensation restrictions on the Bank and impose enhanced reporting and corporate governance requirements on the Bank.

*American Recovery and Reinvestment Act.* On February 16, 2009, the ARRA was adopted. Among other things, the ARRA amended various provisions of the EESA to, among other things, substantially restrict executive compensation for those entities that participate in the CPP, including those institutions that participated prior to the adoption of the ARRA, impose more stringent reporting requirements on such institutions and require such institutions to permit their shareholders to have a non-binding, advisory vote on executive compensation.

*Federal Securities Regulation.* Upon effectiveness of this Registration Statement, the Bank will become a reporting company with the FDIC under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and will therefore be required to file current, quarterly and annual reports, as well as proxy statements and certain other materials, with the FDIC. Compliance with these requirements will increase our non-interest expenses in future periods.

On July 30, 2002, the Sarbanes-Oxley Act, or “SOX” was enacted. SOX is not a banking law, but applies to all companies that are subject to the Exchange Act. The stated goals of SOX are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws. SOX is the most far reaching U.S. securities legislation enacted in some time.

SOX includes very specific additional disclosure requirements and new corporate governance rules and requires the Securities Exchange Commission (“SEC”) and securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules, which will be incorporated into the FDIC’s regulations under the Exchange Act, and mandates further studies of specific issues by the SEC. SOX represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees. SOX addresses, among other matters:

- audit committees;
- certification of financial statements by the chief executive officer and the chief financial officer;
- management’s assessment of a company’s internal controls over financial reporting, and a company’s auditor’s certification of such assessment;
- the forfeiture of bonuses or other incentive-based compensation and profits from the sale of an issuer’s securities by directors and senior officers in the twelve month period following initial publication of any financial statements that later require restatement;
- a prohibition on insider trading during pension plan black out periods;
- disclosure of off-balance sheet transactions;
- a prohibition on personal loans to officers and directors, unless subject to Federal Reserve Regulation O;
- expedited filing requirements for Form 4 statements of changes of beneficial ownership of securities required to be filed by officers, directors and 10% shareholders;
- disclosure of whether or not a company has adopted a code of ethics;

- “real time” filing of periodic reports;
- auditor independence; and
- various increased criminal penalties for violations of securities laws.

Complying with the requirements of SOX will increase our compliance costs and could make it more difficult to attract and retain board members.

*Anti-Terrorism Legislation* - On October 26, 2001, a new anti-terrorism bill, the International Money Laundering Abatement and Anti-Terrorism Funding Act of 2001, was signed into law. This law restricts money laundering by terrorists in the United States and abroad. This act specifies new "know your customer" requirements that will obligate financial institutions to take actions to verify the identity of the account holders in connection with opening an account at any U.S. financial institution. Banking regulators will consider compliance with the act's money laundering provisions in making decisions regarding approval of acquisitions and mergers. In addition, sanctions for violations of the act can be imposed in an amount equal to twice the sum involved in the violating transaction, up to \$1 million.

## **Employees**

At December 31, 2008, we employed 33 full-time equivalent employees. None of these employees are covered by a collective bargaining agreement and we believe that our employee relations are good.

## **Item 1A. Risk Factors.**

### ***Risks affecting Our Business:***

#### **The Bank's successful integration of the operations of Noble Community Bank will impact our future results of operations.**

Effective December 31, 2008, the Bank consummated its acquisition of Noble Community Bank. At year-end, Noble contributed \$46.0 million or 38.4% of total assets, \$31.5 million or 35.2% of net loans and \$36.9 million or 38.1% of deposits. The Bank's future results of operations depend in part on its ability to fully integrate the operations of Noble to produce a single and efficient operation. If the Bank is unable to realize synergies and cost savings from the combined operations and/or enhance revenue from cross selling operations while maintaining both customer bases, results of operations may be negatively affected.

#### **The nationwide recession may adversely affect the Bank's business by reducing real estate values in its trade area and stressing the ability of customers to repay their loans.**

The New Jersey trade area, like the rest of the United States, is currently experiencing economic contraction. As a result, many companies have experienced reduced revenues and have laid off employees. These factors have stressed the ability of both commercial and consumer customers to repay their loans, and have, and may in the future, result in higher levels of nonaccrual loans. In addition, real estate values have declined in the trade area. Since the majority of the Bank's loans are secured by real estate, declines in the market value of real estate impact the value of the collateral securing its loans, and could lead to greater losses in the event of defaults on loans secured by real estate.

#### **The Bank's FDIC deposit insurance premiums have increased and may continue to increase, substantially increasing our noninterest expense.**

During 2008 and 2009, the FDIC has significantly increased its assessments for deposit insurance due to the weakness in the economy and the increased number of bank failures. In 2007, we paid \$18 thousand in deposit insurance assessments, and in 2008 this increased to \$31 thousand. The FDIC has already announced an increased assessment, which went into effect for the second quarter of 2009, and which will raise insurance premiums for the healthiest banks by 7 basis points. Banks like Highlands State Bank that have opted to remain eligible for the FDIC's increased insurance program for noninterest bearing deposits must also pay an assessment of 10 basis points of the amount of noninterest bearing deposits in excess of \$250,000. Finally, the FDIC has adopted a special

assessment on all insured depository institutions equal to 5 basis points on each institution's assets, minus its Tier 1 capital, as of June 30, 2009. The special assessment will be collected September 30, 2009. The FDIC has also retained the right to impose additional special assessments, if needed to recapitalize the Deposit Insurance Fund. Had this assessment been levied against the Bank's assets at March 31, 2009, the Bank would have paid \$57 thousand.

**Compliance with the requirements of the Securities Exchange Act of 1934 and the Sarbanes-Oxley Act of 2002 will increase our compliance costs.**

Upon the effectiveness of this registration statement, the Bank will become subject to the periodic reporting and disclosure requirements of the Exchange Act and FDIC regulations thereunder. In addition, the Bank will become subject to the corporate governance and procedural requirements of SOX. Complying with these requirements will increase our costs, through, among other things, requiring substantial management time and focus and increasing our professional fees, such as auditing and legal fees.

**A flattening of the yield curve may reduce our net-interest margin and net-interest spread, which could negatively impact our results of operations.**

The yield curve is currently positively sloped. If the yield curve flattens, i.e., short term rates rise relative to longer-term rates, our net interest margin and net-interest spread may contract, since most of our funding (our deposits) are short-term, while our assets (our loans) are longer-term obligations. A contraction of our net interest margin and net interest spread will reduce net interest income and negatively impact our results of operations.

**The potential impact of changes in monetary policy and interest rates may negatively affect the Bank's operations.**

Operating results may be significantly affected (favorably or unfavorably) by market rates of interest that, in turn, are affected by prevailing economic conditions, by the fiscal and monetary policies of the United States government and by the policies of various regulatory agencies. The Bank's earnings will depend primarily upon its interest rate spread (i.e., the difference between income earned on loans and investments and the interest paid on deposits and borrowings). Like most financial institutions, the Bank may be subject to the risk of fluctuations in interest rates, which, if significant, may have a material adverse effect on operations.

**Earnings may not grow if the Bank is unable to successfully attract core deposits and lending opportunities and exploit opportunities to generate fee-based income.**

In the event that the Bank is unable to execute its business strategy of continued growth in loans and deposits, earnings could be adversely impacted. The ability to continue to grow depends, in part, upon the ability to expand the Bank's market share, to successfully attract core deposits and identify loan and investment opportunities, as well as opportunities to generate fee-based income. The ability to manage growth successfully will also depend on whether the Bank can continue to efficiently fund asset growth and maintain asset quality and cost controls, as well as on factors beyond its control; such as, economic conditions and interest rate trends.

**There is no active and liquid public trading market for the Bank's stock.**

Although there are sporadic quotations and trading in the Bank's common stock on the OTC Bulletin Board, there is no established, liquid market for its common stock. It is unlikely that an active or liquid trading market in the Bank's common stock will develop in the near term, and if such a market develops, there is no assurance that it will continue. In an inactive and/or illiquid market, shareholders wishing to sell their shares may have to find buyers through their own efforts. In addition, sales of large amounts of shares could adversely affect the prevailing market price.

## **Risk of continued losses**

The Bank has recognized operating losses since commencing operations. General economic conditions have been tumultuous and have resulted in a downturn in the economy amid a climate of tightening credit. There is no assurance that the Bank will achieve profitable operations, or that if it achieves profitable operations, they will be sustained.

### ***Risks Related to the Bank and the Banking Industry:***

#### **Changes in local economic conditions could adversely affect our loan portfolio.**

The Bank's success depends to a great extent upon the general economic conditions of the local markets that it serves. Unlike larger banks that are more geographically diversified, Highlands State Bank provides banking and financial services primarily to customers in Sussex and Passaic Counties in the New Jersey market, so any decline in the economy of New Jersey could have an adverse impact the Bank.

Loans, the ability of borrowers to repay these loans, and the value of collateral securing these loans are impacted by economic conditions. Financial results, the credit quality of the existing loan portfolio, and the ability to generate new loans with acceptable yield and credit characteristics may be adversely affected by changes in prevailing economic conditions, including declines in real estate values, changes in interest rates, adverse employment conditions and the monetary and fiscal policies of the federal government. We cannot assure you that positive trends or developments discussed in this Registration Statement will continue or that negative trends or developments will not have a significant adverse effect on us.

#### **The financial services industry is undergoing a period of great volatility and disruption**

The Bank is subject to interest rate risk and variations in interest rates may negatively affect its financial performance, in addition dislocation and volatility in the credit markets may negatively affect the value of assets.

Beginning in mid 2007, there has been significant turmoil and volatility in global financial markets. Nationally, economic factors such as inflation or recession, a rise in unemployment, a weakened US dollar, and rising consumer costs persist. Recent market uncertainty regarding the financial sector has increased. In addition to the impact on the economy generally, changes in interest rates, in the shape of the yield curve, or in valuations in the debt or equity markets or disruptions in the liquidity or other functioning of financial markets, all of which have been seen recently, could directly impact the Bank in one or more of the following ways:

- Net interest income, the difference between interest earned on our interest earning assets and interest paid on interest bearing liabilities, represents a significant portion of our earnings. Both increases and decreases in the interest rate environment may reduce profits. We expect that we will continue to realize income from the spread between the interest we earn on loans, securities and other interest-earning assets, and the interest we pay on deposits, borrowings and other interest-bearing liabilities. The net interest spread is affected by the differences between the maturity and repricing characteristics of our interest-earning assets and interest-bearing liabilities. Our interest-earning assets may not reprice as slowly or rapidly as our interest-bearing liabilities.
- The market value of the Bank's securities portfolio may decline and result in other than temporary charges. The values of securities in the portfolio are affected by factors that impact the U.S. securities market in general as well as specific financial sector factors and entities. Recent uncertainty in the market regarding the financial sector has negatively impacted the value of securities within our portfolio. Further declines in these sectors may result in future other than temporary impairment charges.
- Asset quality may deteriorate as borrowers become unable to repay their loans.
- Lack of liquidity within the capital markets that the Bank uses to raise funds to support our business transactions could impact the cost of funds or its ability to raise funds.

**There is a risk that we may not be repaid in a timely manner, or at all, for loans we make.**

The risk of non-payment (or deferred or delayed payment) of loans is inherent in commercial banking. Such non-payment, or delayed or deferred payment of loans to the Bank, if they occur, may have a material adverse effect on our earnings and overall financial condition. Additionally, in compliance with applicable banking laws and regulations, the Bank maintains an allowance for loan losses created through charges against earnings. As of December 31, 2008, the Bank's allowance for loan losses was \$1.15 million. The Bank's marketing focus on small to medium size businesses may result in the assumption by the Bank of certain lending risks that are different from or greater than those which would apply to loans made to larger companies. We seek to minimize our credit risk exposure through credit controls, which include evaluation of potential borrowers' available collateral, liquidity and cash flow. However, there can be no assurance that such procedures will actually reduce loan losses.

**Our allowance for loan losses may not be adequate to cover actual losses.**

Like all financial institutions, the Bank maintains an allowance for loan losses to provide for loan defaults and nonperformance. The Bank's allowance for loan losses may not be adequate to cover actual losses, and future provisions for loan losses could materially and adversely affect the results of our operations. Although risks within the loan portfolio are analyzed on a continuous basis by management, we can provide you no assurance that our analysis will cause us to avoid future losses. The amount of future losses is susceptible to changes in economic, operating and other conditions, including changes in interest rates that may be beyond our control, and these losses may exceed current estimates. State and federal regulatory agencies, as an integral part of their examination process, review our loans and allowance for loan losses and have in the past required an increase in our allowance for loan losses. Although we believe that our allowance for loan losses is adequate to cover probable and reasonably estimated losses, we cannot assure you that we will not further increase the allowance for loan losses or that our regulators will not require us to increase this allowance. Either of these occurrences could adversely affect our earnings.

**Competition from other financial institutions in originating loans and attracting deposits may adversely affect our profitability.**

The Bank faces substantial competition in originating loans. This competition comes principally from other banks, savings institutions, mortgage banking companies, credit unions and other lenders. Many of our competitors enjoy advantages, including greater financial resources and higher lending limits, a wider geographic presence, more accessible branch office locations, the ability to offer a wider array of services or more favorable pricing alternatives, as well as lower origination and operating costs. This competition could reduce our net income by decreasing the number and size of loans that we originate and the interest rates we may charge on these loans.

In attracting deposits, the Bank faces substantial competition from other insured depository institutions such as banks, savings institutions and credit unions, as well as institutions offering uninsured investment alternatives, including money market funds. Many of our competitors enjoy advantages, including greater financial resources, more aggressive marketing campaigns and better brand recognition and more branch locations. These competitors may offer higher interest rates than we do, which could decrease the deposits that we attract or require us to increase our rates to retain existing deposits or attract new deposits. Increased deposit competition could adversely affect our ability to generate the funds necessary for lending operations that may increase our cost of funds.

The Bank also competes with non-bank providers of financial services, such as brokerage firms, consumer finance companies, insurance companies and governmental organizations that may offer more favorable terms. Some of our non-bank competitors are not subject to the same extensive regulations that govern our operations. As a result, such non-bank competitors may have advantages over us in providing certain products and services. This competition may reduce or limit our margins on banking services, reduce our market share and adversely affect our earnings and financial condition.

**The securities of the Bank are not FDIC insured.**

The securities of the Bank are not savings or deposit accounts or other obligations of any bank and are not insured by the Federal Deposit Insurance Corporation, the Deposit Insurance Fund or any other governmental agency and are subject to investment risk, including the possible loss of principal.

**The laws that regulate our operations are designed for the protection of depositors and the public, not our shareholders.**

The federal and state laws and regulations applicable to our operations give regulatory authorities extensive discretion in connection with their supervisory and enforcement responsibilities, and generally have been promulgated to protect depositors and the deposit insurance funds and not for the purpose of protecting shareholders. These laws and regulations can materially affect our future business. Laws and regulations now affecting us may be changed at any time, and the interpretation of such laws and regulations by bank regulatory authorities is also subject to change.

For example, on October 3, 2008, the Emergency Economic Stabilization Act of 2008 (the “EESA”) was signed into law. Although the act is designed to help alleviate the effects of the current economic crises, and does not directly change the regulation of community banks like us, it is expected that congressional or regulatory acts may directly impact the regulation of community banks. The EESA was further amended on February 17, 2009 by the American Recovery and Reinvestment Act (the “ARRA”).

We can give no assurance that future changes in laws and regulations or changes in their interpretation will not adversely affect our business. Legislative and regulatory changes may increase our cost of doing business or otherwise adversely affect us and create competitive advantages for non-bank competitors.

**We may be subject to higher operating costs as a result of government regulation.**

We are subject to extensive federal and state legislation, regulation and supervision which are intended primarily to protect depositors and the Federal Deposit Insurance Corporation’s Deposit Insurance Fund, rather than investors. Legislative and regulatory changes may increase our costs of doing business or otherwise, adversely affect us and create competitive advantages for non-bank competitors.

**We cannot predict how changes in technology will impact our business.**

The financial services market, including banking services, is increasingly affected by advances in technology, including developments in:

- telecommunications;
- data processing;
- automation;
- internet-based banking;
- telephone banking; and
- debit cards and so-called “smart cards.”

Our ability to compete successfully in the future will depend, to a certain extent, on whether we can anticipate and respond to technological changes. We offer electronic banking services for our consumer and business customers via our website, [www.highlandsstatebank.com](http://www.highlandsstatebank.com), including internet banking and electronic bill payment. We also offer MasterCard Check Cards, ATM cards and automatic and ACH transfers. The successful operation and further development of these and other new technologies will likely require additional capital investments in the future. We cannot assure you that we will have sufficient resources or access to the necessary proprietary technology to remain competitive in the future.

**The Bank's information systems may experience an interruption or breach in security.**

The Bank relies heavily on communications and information systems to conduct its business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in the Bank's customer-relationship management, general ledger, deposit, loan and other systems. While the Bank has policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of its information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur; or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of the Bank's information systems could damage the Bank's reputation, result in a loss of customer business, subject the Bank to additional regulatory scrutiny or expose the Bank to civil litigation and possible financial liability; any of which could have a material adverse affect on the Bank's financial condition and results of operations.

**Item 2. Financial Information - Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The following presents management's discussion and analysis of our financial condition and results of operations and should be read in conjunction with the financial statements and related notes included elsewhere in this registration statement. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ significantly from those anticipated in these forward-looking statements as a result of these risks and uncertainties, which include those listed under Item 1A - Risk Factors in this Registration Statement and changes to interest rates, the ability to control costs and expenses, general economic conditions, the success of the Bank's efforts to diversify its revenue base by developing additional sources of non-interest income, risks associated with the quality of the Bank's assets and the ability of its borrowers to comply with repayment terms, and the risks inherent in integrating acquisitions into the Bank and commencing operations in new markets. The Bank undertakes no obligation to publicly release the results of any revisions to those forward looking statements that may be made to reflect events or circumstances after this date or to reflect the occurrence of unanticipated events.*

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Management's Discussion and Analysis of Financial Condition and Results of Operation," is based upon the Bank's financial statements, which have been prepared in accordance with U.S. Generally Accepted Accounting Principles. The preparation of these financial statements requires the Bank to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. Note 1 to the Bank's Audited Financial Statements for the year ended December 31, 2008 contains a summary of the Bank's significant accounting policies. Since future events and their effect cannot be determined with absolute certainty, actual results may differ from those estimates. Management makes adjustments to its assumptions and judgments when facts and circumstances dictate. The amounts currently estimated by us are subject to change if different assumptions as to the outcome of future events were made. We evaluate our estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances. Management believes the following critical accounting policies encompass the more significant judgments and estimates used in preparation of our consolidated financial statements:

**Allowance for Loan Losses.** The allowance for loan losses is based upon management's evaluation of the adequacy of the allowance, including an assessment of known and inherent risks in the portfolio, giving consideration to the size and composition of the loan portfolio, actual loan loss experience, level of delinquencies, detailed analysis of individual loans for which full collectability may not be assured, the existence and estimated net realizable value of any underlying collateral and guarantees securing the loans, and current economic and market conditions. Although management uses the best information available, the level of the allowance for loan losses remains an estimate which is subject to significant judgment and short-term change. Various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the Bank to make additional provisions for loan losses based upon information available to them at the time of their examination. Furthermore, the majority of the Bank's loans are secured by real estate in the State of New Jersey. Accordingly, the collectability of a substantial portion of the carrying value of the Bank's loan portfolio is susceptible to changes in local market conditions and may be adversely affected should real estate values decline or the northern New Jersey area experience an adverse economic shock. Future adjustments to the allowance for loan losses may be necessary due to economic, operating, regulatory and other conditions beyond the Bank's control.

**Share-Based Compensation.** The Bank recognizes compensation expense for stock options in accordance with SFAS No. 123 (revised 2004, “Share-Based Payment” (SFAS No. 123(R)) adopted at January 1, 2006 under the prospective application method of transition. As a result, options granted prior to January 1, 2006 will generally not be subject to expense. Prior to 2006, the Bank had no stock option plans in place and no stock-based compensation expense. The expense related to options granted after January 1, 2006 is generally measured based on the fair value of the option at the grant date, with compensation expense recognized over the service period, which is usually the vesting period. The Bank utilizes the Black-Scholes option-pricing model (as used under SFAS No. 123(R)) to estimate the fair value of each option on the date of grant. The Black-Scholes model takes into consideration the exercise price and expected life of the option, the current price of the underlying stock and its expected volatility, the expected dividends on the stock and the current risk-free interest rate for the expected life of the option. The Bank’ estimate of the fair value of a stock option is based on expectations derived from historical experience and may not necessarily equate to its market value when fully vested. Share-based compensation expense of \$47,598 and \$100,596 is included in the accompanying statement of operations for the years ended December 31, 2008 and 2007, respectively. There were no tax benefits recognized on the stock compensation expense.

**Unrealized Gains and Losses on Securities Available for Sale.** The Bank receives estimated fair values of debt securities from independent valuation services and brokers. In developing these fair values, the valuation services and brokers use estimates of cash flows based on historical performance of similar instruments in similar rate environments. Debt securities available for sale are comprised of U.S. government agency securities, federal agency mortgage-backed securities, and other debt securities. The Bank uses various indicators in determining whether a security is other than temporarily impaired, including for equity securities, if the market value is below its cost for an extended period of time with low expectation of recovery or, for debt securities, when it is probable that the contractual interest and principal will not be collected. The debt securities are monitored for changes in credit ratings because adverse changes in credit ratings could indicate a change in the estimated cash flows of the underlying collateral or issuer. As of December 31, 2008, the unrealized losses associated with securities that management has the ability and intent to hold until maturity or market recovery were not considered to be other than temporary, because the unrealized losses were related to changes in interest rates or market conditions and did not affect the expected cash flows of the underlying collateral or issuer.

**Goodwill.** The Bank recognized goodwill associated with the acquisition of Noble Community Bank in accordance with the purchase method of accounting. Goodwill represents the excess of the cost of an acquired entity over the fair value of the identifiable net assets acquired. Goodwill is not amortized but is reviewed for potential impairment on an annual basis, or more often if events or circumstances indicate that there may be impairment, in accordance with SFAS No. 142, “Goodwill and Other Intangible Assets.” Goodwill is tested for impairment at the reporting unit level and an impairment loss is recorded to the extent that the carrying amount of goodwill exceeds its implied fair value. The Bank employs general industry practices in evaluating the fair value of its goodwill. Any impairment loss related to goodwill and other intangible assets is reflected as other non-interest expense in the statement of income in the period in which the impairment is determined.

**Deferred Income Taxes.** The Bank provides for deferred income taxes on the liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and net operating loss carryforwards and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

#### **Recently Issued Accounting Standards**

Refer to Note 1 of the Notes to Consolidated Financial Statements for a discussion of recently issued accounting standards.

## Overview and Strategy

Highlands State Bank (the “Bank”) is a New Jersey state chartered commercial bank that commenced operations on October 31, 2005. The Bank’s principal office located in Vernon, New Jersey and it operates two additional branches, one each in Sparta, New Jersey and Totowa, New Jersey.

On December 31, 2008, the Bank completed its previously announced merger with Noble Community Bank (“Noble”), a bank headquartered in Sparta, New Jersey, pursuant to the terms of the Bank Merger Agreement dated as of August 6, 2008 (the “Merger Agreement”). At the time of the merger, Noble had approximately \$46.0 million in total assets, \$31.5 million in loans and \$36.9 million in deposits. Noble’s former branch, located in Sparta, Sussex County is now a branch of the Bank.

Pursuant to the purchase accounting requirements applicable to our merger with Noble, our financial statements for the year ended December 31, 2008 reflect the combination of Highlands State Bank and Noble as of December 31, 2008, the date of the merger, while our financial statements for the year ended December 31, 2007 have not been restated to reflect the merger. Highlands' results of operations will include Noble beginning January 1, 2009. This will impact the comparability of the two periods, and should be considered carefully when interpreting our results of operations and our financial condition.

The following table sets forth selected measures of the Bank’s financial position or performance for the dates or periods indicated.

	<b>As of December 31, and For the Years Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
	<b>(Dollars in thousands)</b>	
Total revenue (1)	\$ 2,021	\$ 1,405
Net loss	(993)	(905)
Total assets	119,646	42,878
Total loans receivable	90,603	31,327
Total deposits	96,781	33,212

(1) Total revenue equals net interest income plus non-interest income.

Like most financial institutions, the Bank derives the majority of its income from interest it receives on its interest-earning assets, such as loans and investments. The Bank’s primary source of funds for making these loans and investments is its deposits, on which it pays interest. Consequently, one of the key measures of the Bank’s success is its amount of net interest income, or the difference between the income on its interest-earning assets and the expense on its interest-bearing liabilities, such as deposits and borrowings, which is called the net interest income. Another key measure is the spread between the yield the Bank earns on these interest-earning assets and the rate it pays on its interest-bearing liabilities, which is called its net interest spread.

There are risks inherent in all loans, and the Bank maintains an allowance for loan losses to absorb probable losses on existing loans that may become uncollectible. This allowance is maintained by charging a provision for loan losses against operating earnings. A detailed discussion of this process, as well as several tables describing the allowance for loan losses is included.

In addition to earning interest on its loans and investments, the Bank earns income through other sources, such as fees and other charges to its customers. The various components of non-interest income, as well as non-interest expense, are described in the following discussion.

## Results of Operations

### *Income Statement Review*

The Bank's results of operations depend primarily on its net interest income, which is the difference between the interest earned on its interest-earning assets and the interest paid on funds borrowed to support those assets, primarily deposits. Net interest margin is the difference between the weighted average rate received on interest-earning assets and the weighted average rate paid on interest-bearing liabilities, as well as the average level of interest-earning assets as compared with that of interest-bearing liabilities. Net income is also affected by the amount of non-interest income and other non-interest expenses.

### *Summary*

For the year ended December 31, 2008, the Bank had a net loss of \$993 thousand or \$(.91) per basic share based on average shares outstanding of 1,095,159. This compares to a net loss of \$905 thousand or \$(.89) per basic share for the year ended December 31, 2007 based on average shares outstanding of 1,017,928. The increased loss in 2008 of \$88 thousand, when compared to 2007, resulted from an increase in operating expenses, reflecting costs associated with our growth and opening a new branch office, of \$519 thousand, partially offset by an increase in net interest income after the provision for loan losses of \$428 thousand between these periods. The increase in average shares in the current year from the prior year resulted from the exercise of stock warrants during 2007 associated with the initial stock offering.

Net interest margin averaged 3.43% during 2008 compared to 3.81% in 2007. Total average earning assets increased \$21.7 million to \$56.8 million in 2008 compared to \$35.1 million for 2007 primarily as a result of loan portfolio growth. Average total interest bearing liabilities increased \$21.6 million to \$41.6 million in the current year compared to \$20.0 million in the prior year, reflecting increased balances in certificate of deposit, savings, and money market accounts. Deteriorating economic conditions experienced during 2008 were very challenging for all banks as interest rates realized on interest earning assets declined, and credit market dysfunction and competition for deposits as the Federal Reserve lowered short-term interest rates adversely impacted the Bank's net interest margin. The net interest spread however, improved to 2.62% for 2008, when compared to 1.96% for 2007.

### *Net Interest Income*

The Bank's primary source of revenue is net interest income. Net interest income is determined by the balances of interest-earning assets and interest-bearing liabilities and the interest rates earned and paid on these balances. The amount of net interest income recorded by the Bank is affected by the rate and amount of growth of interest-earning assets and interest-bearing liabilities, the amount of interest-earning assets as compared to the amount of interest-bearing liabilities, and by changes in interest rates earned and interest rates paid on these assets and liabilities.

Net interest income increased 45.7%, or \$612 thousand, in 2008 to \$2.0 million from \$1.3 million in 2007. The increase in net interest income resulted from growth in interest earning assets of 38.2% from \$35.1 million in 2007 to \$56.8 million in 2008. The growth was primarily in newly originated loans. In order to fund the growth in assets, average interest bearing liabilities increased \$21.6 million, or 107.8% in 2008 to \$41.6 million from \$20.0 million in 2007.

The following table sets forth certain information relating to the Bank's average assets and liabilities for the years ended December 31, 2008 and 2007, and reflects the average yield on assets and average cost of liabilities for the periods indicated. Such yields are derived by dividing income or expense by the average balance of assets or liabilities, respectively, for the periods shown. Average loans are stated net of deferred costs and include non-accrual loans. Securities available for sale are reflected in the following table at amortized cost.

**Average Balances, Interest Income and Interest Expense, and Rates**

(Dollars in thousands)	2008			2007		
	<u>Average Balance</u>	<u>Income/ Expense</u>	<u>Yield/ Rate</u>	<u>Average Balance</u>	<u>Income/ Expense</u>	<u>Yield/ Rate</u>
<b>Interest-earning assets:</b>						
Loans receivable	\$ 44,498	\$ 2,626	5.90%	\$ 19,633	\$ 1,391	7.09%
Securities available for sale	9,567	484	5.06%	8,691	445	5.12%
Federal funds sold	1,373	35	2.55%	3,325	173	5.20%
Deposits with other banks	1,400	69	4.93%	3,491	192	5.50%
Total interest-earning assets	<u>56,838</u>	<u>3,214</u>	<u>5.65%</u>	<u>35,140</u>	<u>2,201</u>	<u>6.26%</u>
Non-interest earning assets	<u>1,632</u>			<u>1,332</u>		
<b>TOTAL ASSETS</b>	<u><u>\$ 58,470</u></u>			<u><u>\$ 36,472</u></u>		
<b>Interest-bearing liabilities:</b>						
Demand, interest-bearing	\$ 437	\$ 10	2.29%	\$ 206	\$ 6	2.91%
Money market and savings	21,914	557	2.54%	16,651	701	4.21%
Time deposits	15,253	575	3.77%	3,002	146	4.86%
Borrowed funds	3,994	120	3.00%	164	8	4.88%
Total interest-bearing liabilities	<u>41,598</u>	<u>1,262</u>	<u>3.03%</u>	<u>20,023</u>	<u>861</u>	<u>4.30%</u>
<b>Non-interest bearing liabilities:</b>						
Demand, non-interest bearing deposits	8,367			7,859		
Other liabilities	266			338		
<b>Shareholders' equity</b>	<u>8,239</u>			<u>8,252</u>		
<b>TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY</b>	<u><u>\$ 58,470</u></u>			<u><u>\$ 36,472</u></u>		
Net interest income/rate spread		<u>\$ 1,952</u>	<u>2.62%</u>		<u>\$ 1,340</u>	<u>1.96%</u>
Net interest margin			<u>3.43%</u>			<u>3.81%</u>

Total average earning assets increased \$21.7 million in 2008 compared to the prior year, driven by an increase in average loans of \$24.9 million, or 126.6%. Funding for the growth in loans was provided by an increase in average interest bearing liabilities of \$21.6 million, comprised of increases in average time deposits of \$12.2 million, money market and savings of \$5.3 million and borrowed funds of \$3.8 million. As the Noble transaction closed on December 31, 2008, the earning assets and interest bearing liabilities acquired from Noble did not have a material effect on the average balances of earning assets or interest bearing liabilities in 2008.

Net interest margin averaged 3.43% in 2008, a decline of 38 basis points from 3.81% in 2007. Short-term interest rates, as measured by the overnight federal funds rate determined by the Federal Open Market Committee, averaged 5.05% during 2007. This rate, however, declined to 25 basis points by the end of 2008, creating an average for 2008 of 2.09%, or a decline of 296 basis points between the two years. The average yield on the Bank's earning assets declined 61 basis points from 6.26% in 2007 to 5.65% in 2008, as the yield on loans decreased 119 basis points and the yield on Federal funds sold and deposits with banks declined 265 basis points and 57 basis points, respectively. The rate on the Bank's interest bearing liabilities declined 127 basis points during this same time, which resulted in an increase in the net interest spread of 66 basis points to 2.62% for 2008, compared to 1.96% for 2007. The increase in net interest spread is due to the additional volume of loans, which generally earn a higher average rate of interest than investments or overnight funds. However, since a portion of the Bank's earning assets are funded by equity and other non-interest bearing balances, which are not sensitive to interest rate changes, the negative impact to both net interest income and net interest margin is larger when rates decline, since the reduction of interest income on earning assets will be higher than the reduction of interest expense on interest-bearing liabilities based on the proportionate balances within each category.

### *Analysis of Changes in Net Interest Income*

Net interest income also can be analyzed in terms of the impact of changing interest rates and changing volume. As shown in the Changes in Net Interest Income Table below, of the total increase in net interest income of \$612 thousand in 2008 compared to 2007, growth in earning assets accounted for \$537 thousand with the increase in net interest income related to rate accounting for \$75 thousand. The increased volume of earning assets provided an additional \$1.56 million in interest income, primarily due to loan growth, while increased deposits to fund that growth resulted in higher interest expense of \$1.02 million when comparing 2008 to 2007. Changes related to lower yields on interest earning assets had a negative impact of \$542 thousand on net interest income while lower rates on interest-bearing liabilities reduced interest expense by \$617 thousand for these same periods.

The following table sets forth the effect which varying levels of interest-earning assets, interest-bearing liabilities and the applicable rates have had on changes in net interest income for the periods presented. Changes due to both volume and rates have been allocated in proportion to the relationship of the dollar amount change in each.

(In thousands)	<b>Years Ended December 31, 2008 vs. 2007</b>		
	<b>Increase (Decrease) Due to Change In</b>		
	<b>Volume</b>	<b>Rate</b>	<b>Net Change</b>
<b>Interest income:</b>			
Loan receivable	\$ 1,727	\$ (492)	\$ 1,235
Securities available for sale	45	(6)	39
Federal funds sold	(102)	(36)	(138)
Deposits with other banks	(115)	(8)	(123)
Total interest-earning assets	1,555	(544)	1,013
<b>Interest Expense:</b>			
Demand, interest-bearing	7	(3)	4
Money market and savings	228	(372)	(144)
Time deposits	596	(167)	429
Borrowed funds	187	(75)	112
Total interest-bearing liabilities	1,018	(615)	401
<b>Change in net interest income</b>	<b>\$ 537</b>	<b>\$ 75</b>	<b>\$ 612</b>

### *Provision for Loan Losses*

The allowance for loan losses is established through provisions for loan losses charged against income. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses will be maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management's periodic evaluation of the adequacy of the allowance is based on known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revisions as more information becomes available.

At the end of each quarter or more often, if necessary, the Bank analyzes the collectability of its loans and accordingly adjusts the loan loss allowance to an appropriate level. The allowance for loan losses covers estimated credit losses on individually evaluated loans that are determined to be impaired, as well as estimated credit losses inherent in the remainder of the loan portfolio. For a description of the process for determining the adequacy of the allowance for loan losses, see the “Allowance for Loan Losses” section below.

The provision for loan losses totaled \$410 thousand in 2008 compared to \$226 thousand in the prior year. The increase in the provision of \$184 thousand for 2008 compared to the prior year is due to additional loan volume between the periods, and additional provisions in 2008 related to the general economic environment.

The allowance as a percentage of loans was 1.27% at December 31, 2008 compared to .97% at December 31, 2007. Management continues to review and evaluate the allowance for loan losses based on the performance of the loan portfolio.

#### *Non-Interest Income*

Non-interest income totaled \$68 thousand in 2008 compared to \$65 thousand for 2007. Non-interest income is comprised of service charges on deposit accounts, and other fees which the Bank collects from its banking customers. During 2008, the Bank recognized an other-than-temporary impairment loss on FNMA preferred stock investments totaling \$97 thousand.

#### *Non-Interest Expenses*

Non-interest expenses were \$2.60 million in 2008 compared to \$2.08 million in 2007. The following table sets forth information related to the various components of non-interest expenses for each period.

	<b>For the Year Ended</b>	
	<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>
	(Dollars in thousands)	
<b>Non-Interest Expenses</b>		
Salaries and employee benefits	\$ 1,282	\$ 1,003
Share-based compensation	48	101
Occupancy and equipment	409	365
Data processing	264	187
Professional fees	138	108
Advertising and promotion	104	75
Other	359	246
	<u>359</u>	<u>246</u>
<b>Total Non-Interest Expenses</b>	<b><u>\$ 2,604</u></b>	<b><u>\$ 2,085</u></b>

Non-interest expenses increased \$519 thousand, or 24.9%, in 2008 compared to 2007. Employee salaries and benefits increased \$279 thousand or 27.8% reflecting additions made to staff required to support the loan and deposit growth of the Bank achieved during 2008 and to staff the new branch location. Share-based compensation expense declined \$53 thousand or 52.5% as a result of the lower balance remaining in unrecognized compensation cost relating to the Bank’s 2006 Stock Option Plans for non-vested stock options yet to be recognized on a graded vesting method over a weighted average period of one year. Occupancy and equipment charges increased \$44 thousand or 12.1% due to the additional cost of renting the new branch location in Totowa, New Jersey and higher depreciation charges associated with capital asset additions. Data processing costs grew \$77 thousand or 41.2% as a result of increased core processing charges associated with the implementation of new products and services, and data security enhancements. Professional fees increased \$30 thousand or 27.8% due to increases in legal, consulting and audit fees incurred relating to the new branch opening, the CPP application, and loan collections. Advertising

and promotional expenses increased \$29 thousand or 38.7% as a result of increased marketing of promotional loan and deposit products. All other expenses increased \$113 thousand or 45.9% reflecting higher costs associated with loan origination, deposit insurance coverage, merger-related forms and supplies, and communications charges.

### *Provision for Income Taxes*

There is no provision for income taxes for each of the years ended December 31, 2008 and 2007 due to the net operating losses incurred. Deferred income taxes are provided on the liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the deferred tax assets will not be realized. To satisfy the “more likely than not” criteria required to reduce the valuation allowance, the Bank would need to become profitable and demonstrate that a consistent positive trend of profitability is sustainable. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

The Bank has net operating loss (“NOL”) carryforwards available for federal and state income tax purposes of approximately \$5.8 million at December 31, 2008, which start to expire in 2025 for federal purposes and 2012 for state purposes.

### *Financial Condition*

#### *Balance Sheet Review Overview*

As of December 31, 2008, the Bank had total assets of \$119.6 million, an increase of 178.8% over total assets of \$42.9 million on December 31, 2007. Total assets at December 31, 2008 consisted primarily of loans outstanding of \$89.4 million and investment securities available for sale of \$19.6 million. At December 31, 2007, total assets consisted principally of loans outstanding of \$31.0 million and investment securities available for sale of \$7.4 million. The Bank’s acquisition of Noble resulted in increases of \$31.5 million in net loans receivable, \$11.5 million in securities available for sale, and \$46.0 million in total assets. The Bank maintained restricted investments in bank stocks of \$622 thousand at December 31, 2008, consisting of stock of the Federal Home Loan Bank of New York (“FHLB”) in the amount of \$522 thousand and Atlantic Central Bankers Bank in the amount of \$100 thousand. Federal law requires a member institution of the FHLB to hold stock according to a predetermined formula. All restricted stock is recorded at cost. Premises and equipment was \$1.2 million, increasing \$704 thousand during 2008, principally resulting from the merger with Noble. Goodwill of \$757 thousand was also recorded in connection with the acquisition during the last month of 2008.

Total deposits at December 31, 2008, were \$96.8 million compared to \$33.2 million at December 31, 2007, an increase of \$63.6 million or 191.4%. The acquisition of Noble contributed \$36.9 million of this increase. Deposits consisted principally of certificates of deposit, savings, checking, and money market accounts which at December 31, 2008 were \$52.0 million, \$22.1 million, \$11.3 million, and \$10.5 million, respectively, compared to \$7.2 million, \$14.6 million, \$6.7 million, and \$6.7 million at December 31, 2007, respectively. Borrowings were \$9.5 million at December 31, 2008 compared to no borrowings at December 31, 2007. Noble had \$4.5 million of borrowings at the time of acquisition. Other liabilities were \$853 thousand as of December 31, 2008 compared to \$204 thousand at December 31, 2007. This increase was due to higher interest and accounts payable, and accrued expense balances at the end of 2008.

#### *Investments*

On December 31, 2008, and 2007, the Bank’s investment securities portfolio totaled \$19.6 million and \$7.4 million, respectively, and represented approximately 17% and 18%, respectively, of total interest-earning assets. The acquisition of Noble accounted for \$11.5 million of the increase over the prior year end. As of December 31, 2008, the Bank’s portfolio consisted of U.S. Government agency and sponsored agency securities, Federal agency mortgage-backed securities, corporate bonds, and corporate preferred stock which were classified as available for sale with an amortized cost of \$19.6 million for an unrealized gain of \$26 thousand. As of December 31, 2007, all

investments were classified as available for sale with an amortized cost of \$7.4 million for a net unrealized gain of \$62 thousand.

The following table sets forth information about the maturities and weighted yields on the Bank's investment securities as of December 31, 2008.

(Dollars in thousands)	As of December 31, 2008								
	Within 1 year		After one but with five years		After five but within ten years		Over ten years		Tot
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount
U.S Government agency securities	\$ 8,049	5.50%	\$ 1,522	4.22%	\$ 902	5.25%	\$ 4,995	5.31%	\$ 15,468
Mortgage-backed securities	416	5.26%	1,425	5.24%	1,372	5.22%	297	5.18%	3,510
Other securities	-	-	237	8.14%	-	-	381	7.97%	618
<b>Total investments available for sale</b>	<b>\$ 8,465</b>	<b>5.49%</b>	<b>\$ 3,184</b>	<b>4.97%</b>	<b>\$ 2,274</b>	<b>5.23%</b>	<b>\$ 5,673</b>	<b>5.48%</b>	<b>\$ 19,596</b>

The amortized cost and fair value of the Bank's investments (all available for sale) as of each of the years ended December 31, 2008 and 2007 are shown in the following table:

(In thousands)	As of December 31,			
	2008		2007	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
U.S Government agency securities	\$ 15,368	\$ 15,468	\$ 3,993	\$ 4,009
Mortgage-backed securities	3,394	3,510	3,010	3,055
Other securities	808	618	300	301
<b>Total investments available for sale</b>	<b>\$ 19,570</b>	<b>\$ 19,596</b>	<b>\$ 7,303</b>	<b>\$ 7,365</b>

#### *Restricted investments in bank stocks*

Restricted investments in bank stocks represent required investments in the common stock of correspondent banks. As of December 31, 2008 and December 31, 2007 the Bank had an investment of \$100 thousand, and \$50 thousand, respectively in the common stock of Atlantic Central Bankers' Bank, Camp Hill, Pennsylvania, which is carried at cost. The increase in correspondent bank stock is the result of membership shares acquired in the Noble merger. In addition, the Bank is also required to maintain an investment in the stock of the FHLB according to a predetermined formula as set forth in the FHLB's Capital Plan. This required investment in FHLB stock fluctuates in proportion to the Bank's outstanding debt to the FHLB and is also carried at cost. As debt is repaid, stock held in excess of the minimum requirement is periodically adjusted and refunded. The Bank became a member of the FHLB in March 2008. At December 31, 2008, the investment in FHLB stock totaled \$522 thousand.

#### *Loans*

The Bank's loan portfolio is the primary component of its assets. At December 31, 2008, total loans were \$89.5 million, an increase of \$58.5 million, or 188.7%, from \$31.0 million at December 31, 2007. The overall growth in the loan portfolio in 2008 is partially due to the acquisition of Noble, which had \$31.5 million in net loans at December 31 2008, the effective date of the acquisition.

The following table sets forth the classification of the Bank's loan portfolio for each of the years ended December 31, 2008 and 2007.

	<b>As of December 31,</b>			
	<b>2008</b>		<b>2007</b>	
	(Dollars in thousands)			
	<b>Amount</b>	<b>Percent of total</b>	<b>Amount</b>	<b>Percent of total</b>
Commercial Real Estate	\$ 39,546	44%	\$ 14,749	47%
Commercial	11,463	13%	4,200	14%
Residential Real Estate	10,143	11%	852	3%
Home Equity	29,167	32%	11,390	36%
Consumer	199		121	
Total Loans	<u>90,518</u>	<u>100%</u>	<u>31,312</u>	<u>100%</u>
Net deferred loan fees/costs	85		15	
<b>Total</b>	<u><u>\$ 90,603</u></u>	<u><u>100%</u></u>	<u><u>\$ 31,327</u></u>	<u><u>100%</u></u>

Commercial loans are made for the purpose of providing working capital, financing the purchase of equipment or inventory, and for other business purposes. Real estate loans consist of loans secured by commercial or residential real property and loans for the construction of commercial or residential property. Consumer loans are made for the purpose of financing the purchase of consumer goods, home improvements, and other personal needs, and are generally secured by the personal property purchased.

Due to the limited length of time the Bank has been in business, the current mix of the loan portfolio may not be indicative of the ongoing portfolio mix. Generally, the Bank limits the loan-to-value ratio on loans it makes to 75% and attempts to maintain a relatively diversified loan portfolio to help reduce the risk inherent in concentration in certain types of collateral.

Commercial real estate loans typically involve large loan balances to single borrowers or groups of related borrowers. The payment experience of such loans is typically dependent upon the successful operation of the real estate project. These risks can be significantly affected by supply and demand conditions in the market for office and retail space and for apartments and, as such may be subject, to a greater extent, to adverse conditions in the economy. In dealing with these risk factors, the Bank generally limits itself to a real estate market or to borrowers with which the Bank has experience. The Bank generally concentrates on originating commercial real estate loans secured by properties located within its market area. In addition, many of the Bank's commercial real estate loans are secured by owner-occupied property with personal guarantees for the debt.

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

The following tables summarize the loan maturity distribution by type and related interest rate characteristics as of December 31, 2008.

At December 31, 2008				
Maturities of Outstanding Loans				
	Within 1	After 1 But	After 5	Total
	Year	Within 5	Years	Loans
		Years	Years	
(Dollars in thousands)				
Commercial Real Estate	\$ 13,531	\$ 5,905	\$ 15,410	\$ 34,846
Commercial	2,590	4,594	4,266	11,450
Construction	2,835	1,803	-	4,638
Residential Real Estate	485	-	9,640	10,125
Home Equity	202	569	28,538	29,309
Consumer	90	116	29	235
Total Loans	<u>\$ 19,733</u>	<u>\$ 12,987</u>	<u>\$ 57,883</u>	<u>\$ 90,603</u>

#### *Credit Quality*

The Bank's written lending policies require specified underwriting, loan documentation and credit analysis standards to be met prior to funding for the majority of new loan balances. The Loan Committee is comprised of senior members of management who oversee the loan approval process to monitor that proper standards are maintained.

The accrual of interest on loans is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectability of principal or interest, even though the loan is currently performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on non-accrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan losses. Interest received on non-accrual loans is generally either applied against principal or reported as interest income, according to management's judgment as to the collectability of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time, and the ultimate collectability of the total contractual principal and interest is no longer in doubt. During 2008, interest accrued on non-accruing loans and not recognized as interest income totaled \$87 thousand. There were no non-accrual loans and no loans greater than 90 days past due and still accruing interest at December 31, 2007.

The following table summarizes loan delinquency and other non-performing assets at the dates indicated.

	<b>At December 31,</b>	
	<b>2008</b>	<b>2007</b>
	(Dollars in thousands)	
Loans past due 90 days or more and still accruing interest	\$ 593	\$ -
Non-accrual loans	675	-
Total non-performing loans (1)	<u>1,268</u>	<u>-</u>
Other real estate owned	<u>-</u>	<u>-</u>
<b>Total non-performing assets (2)</b>	<b><u>\$ 1,268</u></b>	<b><u>\$ -</u></b>
Non-performing loans as a percentage of total loans	1.40%	-
Non-performing assets as a percentage of total assets	1.06%	-
Ratio of allowance to non-performing loans at end of period	90.46%	-
Ratio of allowance to non-performing assets at end of period	90.46%	-
Allowance for loan losses as a percentage of total loans	1.27%	0.97%

- (1) Non-performing loans are comprised of (i) loans that have a non-accrual status; (ii) accruing loans that are 90 days or more past due and (iii) restructured loans.
- (2) Non-performing assets are comprised of non-performing loans and other real estate owned (assets acquired in foreclosure). The Bank had no real estate owned at each of the periods reported.

Asset quality remains acceptable compared to the industry's averages. The balance of non-performing loans is primarily the result of two loan relationships. The Bank's management continues to monitor and explore potential options and remedial actions to recover the Bank's investment in these loans. The Bank had impaired loans totaling \$1,398,000 at December 31, 2008 with specific allowance for loan losses totaling \$86 thousand. The Bank believes these loans are well collateralized and the specific allowance recorded is a reasonable estimate of the loss. According to policy, the Bank is required to maintain a specific reserve for impaired loans. See the "Allowance for Loan Losses" section below for further information. There were no restructured loans as of December 31, 2008 or 2007.

#### *Allowance for loan losses*

The allowance for loan losses represents an amount that the Bank believes will be adequate to absorb estimated probable credit losses on existing loans that may become impaired. The allowance for loan losses is established through provisions for loan losses charged against income. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance. The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management's periodic evaluation of the adequacy of the allowance is based on known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revisions as more information becomes available.

The allowance consists of specific, general, and unallocated components. The specific component relates to loans that are classified as either doubtful, substandard, or special mention. For such loans that are also classified as

impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and home equity loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

As of December 31, 2008, the Bank's allowance for loan losses totaled \$1.15 million, compared to \$304 thousand at December 31, 2007. The increase includes a \$468 thousand reserve acquired in the Noble transaction. Based on the information available as of December 31, 2008, management believes that the allowance for loan losses is adequate.

The following table sets forth a summary of the changes in the allowance for loan losses for the periods indicated:

	<b>For the Year Ended</b>	
	<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>
	(Dollars in thousands)	
Balance at the beginning of period	\$ 304	\$ 78
Charge-offs:		
Commercial	25	-
Consumer	10	-
Net loans charged-off	35	-
Acquired reserve in business combination	468	-
Provision charged to operations	410	226
Balance at end of period	<u>\$ 1,147</u>	<u>\$ 304</u>
Average loans (1)	<u>\$ 44,498</u>	<u>\$ 19,633</u>
Ratio of net charge-offs during period to average loans	0.08%	-
Allowance for loan loss as a percentage of total loans	1.27%	0.97%

(1) Includes non-accrual loans.

The following table sets forth the allocation of the allowance for loan losses by loan category as of December 31 at each of the periods presented. The specific allocations in any particular category may be reallocated in the future to reflect then current conditions. Accordingly, management considers the entire allowance to be available to absorb losses in any category.

(Dollars in thousands)	<u>2008</u>		<u>2007</u>	
	<u>Amount</u>	<u>Percent of total loans (1)</u>	<u>Amount</u>	<u>Percent of total loans (1)</u>
Commercial real estate	\$ 545	44%	\$ 140	47%
Commercial	311	13%	80	13%
Consumer	237	32%	71	37%
Residential real estate	<u>40</u>	<u>11%</u>	<u>3</u>	<u>3%</u>
<b>Total Allocated</b>	1,133	100%	294	100%
<b>Unallocated</b>	<u>14</u>		<u>10</u>	
<b>Total</b>	<u><b>\$ 1,147</b></u>		<u><b>\$ 304</b></u>	

(1) Represents loans outstanding in each category, as of the date shown, as a percentage of total loans outstanding.

#### *Loan Concentrations*

As of December 31, and 2007, there were no concentrations of loans exceeding 10% of the Bank's total loans. The Bank's loans consist primarily of credits to business and individual borrowers located in northern New Jersey.

#### *Deposits*

The Bank's primary source of funds for loans and investments is its deposits. The Bank attracts deposits by offering competitive interest rates on all deposit products. The Bank supplements deposits raised in the local market with brokered certificates of deposit. At December 31, 2008, the Bank had \$4.5 million in brokered certificates of deposits, and no brokered certificate of deposits as December 31, 2007.

The following table sets forth the average balance of the Bank's deposits and the average rates paid on deposits for the years ended December 31, 2008 and 2007.

	<b>For the Year Ended December 31,</b>			
	<b>2008</b>		<b>2007</b>	
	<b>Average Balance</b>	<b>Rate</b>	<b>Average Balance</b>	<b>Rate</b>
	(Dollars in thousands)			
Demand, non-interest bearing	\$ 8,367		\$ 7,859	
Demand, interest-bearing	437	2.29%	206	2.91%
Money market and savings deposits	21,914	2.54%	16,651	4.21%
Time deposits	<u>15,253</u>	<u>3.77%</u>	<u>3,002</u>	<u>4.86%</u>
Total interest-bearing deposits	<u>37,604</u>	<u>3.04%</u>	<u>19,859</u>	<u>4.30%</u>
Total deposits	<u>\$ 45,971</u>		<u>\$ 27,718</u>	

On December 31, 2008 and 2007, total deposits were \$96.8 million and \$33.2 million respectively. The acquisition of Noble accounted for \$36.9 million of the \$63.6 million increase in deposits.

Core deposits, which exclude time deposits of \$100,000 or more provide a relatively stable funding source for the Bank's interest earning assets. The Bank's core deposits totaled \$72.8 million and \$31.1 million as of December 31, 2008, and December 31, 2007, respectively.

The maturity distribution of time deposits of \$100,000 or more as of December 31, 2008, is as follows:

(Dollars in thousands)	<b>December 31, 2008</b>
Three Months or Less	\$ 7,718
Over Three Through Six Months	3,672
Over Six Through Twelve Months	11,358
Over Twelve Months	<u>1,266</u>
<b>TOTAL</b>	<u>\$ 24,014</u>

*Other Interest-Bearing Liabilities*  
*Short-Term Borrowed Funds*

The Bank's short-term borrowings generally consist of Federal funds purchased, securities sold under repurchase agreements and other secured borrowings from correspondent banks.

The following table outlines the Bank's various sources of borrowed funds at or for each of the years ended December 31, 2008 and 2007. The maximum balance represents the highest indebtedness for each category of short-term borrowed funds at any month ended during each of the periods shown.

	<b>At or For the Years Ended</b>	
	<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>
	(Dollars in thousands)	
<b>Federal funds purchased:</b>		
Balance at year end	\$ -	\$ 759
Weighted average rate at year end	-	3.97 %
Maximum month end balance	1,248	2,238
Average daily balance during the year	463	164
Weighted average rate during the year	2.31 %	4.88 %
<b>Short-term advances:</b>		
Balance at year end	\$ 1,500	\$ -
Weighted average rate at year end	0.48 %	-
Maximum month end balance	5,000	-
Average daily balance during the year	890	-
Weighted average rate during the year	2.18 %	-

As of December 31, 2008 and 2007, the Bank had a borrowing facility with a correspondent bank totaling \$5 million, of which \$2.5 million is available unsecured. The remaining \$2.5 million is a secured line of credit with security provided by a pledge of securities held in safekeeping.

#### *Long-Term Debt*

Long-term debt at December 31, 2008 consisted of FHLB advances totaling \$8.0 million with a weighted average interest rate of 3.04% and a weighted average life of 2.0 years. The Bank became a member of FHLB in March 2008. The advances are collateralized by restricted investments in FHLB bank stock, U.S Government sponsored agency securities, and mortgage backed securities.

#### *Capital Resources*

During 2005 the Bank sold 1,000,000 shares of common stock at \$10 per share which resulted in net proceeds of \$9,965,990 (net of offering cost of \$34,010) under an initial stock offering which was fully subscribed.

In conjunction with the Bank's initial stock offering, each stockholder received a stock purchase warrant to purchase 0.25 shares of the Bank's common stock. Four warrants allowed the holder to purchase one share of common stock at an exercise price of \$10.00. Accordingly, there were 1,000,000 stock warrants issued under the initial stock offering enabling holders to purchase 250,000 shares of the Bank's common stock. The warrants were exercisable through October 11, 2007. Through that date, 380,661 warrants were exercised to purchase 95,159 shares of the Bank's common stock for total proceeds of \$951,590. Warrants to purchase a total of 154,801 shares expired without being exercised.

In June 2007, the Bank's Board of Directors approved the issuance of new stock warrants (2007 warrants) to its stockholders who fully exercised their initial stock warrants on or before October 11, 2007. The 2007 stock warrants were equal to the number of initial stock warrants that had not been exercised. No 2007 stock warrants were exercised through December 31, 2008. All warrants had expired as of December 31, 2008.

Total shareholders' equity was \$12.5 million and \$8.7 million on December 31, 2008 and 2007, respectively. The increase of \$3.8 million during 2008 resulted from the additional equity of \$4.8 million due to the Noble acquisition

and \$48 thousand relating to stock option amortization, offset by the net loss recorded of \$993 thousand and an unrealized loss of \$36 thousand on securities available for sale.

The Bank exceeds the minimum capital requirements established by regulatory agencies. Under the capital adequacy guidelines, capital is classified into two tiers. These guidelines require an institution to maintain a certain level of Tier 1 and Tier 2 capital to risk-weighted assets. Tier 1 capital consists of common shareholders' equity, excluding the unrealized gain or loss on securities available for sale, minus certain intangible assets plus certain hybrid instruments up to 25% of Tier 1 capital, with the excess being treated as Tier 2 capital. Tier 2 capital also consists of the allowance for loan losses subject to certain limitations and qualifying subordinated debt. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 100% based on the risks believed inherent in the type of asset.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets and of Tier 1 capital to average assets which is known as the Tier 1 leverage ratio.

Under the capital guidelines, the Bank must maintain a minimum total risk-based capital of 8%, with at least 4% being Tier 1 capital. In addition, the Bank must maintain a minimum Tier 1 leverage ratio of at least 4%. To be considered "well-capitalized," the Bank must maintain total risk-based capital of at least 10%, Tier 1 risk based capital of at least 6%, and a leverage ratio of at least 5%.

Brokered certificates of deposits, which are used by the Bank as a funding alternative, were \$4.5 million, and \$0, at December 31, 2008 and 2007, respectively. The FDIC places restrictions on banks in regards to issuing brokered deposits based on the bank's level of capital. A well-capitalized institution may accept brokered deposits without FDIC restrictions. An adequately capitalized institution must obtain a waiver from the FDIC in order to accept brokered deposits, while an undercapitalized institution is prohibited by the FDIC from accepting brokered deposits.

The following table sets forth the Bank's capital ratios for each of the years ended December 31, 2008 and 2007. For all periods, the Bank was considered "well-capitalized" and met or exceeded its applicable regulatory requirements.

	<b>To Be Considered "Well- Capitalized" (1)</b>	<b>As of December 31, 2008</b>	<b>As of December 31, 2007</b>
<b>Highlands State Bank:</b>			
Total risk-based capital	10.0%	12.4%	25.3%
Tier I risk-based capital	6.0%	11.3%	24.5%
Tier I leverage capital (1)	5.0%	10.2%	20.6%

(1) The Federal Deposit Insurance Corporation required the Bank to maintain a ratio of Tier 1 leverage capital to total assets of at least 8% during the first three years of operation.

(2) Does not give effect to the incremental capital issued on May 8, 2009 pursuant to the CPP totaling \$3.1 million.

The decrease in Highlands State Bank's capital ratios from December 31, 2007, to December 31, 2008, is primarily due to the growth of the balance sheet resulting in increased risk-weighted assets and average total assets at December 31, 2008.

At the close of business on December 31, 2008, the Bank consummated its acquisition of Noble. The acquisition resulted in incremental capital for the Bank, after merger costs and other adjustments, of \$4.8 million, which was used for general corporate purposes, including, among other things, to provide additional capital to support asset growth and the expansion of the Bank's market presence.

***Return on Average Equity and Assets***

The following table shows the return on average assets (net income divided by total average assets), return on equity (net income divided by average equity), and the equity to assets ratio (average equity divided by total average assets) for each of the years ended December 31, 2008 and 2007.

	<b>At or For the Years Ended</b>	
	<b>December 31,</b>	
	<b>2008</b>	<b>2007</b>
Return on average assets	-1.70%	-2.48%
Return on average equity	-12.05%	-10.97%
Average equity to average assets ratio	14.09%	22.63%

Given that the Bank is still in the early stages of its development, with asset growth its primary goal, management does not believe these ratios are a meaningful way to measure performance.

***Effect of Inflation and Changing Prices***

The effect of relative purchasing power over time due to inflation has not been taken into effect in the Bank's consolidated financial statements. Rather, the statements have been prepared on a historical cost basis in accordance with accounting principles generally accepted in the United States of America.

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

***Off-Balance Sheet Arrangements***

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

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

The contract or notional amounts of financial instruments where contract amounts represent credit risk at December 31, 2008 and 2007 are as follows:

(Dollars in thousands)	<u>December 31, 2008</u>	<u>December 31, 2007</u>
Outstanding loan and credit line commitments	\$ 25,644	\$ 8,949
Outstanding letters of credit	678	506

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

Outstanding letters of credit written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. These standby letters of credit expire within twelve months of issuance. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending other loan commitments. The Bank requires collateral supporting these letters of credit as deemed necessary. Outstanding letters of credit at December 31, 2008 were \$678 thousand, of which \$455 were secured by collateral. Outstanding letters of credit at December 31, 2007 were \$506 thousand, of which \$456 thousand were secured by collateral. The current amount of the liability as of December 31, 2008 and 2007 for guarantees under standby letters of credit is not material.

### ***Liquidity***

The objective of liquidity management is to assure that sufficient sources of funds are available as needed and at a reasonable cost to meet the ongoing and unexpected operational cash needs and commitments of the Bank and to take advantage of income producing opportunities as they arise. Sufficient liquidity must be available to meet the cash requirements of depositors wanting to withdraw funds and of borrowers wanting their credit needs met. Additionally, liquidity is needed to insure that the Bank has the ability to act at those times when profitable new lending and/or investment opportunities arise. While the desired level of liquidity may vary depending upon a variety of factors, it is a primary goal of the Bank to maintain strong liquidity in all economic environments through active balance sheet management.

Liquidity management is the ongoing process of monitoring and managing the Bank's sources and uses of funds. The primary sources of funds are deposits, scheduled amortization of loan principal, maturities of investment securities and funds provided by operations. While scheduled loan payments and investment maturities are relatively predictable sources of funds, deposit flows and loan prepayments are far less predictable and are influenced by general interest rates, economic conditions and competition. The Bank measures and monitors its liquidity position on a frequent basis in order to better understand, predict and respond to balance sheet trends. The liquidity analysis encompasses a review of anticipated changes in loan balances, investments securities, core deposits and borrowed funds over a three month, six month and one year period.

The Bank maintains certain additional short-term borrowing facilities that can also be accessed for incremental funding. The Bank has a borrowing facility with a correspondent bank totaling \$5 million, with half of the credit available on an unsecured basis. The remaining half is a secured line of credit with security provided by a pledge of Bank investment assets. All secured facilities are available for short-term limited purpose usage.

As of December 31, 2008, the Bank's FHLB advances outstanding were \$9.5 million.

As of December 31, 2008 and 2007, the bank's liquid assets, consisting of cash and due from banks, interest bearing deposits of other banks, Federal funds sold and investment securities available for sale, totaled \$25.5 million, and \$8.5 million, respectively, representing 21.3% and 19.9 % of total assets, respectively.

### ***Interest Rate Sensitivity***

The primary objective of asset liability management is to optimize net interest income over time while maintaining a balance sheet mix that is prudent with respect to liquidity, capital adequacy and interest rate risk. Interest rate risk addresses the potential adverse impact of interest rates movements on the Bank's net interest income.

Market risk is the risk of loss from adverse changes in market prices and rates that principally arise from interest rate risk inherent in the Bank's lending, investing, deposit gathering, and borrowing activities. Other types of market risks, such as foreign currency exchange rate risk and commodity price risk, do not normally arise in the normal course of the Bank's business. The Bank actively monitors and manages its interest rate risk exposure.

One tool used to monitor interest rate risk is the measurement of its interest sensitivity "gap," which is the positive or negative dollar difference between interest earning assets and interest bearing liabilities that are subject to interest rate repricing within a given period of time. Interest rate sensitivity can be managed by repricing assets or liabilities, selling securities available for sale, or replacing an asset or liability at maturity. Managing the amount of assets and liabilities repricing in this same time interval helps to hedge the risk and minimize the impact on net interest income of rising or falling interest rates. The Bank generally would benefit from increasing market rates of interest when it has an asset-sensitive gap position and generally would benefit from decreasing market rates of interest when the Bank is liability-sensitive.

As of December 31, 2008, the Bank was liability sensitive over a one-year time frame. However, gap analysis is not a precise indicator of the interest sensitivity position. This analysis presents only a static view of the timing of maturities and repricing opportunities, without taking into consideration that changes in interest rates do not affect all assets and liabilities equally. For example, assumptions are made concerning the repricing characteristics of deposit products with no contractual maturities. Net interest income may be impacted by other significant factors in a given interest rate environment, including changes in the volume and mix of interest-earning assets and interest-bearing liabilities.

It is the responsibility of the board of directors and senior management to understand and control the interest rate risk exposures assumed by the Bank. The board has delegated authority to the asset liability management committee ("ALCO") for the development of ALCO policies and for the management of the asset liability management function. The ALCO committee is comprised of members of the Board and senior management of the Bank and meets quarterly, or more frequently as needed. The ALCO committee has the responsibility for maintaining a level of interest rate risk exposures within board approved limits.

The following table sets forth information regarding the Bank's interest rate sensitivity as of December 31, 2008, for each of the time intervals indicated. The information in the table may not be indicative of the Bank's interest rate sensitivity position at other points in time. In addition, management makes assumptions concerning the repricing characteristics of deposit products with no contractual maturities and the maturity distribution indicated in the table may differ from the contractual maturities of interest-earning assets due to consideration of prepayment speeds under various interest rate change scenarios in the application of interest rate sensitivity methods described above.

(Dollars in thousands)	<u>1-90 days</u>	<u>91-365 days</u>	<u>1-5 years</u>	<u>5 years and over</u>	<u>Total</u>
<b>Interest-Sensitive Assets</b>					
Federal funds sold and deposits in banks	\$ 5,821	\$ 297	\$ -	\$ -	\$ 6,118
Loans receivable	33,263	7,897	23,670	25,773	90,603
Investment securities available for sale	777	834	3,457	14,528	19,596
<b>Total Interest Earning Assets</b>	<u>\$ 39,861</u>	<u>\$ 9,028</u>	<u>\$ 27,127</u>	<u>\$ 40,301</u>	<u>\$ 116,317</u>
<b>Cumulative Total</b>	<u>\$ 39,861</u>	<u>\$ 48,889</u>	<u>\$ 76,016</u>	<u>\$ 116,317</u>	
<b>Interest-Sensitive Liabilities</b>					
Interest-bearing demand	\$ 843	\$ -	\$ -	\$ -	\$ 843
Savings accounts	22,225	-	-	-	22,225
Money market accounts	10,516	-	-	-	10,516
Time deposits	16,090	28,234	7,574	-	51,898
Borrowed funds	1,509	3,015	5,006	-	9,530
<b>Total Interest Sensitive Liabilities</b>	<u>\$ 51,183</u>	<u>\$ 31,249</u>	<u>\$ 12,580</u>	<u>\$ -</u>	<u>\$ 95,012</u>
<b>Cumulative Total</b>	<u>\$ 51,183</u>	<u>\$ 82,432</u>	<u>\$ 95,012</u>	<u>\$ 95,012</u>	
Gap	\$ (11,322)	\$ (22,221)	\$ 14,547	\$ 40,301	
Cumulative Gap	\$ (11,322)	\$ (33,543)	\$ (18,996)	\$ 21,305	
Interest-sensitive assets/interest-sensitive liabilities (cumulative)	0.8	0.6	0.8	1.2	
Cumulative Gap/total earning assets	(0.28)	(3.72)	(0.70)	0.53	

Based upon the interest rate gap shown in the table above, the Bank's interest rate sensitivity is within Board approved guidelines.

### Item 3. Properties.

The Bank currently leases its main banking office at 310 Route 94 in Vernon, New Jersey and each of its two branch locations at 351 Union Boulevard in Totowa, New Jersey and 351 Sparta Ave in Sparta, New Jersey.

<u>Leased Properties Location</u>	<u>Date Leased</u>	<u>Monthly Rental</u>	<u>Square Feet</u>	<u>Expiration of Term</u>
Vernon	4/5/2005	\$ 12,840.00	6,000	4/5/2016
Totowa	9/26/2008	\$ 2,500.00	1,375	9/30/2010
Sparta	8/31/2004	\$ 16,552.00	7,700	8/31/2014

### Item 4. Security Ownership of Certain Beneficial Owners and Management.

The following table sets forth information concerning the beneficial ownership of shares of Common Stock as of May 31, 2009, by (i) each person who is known by the Bank to own beneficially more than five percent (5%) of the issued and outstanding Common Stock, (ii) each director and nominee for director of the Bank, (iii) each executive officer of the Bank described in Item 6 of this Registration Statement "Executive Compensation" and (iv) all directors and executive officers of the Bank as a group.

<u>Name</u>	<b>Common Stock Beneficially Owned (1)</b>	<b>Percentage of Class (2)</b>
John V. Bosma	9,249 (3)	0.52%
E. Jane Brown	12,305 (3)	0.69%
Paul F. Castellano	15,500 (3)	0.87%
Peter J. Cofrancesco, III	14,929 (3)	0.83%
Terrance A. Duddy, DDS	15,724 (3)	0.88%
George E. Irwin	81,900 (4)	4.46%
Andrew J. Mulvihill	17,488 (5)	0.98%
Steven V. Oroho	18,985 (3)	1.06%
Jeffrey M. Parrott	16,515 (6)	0.92%
Dov Perlysky	32,300 (7)	1.81%
Edward H. Rolando	15,500 (3)	0.87%
Charles H. Shotmeyer	16,000 (3)	0.89%
Martin Theobald	15,500 (3)	0.87%
Doulgas Verduin	15,500 (3)	0.87%
Harold J. Wirths	14,929 (3)	0.83%
Bruce D. Zaretsky	<u>23,750</u> (8)	1.33%
All Executive Officers and Directors as a Group (16 persons)	<u><u>336,074</u></u> (9)	17.83%

- (1) The address for all persons listed is c/o Highlands State Bank, 310 Route 94, PO Box 160, Vernon, NJ 07462.
- (2) Based on 1,788,262 shares actually outstanding. Pursuant to SEC Regulation 13d, the percentage owned by each of the named individuals assumes the exercise of options held by that individual but the nonexercise of options held by any other stockholder, and the percentage owned by all executive officers and Directors as a group assumes the exercise of options held by all members of the group but the nonexercise of options held by any other stockholder.
- (3) Includes 3,000 shares purchasable upon the exercise of immediately exercisable options.
- (4) Includes 50,000 shares subject to stock options.
- (5) Includes 1,988 shares held jointly with wife.
- (6) Includes 397 shares held jointly with wife and 197 shares held by wife. Also includes 594 shares held as custodian for Carson, Carley & Connor Parrott, of which Mr. Parrott disclaims beneficial ownership and 397 shares owned by Parr Homes, Inc.
- (7) Includes 27,300 shares owned through limited liability companies over which Mr. Perlysky has sole voting power.
- (8) Includes 5,000 shares subject to stock options.
- (9) Includes 97,000 shares subject to stock options.

Other than as provided above, the following table sets forth information concerning the beneficial ownership of shares of Common Stock as of May 31, 2009 of all holders of common stock known to the Bank who beneficially own five (5%) percent or greater of our common stock.

<b>Name of Beneficial Owner of More Than 5% of the Common Stock</b>	<b>Number of Shares Beneficially Owned (1)</b>	<b>Percentage of Class</b>
Starboard Fund for New Bancs, L.P. 200 W. Adams Street, Suite 1015 Chicago, Illinois 60606	159,000	8.89%

- (1) Beneficially owned shares include shares over which the named person exercises either sole or shared voting power or sole or shared investment power. It also includes shares owned (i) by a spouse, minor children or by relatives sharing the same home, (ii) by entities owned or controlled by the named person, and (iii) by other persons if the named person has the right to acquire such shares within 60 days by the exercise of any right or option. Unless otherwise noted, all shares are owned of record and beneficially by the named person, either directly or through the dividend reinvestment plan.

**Item 5. Directors and Executive Officers.**

The following table sets forth the names, ages, principal occupations, and business experience for all directors of the Bank, Unless otherwise indicated, principal occupations shown for each Director have extended for five or more years.

<b>Name and Position with the Bank</b>	<b>Age</b>	<b>Principal Occupation for Past Five Years</b>	<b>Term of Office Commenced:</b>
John V. Bosma Director	42	President and manager/estimator of Boz Electrical Contractors, Inc. (electrical contractor), Vernon, NJ.	2005
E. Jane Brown Director	61	Chief Financial Officer, Pope John XXIII High School, Sparta, NJ.	2008
Paul F. Castellano Director	64	Operation Management Consultant, Allstate Blasting Corporation (explosives firm), Hamburg, NJ.	2005
Peter J. Cofranceso Director	37	Chairman, Grinnell Group of Companies (concrete products manufacturer).	2008
Terrence A. Duddy, DDS Director	69	Dentist	2008
George E. Irwin Director, President, CEO	65	President and Chief Executive Officer of the Bank since 2005; Director, American Bankers Professional Insurance Company (mutual insurance company) from 1999-2004.	2005
Andrew J. Mulvihill Director	46	President, Mountain Resort Properties (real estate brokerage), Vernon, NJ; Executive, Crystal Springs Builders LLC, Crystal Springs Development LLC, Crystal Springs Resort Development LLC and affiliates (real estate developer/builders), Vernon, NJ	2005
Steven V. Oroho Director	50	New Jersey State Senator, District 24.	2008
Jeffrey M. Parrott Vice-Chairman	53	President/CEO of Parr Homes, Inc., t/a Neil Parrott Real Estate (real estate brokerage), Wantage, NJ.	2008

Dov Perlysky Director	46	Managing Member, Neshor, LLC (private investment firm) since 2000; Director, Engex, Inc. (closed-end mutual fund); Director, Pharma-Bio Serv (pharmaceutical services); Vice President of Private Client Group, Laidlaw Global Securities (registered broker-dealer) from 1998-2002.	2006
Edward H. Rolando Director	66	General Manager, Earth-Tec Associates (site and utility contractor), Vernon, NJ.	2005
Charles H. Shotmeyer Director	45	Chief Financial Officer, Van Dyk Health Care, Inc. (assisted living services), Hawthorne, NJ.	2006
Martin Theobald Director	57	Owner, Heaven Hill Farm (retail garden center and farm market), in Vernon, NJ.	2005
Douglas Verduin Director	53	Certified Public Accountant and member, Berry, Verduin & Koch, LLC (certified public accountants), Ridgewood, NJ.	2005
Harold J. Wirths Director	43	Investor (self-employed); Owner, The Oak Shoppe (retail furniture store) from 1986 until 2004.	2008
Bruce D. Zaretsky Chairman of the Board	64	President and Chief Executive Officer, Glenwood Homes, Inc. (real estate construction), Vernon, NJ.	2005

To the Bank's knowledge, no Director of the Bank is also a director of a company having a class of securities registered under Section 12 of the Securities Exchange Act of 1934, as amended, or subject to the requirements of Section 15(d) of such Act or any company registered as an investment company under the Investment Company Act of 1940.

The following table sets forth the names, ages, principal occupations, and business experience for all non-director executive officers of the Bank. Unless otherwise indicated, principal occupations shown for each Director have extended for five or more years.

Name	Age	Positions With the Bank During the Last 5 Years	Term of Office (1) Commenced:
Eileen D. Piersa	47	Vice President and Chief Financial Officer, and Treasurer of the Bank (2005 - Present)	2005
Gerald R. Lake	68	Senior Loan Officer of the Bank since December 2006	2006

(1) Under New Jersey law, executive officers serve at the pleasure of the Board of Directors, without a fixed term.

#### Item 6. Executive Compensation.

The following table sets forth compensation paid to the CEO and the other most highly compensated executive officers of the Bank earning in excess of \$100,000 (the "named executive officers") as of the fiscal year ended December 31, 2008.

Name and Principal Position	Year	Salary (\$)	Bonus (\$)	Stock Awards (\$) <sup>(1)</sup>	Option Awards (\$) <sup>(1)</sup>	Non-equity Incentive Plan Compensation (\$)	All Other Compensation (\$)	Total (\$)
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George E. Irwin President and CEO	2008	164,500	0				12,000 (2)	176,500
	2007	160,000	0				12,000(2)	172,000
Gerald R. Lake Executive Vice President & Senior Lending Officer	2008	128,500	0					128,500
	2007	125,000	0					125,000

- (1) The amounts set forth represent our expense associated with stock option grants pursuant to SFAS 123(R).  
(2) Consists of an automobile allowance.

In 2005 the Bank entered into an Employment Agreement employing George E. Irwin as the Bank's President and Chief Executive Officer and to serve on the Bank board of directors for a five-year term. The term will be renewed automatically for one-year terms after 2010 unless either party provides notice of non-renewal to the other party at least 60 days before the employment anniversary date. Mr. Irwin's base salary for 2008 is \$164,500 per annum and his current annual auto allowance is \$12,000. If the Bank terminates Mr. Irwin's employment without "cause" (as defined in the Employment Agreement) after 2007, as a severance benefit the Bank will continue Mr. Irwin's salary for 12 months, plus accrued vacation and continuation of health benefits for one year. No severance will be due to Mr. Irwin if he terminates the Employment Agreement.

During the twelve (12) months Mr. Irwin is entitled to severance pay following a termination of his employment by Bank without cause, Mr. Irwin may not, within Sussex County, New Jersey or Orange County, New York, accept employment with or render any services to any other entity whose primary business is banking or employ or offer to employ in a professional capacity any officer or employee of the Bank. Furthermore, for two years after a termination of his employment with Highlands, Mr. Irwin will not solicit any customer of Highlands.

If Highlands terminates Mr. Irwin's employment for cause, he will not be entitled to a continuation of salary or other benefits after the termination date, but he will be entitled to a continuation of health benefits for himself and his covered dependents until his 65th birthday.

In the event of a termination of Mr. Irwin's employment as a result of a merger, acquisition of Highlands stock by another entity or a substantial change in ownership of Highlands during the term of his employment, Mr. Irwin will be entitled to severance pay of 2.99 times annual compensation unless he is requested to remain employed by the new entity at a position comparable in title, responsibility, authority and salary at a location within 10 miles of Highlands's current headquarters.

Had Mr. Irwin been terminated without cause at December 31, 2008, his severance payment would have been worth \$193,300. Had Highlands engaged in a change in control and had Mr. Irwin become entitled to severance under these provisions of his agreement, his severance would have been worth \$491,855.

During the second quarter of 2009, the Bank raised \$3.1 million in capital through its participation in the CPP. Under Treasury regulations applicable to all participants in the CPP, the Bank is prohibited from paying certain compensation to certain executive officers. As a result, the Bank is currently unable to pay severance to Mr. Irwin in the event his employment is terminated for any reason other than death or disability, including circumstances where his employment is terminated following a change in control of the Bank.

#### **OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END**

The Bank maintains three (3) stock option plans, the Highland State Bank 2006 Nonstatutory Stock Option Plan, the Highlands State Bank 2006 Incentive Stock Option Plan, and the Highland State Bank 2006 Nonemployee Directors Stock Option Plan (collectively, the "Plans"). Under the Plans, the Bank is authorized to issue options to purchase up to 150,000 shares of the Bank's common stock, in the aggregate. Each of the Plans will terminate in April of 2016.

**As of December 31, 2008**

	<b>Options</b>		
	<b>Granted</b>	<b>Vested</b>	<b>Unvested</b>
<b><u>2006 Non-Statutory Plan:</u></b>			
George E. Irwin	25,000	25,000	-
	<u>25,000</u>	<u>25,000</u>	-
<b><u>2006 Incentive Stock Option Plan:</u></b>			
Susan L. George	3,000	2,000	1,000
George E. Irwin	25,000	16,667	8,333
Gerald R. Lake	5,000	3,333	1,667
Eileen D. Piersa	3,000	2,000	1,000
Joanne E. Sagaas	3,000	2,000	1,000
	<u>39,000</u>	<u>26,000</u>	<u>13,000</u>

**2006 Non-Employee Directors Stock Option Plan:**

Parimal Bhayani	3,000	3,000	-
John V. Bosma	3,000	3,000	-
Thomas Bove	3,000	3,000	-
E. Jane Brown	3,000	3,000	-
David C. Canfield	3,000	3,000	-
Paul F. Castellano	3,000	3,000	-
Peter J. Cofrancesco, III	3,000	3,000	-
Terrence A. Duddy	3,000	3,000	-
Brian Fitzpatrick	3,000	3,000	-
Andrew J. Mulvihill	3,000	3,000	-
Steven V. Oroho	3,000	3,000	-
Jeffrey M. Parrott	3,000	3,000	-
Dov Perlysky	3,000	3,000	-
Edward H. Rolando	3,000	3,000	-
Charles H. Shotmeyer	3,000	3,000	-
Martin Theobald	3,000	3,000	-
Douglas Verduin	3,000	3,000	-
Joseph Vetere	3,000	3,000	-
David S. Wei	3,000	3,000	-
Harold J. Wirths	3,000	3,000	-
Bruce D. Zaretsky	5,000	5,000	-
	<u>65,000</u>	<u>65,000</u>	-

In connection with the merger with Noble, options were granted to members of the Boards of both the Bank and Noble.

## DIRECTOR COMPENSATION

Directors of the Bank do not currently receive cash compensation for their service on the Board of Directors. Directors do participate in the Bank's stock option plans, however. The table below sets forth the options held by each director at year end.

Name	Fees Earned or Paid in Cash (\$)	Stock Awards (shares)	Option Awards (shares) <sup>1</sup>	Total
John V. Bosma	0	0	3,000	3,000
E. Jane Brown	0	0	3,000	3,000
Paul F. Castellano	0	0	3,000	3,000
Peter J. Cofranceso	0	0	3,000	3,000
Terrence A. Duddy, DDS	0	0	3,000	3,000
George E. Irwin	0	0	3,000	3,000
Andrew J. Mulvihill	0	0	3,000	3,000
Steven V. Oroho	0	0	3,000	3,000
Jeffrey M. Parrott	0	0	3,000	3,000
Dov Perlisky	0	0	3,000	3,000
Edward H. Rolando	0	0	3,000	3,000
Charles H. Shotmeyer	0	0	3,000	3,000
Martin Theobald	0	0	3,000	3,000
Douglas Verduin	0	0	3,000	3,000
Harold J. Wirths	0	0	3,000	3,000
Bruce D. Zaretsky	0	0	5,000	5,000

1 – Stock Options Issued pursuant to the 2006 Non-statutory Plan.

### **Item 7. Certain Relationships and Related Transactions, and Director Independence.**

The Bank has had, and expects to have in the future, banking transactions in the ordinary course of its business with Directors, officers, principal stockholders and their associates on substantially the same terms, including interest rates and collateral on loans, as those prevailing at the same time for comparable transactions with others. Those transactions do not involve more than the normal risk of collectibility or present other unfavorable features.

The Bank is also a party to a lease agreement with Main Street Associates Inc., which is partially owned by Mr. Bosma and Mr. Zaretsky, who serve as directors of the Bank. The Board of Directors believes that this lease agreement is an arms length transaction, as favorable to the Bank as the Bank would have received from an unrelated third party.

#### *Board of Directors*

A majority of the board consists of individuals who are “independent” under the listing standards of the Nasdaq Stock Market (George E. Irwin is an officer of the Bank and is therefore not independent). The independent board members meet quarterly without any members not meeting the independence standard.

## Item 8. Legal Proceedings.

From time to time, the Bank is subject to other legal proceedings and claims in the ordinary course of business. The Bank currently is not aware of any such legal proceedings or claims that it believes will have, individually or in the aggregate, a material adverse effect on the business, financial condition, or operating results of the Bank.

## Item 9. Market Price of and Dividends on the Registrant's Common Equity and Related Stockholder Matters.

### Market Price

Presently, there is no active and liquid trading market for the Bank's common stock. The stock is approved for quotation on the OTC Bulletin Board under the ticker symbol HSBK.OB. However, trading in the Bank's common stock on such market has been infrequent and in very limited volume. Registrar and Transfer Company acts as the transfer agent and registrar for the common stock of the Bank.

There are six hundred (600) holders of the Bank's common stock. There are no other classes of equity stock of the Bank

The Bank has not paid any dividends to date and has no plans to do so in the immediate future. The Bank may, in the future pay dividends as declared from time to time by the Board of Directors out of funds legally available, subject to certain restrictions. Under the New Jersey Banking Act of 1948, the Bank may not pay a cash dividend unless, following the payment, the Bank's capital stock will be unimpaired and the Bank will have a surplus of no less than 50% of the Bank capital stock or, if not, the payment of the dividend will reduce the surplus. In addition, the Bank cannot pay dividends in such amounts as would reduce the Bank's capital below regulatory imposed minimums. Finally, as a participant in the CPP, the bank is unable to pay cash dividends without the prior approval of the UST.

### Equity Compensation Plans

<b>Plan category</b>	<b>Number of securities to be issued upon exercise of outstanding options, warrants and rights</b>	<b>Weighted-average exercise price of outstanding options, warrants and rights</b>	<b>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))</b>
	<b>(a)</b>	<b>(b)</b>	<b>(c)</b>
Equity compensation plans approved by security holders	129,000	\$10.00	21,000
Equity compensation plans not approved by security holders	0	0	0
<b>Total</b>	129,000	\$10.00	21,000

## Item 10. Recent Sales of Unregistered Securities.

As a commercial bank, all sales of the Bank's common stock are exempt from registration under Section 5 of the Securities Act of 1933, as amended (the "Act"), pursuant to Section 3(a)(3) of the Act. Therefore, no issuance of the Bank's stock to date has been registered under Section 5 of the Act.

## **Item 11. Description of Registrant's Securities to be Registered.**

### **Common Stock**

The authorized capital stock of the Bank consists of one class of 5,000,000 shares of common stock, \$5.00 par value per share. The Bank currently has 1,788,262 shares issued and outstanding. In addition, the Bank has issued options for an aggregate of 129,000 shares of common stock, and the Board of Directors has the authority to issue an additional option to purchase 21,000 shares of common stock.

*Dividends.* The Bank may pay dividends as declared from time to time by the Bank's Board of Directors out of funds legally available therefor, subject to certain restrictions. Under the New Jersey Banking Act of 1948 (the "Banking Act"), no cash dividend may be paid by the Bank unless, following the payment of such dividend, the capital stock of the Bank will be unimpaired and the Bank will have a surplus of no less than 50% of its capital stock or, if not, the payment of such dividend will not reduce the surplus of the Bank. In addition, the Bank cannot pay dividends in such amounts as would reduce its capital below the regulatory imposed minimums. Finally, as a participant in the CPP, the bank is unable to pay cash dividends without the prior approval of the UST.

*Voting Rights.* Each holder of the Common Stock is entitled to one vote for each share held on all matters voted upon by the shareholders, including the election of directors. There is no cumulative voting in the election of directors.

*Rights in Liquidation.* In the event of a liquidation, dissolution or winding up of the Bank, each holder of the Common Stock would be entitled to receive a pro rata portion of all assets of the Bank available for distribution to holders of the Common Stock after payment of all debts and liabilities of the Bank.

*No Preemptive Rights; Redemption.* Holders of shares of the Common Stock are not entitled to preemptive rights with respect to any shares of the Common Stock that may be issued. The Common Stock is not subject to call or redemption and is fully paid and nonassessable.

### **Preferred Stock**

The Bank has two classes of preferred stock, Series A Preferred Stock and Series B Preferred Stock. Set forth below is a summary of the material terms of the Bank's outstanding preferred stock. Each share of preferred stock was issued to the UST in connection with the Bank's participation in the CPP. The Bank issued 3,091 Series A preferred shares, the terms of which are described in more detail below, to the UST. In addition, the Bank also issued to the Treasury a warrant to purchase 155 shares of Series B preferred stock, the terms of which are also described in more detail below, for nominal additional consideration. The warrant was exercised simultaneously with the closing of the investment.

#### *Series A Preferred Stock*

- The Series A shares are non-voting;
- The Series A shares bear a non-cumulative 5% dividend for the first five years they are outstanding, and at a non-cumulative rate of 9% thereafter;
- The Series A shares can be redeemed at any time, with the consent of the FDIC, at the election of the Bank;
- For so long as Treasury holds the preferred stock, the following dividend restrictions apply:
  - Until the third anniversary of UST's investment, the Bank may not increase its cash dividends paid on its common stock without the UST's prior approval,
  - Between the third and tenth anniversary, the Bank may increase its cash dividends paid on its common stock, but any increase of more than 3% per year per share must be approved by the UST;
  - After the tenth anniversary, the Bank may not pay cash dividends unless and until it has repurchased all of the preferred stock.
- Until the tenth anniversary of the UST's investment, the Bank may not repurchase any equity or trust preferred security without the UST's consent, and after the tenth anniversary of the UST's investment, the Bank is prohibited from repurchasing any equity or trust preferred security; and

- All outstanding shares of the Series A preferred stock must be redeemed before the Series B preferred stock can be redeemed.

*Series B Preferred Stock*

The Series B preferred stock has terms identical to the Series A preferred stock, except that it bears a dividend rate of 9% from the date of issuance.

**Registrar and Transfer Agent**

The registrar and transfer agent for our common stock is Registrar & Transfer Company, Cranford, New Jersey.

**Item 12. Indemnification of Directors and Officers.**

The bank's certificate of incorporation provides that officers (for the duration permitted by the New Jersey Banking Act) and directors of the bank shall not be personally liable to the bank or its shareholders for damages for breach of any duty owed to the bank or its shareholders, except damages for breaches of duty based upon an act or omission (a) in breach of such person's duty of loyalty, (b) not in good faith or involving a knowing violation of law, or (c) resulting in receipt by such person of an improper personal benefit.

**Item 13. Financial Statements and Supplementary Data.**

The information required by this item follows.

**Item 14. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**

None.

**Item 15. Financial Statements and Exhibits.**

(a) List separately all financial statements filed as part of the registration statement.

The financial statements required by this Item follows:

- Balance Sheets
- Statements of Operations
- Statements of Stockholders' Equity
- Statements of Cash Flows
- Notes to Financial Statements

(b) Furnish the exhibits required by Item 601 of Regulation S-K (§229.601 of this chapter).

Exhibit	Description
3(i)	The Certificate of Incorporation of the Bank dated October 11, 200, as amended on April 17, 2009
3(ii)	The Bylaws of the Bank
10.1	Bank Merger Agreement dated as of August 5, 2008 by and between Highlands State Bank and Noble Community Bank
10.2	The Highland State Bank 2006 Nonstatutory Stock Option Plan dated March 9, 2006
10.3	The Highlands State Bank 2006 Incentive Stock Option Plan dated March 9, 2006
10.4	The Highland State Bank 2006 Nonemployee Directors Stock Option Plan dated March 9, 2006
10.5	Employment Agreement dated January 20, 2005 by and between the Bank and George Irwin.
10.6	Form of Series A Preferred Stock Certificate.

- 10.7 Form of Series B Preferred Stock Certificate.
- 10.8 Letter Agreement dated May 8, 2009, including the Securities Purchase Agreement – Standard Terms incorporated by reference therein, between the Bank and the United States Department of the Treasury.
- 10.9 Form of Waiver, executed by each of Messrs. George E. Irwin, Gerald R. Lake, Neill Schreyer and Patrick W. Smith and Ms. Eileen D. Piersa.

**SIGNATURES**

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this registration statement to be signed on its behalf by the undersigned, thereunto duly authorized.

Highlands State Bank

Dated: July 9, 2009

By: /s/ George E. Irwin  
George E. Irwin  
President and Chief Executive Officer

# *Highlands State Bank*

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## **Financial Statements**

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**December 31, 2008 and 2007**

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## Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders  
Highlands State Bank  
Vernon, New Jersey

We have audited the accompanying balance sheets of Highlands State Bank (the "Bank") as of December 31, 2008 and 2007, and the related statements of operations, stockholders' equity and cash flows for the years then ended. Highlands State Bank's management is responsible for these financial statements. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Bank is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Highlands State Bank as of December 31, 2008 and 2007, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

*Beard Miller Company LLP*

Beard Miller Company LLP  
Allentown, Pennsylvania  
June 16, 2009

# Highlands State Bank

## Balance Sheets

December 31, 2008 and 2007

	<u>2008</u>	<u>2007</u>
<b>Assets</b>		
Cash and due from banks	\$ 1,188,266	\$ 1,161,515
Interest bearing deposits in other banks	176,666	-
Federal funds sold	4,555,000	-
	<u>5,919,932</u>	<u>1,161,515</u>
Cash and Cash Equivalents	5,919,932	1,161,515
Time deposits in other banks	1,386,000	2,481,000
Securities available for sale	19,595,832	7,364,599
Restricted investment in bank stock	621,600	50,000
Loans receivable, net of allowance for loan losses 2008 \$1,147,192; 2007 \$304,144	89,455,706	31,022,872
Bank premises and equipment, net	1,172,883	468,443
Goodwill	756,917	-
Accrued interest receivable	559,497	216,292
Other assets	177,908	112,903
	<u>119,646,275</u>	<u>42,877,624</u>
<b>Total Assets</b>	<b>\$119,646,275</b>	<b>\$42,877,624</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
Deposits:		
Non-interest bearing	\$ 11,298,884	\$ 6,693,759
Interest-bearing	85,482,441	26,518,735
	<u>96,781,325</u>	<u>33,212,494</u>
Total Deposits	96,781,325	33,212,494
Federal funds purchased	-	759,000
Borrowings	9,529,526	-
Accrued interest payable	238,626	27,185
Other liabilities	614,281	177,369
	<u>107,163,758</u>	<u>34,176,048</u>
<b>Total Liabilities</b>	<b>107,163,758</b>	<b>34,176,048</b>
<b>Stockholders' Equity</b>		
Preferred stock, \$2 par value; authorized 3,256 shares; none issued	-	-
Common stock, \$5 par value; authorized 5,000,000 shares; issued and outstanding 2008 1,788,262 shares; 2007 1,095,159 shares	8,941,310	5,475,795
Surplus	7,073,787	5,730,086
Accumulated deficit	(3,558,863)	(2,566,089)
Accumulated other comprehensive income	26,283	61,784
	<u>12,482,517</u>	<u>8,701,576</u>
<b>Total Stockholders' Equity</b>	<b>12,482,517</b>	<b>8,701,576</b>
	<u>119,646,275</u>	<u>42,877,624</u>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$119,646,275</b>	<b>\$42,877,624</b>

See notes to financial statements.

# Highlands State Bank

## Statements of Operations

Years Ended December 31, 2008 and 2007

	<u>2008</u>	<u>2007</u>
<b>Interest Income</b>		
Loans	\$2,626,037	\$1,391,941
Securities	483,877	444,557
Federal funds sold	35,481	173,047
Other	<u>68,582</u>	<u>192,073</u>
<b>Total Interest Income</b>	<u>3,213,977</u>	<u>2,201,618</u>
<b>Interest Expense</b>		
Deposits	1,141,157	853,184
Borrowings	<u>120,403</u>	<u>8,149</u>
<b>Total Interest Expense</b>	<u>1,261,560</u>	<u>861,333</u>
<b>Net Interest Income</b>	1,952,417	1,340,285
<b>Provision for Loan Losses</b>	<u>409,858</u>	<u>225,631</u>
<b>Net Interest Income after Provision for Loan Losses</b>	<u>1,542,559</u>	<u>1,114,654</u>
<b>Non-Interest Income</b>		
Fee and service charges	140,197	58,879
Other income	24,969	6,161
Impairment loss on securities	<u>(96,960)</u>	<u>-</u>
<b>Total Non-Interest Income</b>	<u>68,206</u>	<u>65,040</u>
<b>Non-Interest Expenses</b>		
Salaries and employee benefits	1,281,562	1,003,342
Share-based compensation	47,598	100,596
Occupancy and equipment	408,614	365,367
Professional fees	138,172	108,469
Advertising and promotion	104,299	74,547
Data processing	263,930	186,557
Other	<u>359,364</u>	<u>245,966</u>
<b>Total Non-Interest Expenses</b>	<u>2,603,539</u>	<u>2,084,844</u>
<b>Net Loss</b>	<u>\$ (992,774)</u>	<u>\$ (905,150)</u>
<b>Loss per Share - Basic and Diluted</b>	<u>\$ (0.91)</u>	<u>\$ (0.89)</u>
<b>Weighted Average Common Shares Outstanding - Basic and Diluted</b>	<u>1,095,159</u>	<u>1,017,928</u>

See notes to financial statements.

# Highlands State Bank

## Statements of Stockholders' Equity Years Ended December 31, 2008 and 2007

	<u>Common Stock</u>	<u>Surplus</u>	<u>Accumulated Deficit</u>	<u>Accumulated Other Comprehensive Income (Loss)</u>	<u>Total</u>
<b>Balance - December 31, 2006</b>	\$5,000,000	\$5,153,695	\$(1,660,939)	\$ 550	<u>\$8,493,306</u>
Comprehensive loss:					
Net loss	-	-	(905,150)	-	(905,150)
Net change in unrealized gain on securities available for sale	-	-	-	61,234	<u>61,234</u>
<b>Total Comprehensive Loss</b>					<u>(843,916)</u>
Stock warrants exercised (95,159 shares)	475,795	475,795	-	-	951,590
Share-based compensation expense	-	100,596	-	-	<u>100,596</u>
<b>Balance - December 31, 2007</b>	5,475,795	5,730,086	(2,566,089)	61,784	<u>8,701,576</u>
Comprehensive loss:					
Net loss	-	-	(992,774)	-	(992,774)
Net change in unrealized gain on securities available for sale	-	-	-	(35,501)	<u>(35,501)</u>
<b>Total Comprehensive Loss</b>					<u>(1,028,275)</u>
Acquisition of Noble Community Bank (693,103 shares issued)	3,465,515	1,296,103	-	-	4,761,618
Share-based compensation expense	-	47,598	-	-	<u>47,598</u>
<b>Balance - December 31, 2008</b>	<u>\$8,941,310</u>	<u>\$7,073,787</u>	<u>(\$3,558,863)</u>	<u>\$26,283</u>	<u>\$12,482,517</u>

See notes to financial statements.

# Highlands State Bank

## Statements of Cash Flows

Years Ended December 31, 2008 and 2007

	<u>2008</u>	<u>2007</u>
<b>Cash Flows from Operating Activities</b>		
Net loss	\$ (992,774)	\$ (905,150)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	100,145	85,492
Amortization and accretion, net	(10,961)	(74,416)
Impairment loss on securities	96,960	-
Provision for loan losses	409,858	225,631
Share-based compensation expense	47,598	100,596
Increase in accrued interest receivable	(49,252)	(84,006)
Increase in other assets	(208,768)	(66,489)
Increase in accrued interest payable	59,819	20,248
Increase in other liabilities	216,978	54,462
<b>Net Cash Used in Operating Activities</b>	<u>(330,397)</u>	<u>(643,632)</u>
<b>Cash Flows from Investing Activities</b>		
Net decrease in time deposits	1,293,000	195,000
Purchases of securities available for sale	(5,861,662)	(1,306,061)
Maturities and principal repayments on securities available for sale	5,030,780	3,375,167
Net increase in loans receivable	(27,313,384)	(23,453,760)
Net increase in Federal Home Loan Bank stock	(287,100)	-
Purchases of premises and equipment	(178,437)	(87,214)
Net cash received from acquisition	1,518,605	-
<b>Net Cash Used in Investing Activities</b>	<u>(25,798,198)</u>	<u>(21,276,868)</u>
<b>Cash Flows from Financing Activities</b>		
Net increase in deposits	26,646,012	10,659,818
Increase (decrease) in federal funds purchased	(759,000)	759,000
Proceeds from borrowings	5,000,000	-
Stock warrants exercised	-	951,590
<b>Net Cash Provided by Financing Activities</b>	<u>30,887,012</u>	<u>12,370,408</u>
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	4,758,417	(9,550,092)
<b>Cash and Cash Equivalents - Beginning</b>	<u>1,161,515</u>	<u>10,711,607</u>
<b>Cash and Cash Equivalents - Ending</b>	<u>\$ 5,919,932</u>	<u>\$ 1,161,515</u>
<b>Supplementary Cash Flows Information</b>		
Interest paid	<u>\$ 1,201,741</u>	<u>\$ 841,085</u>

See notes to financial statements.

# ***Highlands State Bank***

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## **Notes to Financial Statements**

**December 31, 2008 and 2007**

### **Note 1 - Summary of Significant Accounting Policies**

#### **Organization and Nature of Operations**

Highlands State Bank (the “Bank” or “Highlands”) is a New Jersey state chartered bank which commenced operations on October 31, 2005. The Bank is a full service bank providing personal and business lending and deposit services. As a state chartered bank, the Bank is subject to regulation of the New Jersey Department of Banking and Insurance and the Federal Deposit Insurance Corporation. The area served by the Bank is the Sussex County area of New Jersey.

#### **Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, determination of other than temporary impairment of securities and the valuation of deferred tax assets.

#### **Significant Group Concentrations of Credit Risk**

Most of the Bank’s activities are with customers located within northern New Jersey. Note 3 discusses the types of securities that the Bank invests in. Note 4 discusses the types of lending that the Bank engages in. Although the Bank has a diversified loan portfolio, its debtors’ ability to honor their contracts is influenced by the region’s economy. The Bank does not have any significant concentrations to any one industry or customer.

#### **Presentation of Cash Flows**

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

#### **Time Deposits in Other Banks**

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

#### **Securities**

Management determines the appropriate classification of debt securities at the time of purchase and re-evaluates such designation as of each balance sheet date.

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

# ***Highlands State Bank***

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## **Notes to Financial Statements**

**December 31, 2008 and 2007**

### **Note 1 - Summary of Significant Accounting Policies (Continued)**

#### **Securities (Continued)**

Securities classified as held to maturity are those debt securities the Bank has both the intent and ability to hold to maturity regardless of changes in market conditions, liquidity needs or changes in general economic conditions. These securities are carried at cost, adjusted for the amortization of premium and accretion of discount, computed by the interest method over the terms of the securities. At December 31, 2008 and 2007, the Bank had no securities classified as held to maturity.

Declines in the fair value of securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

#### **Restricted Investment in Bank Stock**

Restricted stock is comprised of stock of the Federal Home Loan Bank of New York (FHLB) in the amount of \$521,600 and Atlantic Central Bankers Bank in the amount of \$100,000. Federal law requires a member institution of the FHLB to hold stock according to a predetermined formula. All restricted stock is recorded at cost. The FHLB has recently notified member banks that it is reducing dividend rates and taking steps to improve liquidity. Management has evaluated the restricted stock for impairment and believes no impairment charge was necessary at December 31, 2008.

#### **Loans Receivable**

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

The accrual of interest is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectibility of principal or interest, even though the loan is currently performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on nonaccrual status, all interest accrued but not collected is reversed against interest income. Interest received on nonaccrual loans generally is either applied against principal or reported as interest income, according to management's judgment as to the collectibility of principal. Generally, a loan is restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time and the ultimate collectibility of the total contractual principal and interest is no longer in doubt.

# ***Highlands State Bank***

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## **Notes to Financial Statements**

**December 31, 2008 and 2007**

### **Note 1 - Summary of Significant Accounting Policies (Continued)**

#### **Allowance for Loan Losses**

The allowance for loan losses is established through provisions for loan losses charged against income. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management's periodic evaluation of the adequacy of the allowance is based on known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revisions as more information becomes available.

The allowance consists of specific, general, and unallocated components. The specific component relates to loans that are classified as either doubtful, substandard, or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and home equity loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

# ***Highlands State Bank***

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## **Notes to Financial Statements**

**December 31, 2008 and 2007**

### **Note 1 - Summary of Significant Accounting Policies (Continued)**

#### **Transfers of Financial Assets**

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

#### **Bank Premises and Equipment**

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

#### **Interest Rate Risk**

The Bank is principally engaged in the business of attracting deposits from the general public and using these deposits, together with other funds, to make loans secured by real estate and to purchase securities. The potential for interest-rate risk exists as a result of the difference in duration of the Bank's interest-sensitive liabilities compared to its interest-sensitive assets. For this reason, management regularly monitors the maturity structure of the Bank's interest-earning assets and interest-bearing liabilities in order to measure its level of interest-rate risk and to plan for future volatility.

#### **Advertising Costs**

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

#### **Income Taxes**

Deferred income taxes are provided on the liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and net operating loss carryforwards and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

# Highlands State Bank

## Notes to Financial Statements

December 31, 2008 and 2007

### Note 1 - Summary of Significant Accounting Policies (Continued)

#### Share-Based Compensation

In 2006, the Board of Directors approved the Highlands State Bank 2006 Nonstatutory Stock Option Plan, the Highlands State Bank 2006 Incentive Stock Option Plan and the Highlands State Bank 2006 Nonemployee Directors Stock Option Plan (2006 Option Plans). Prior to 2006, the Bank had no stock option plans or stock-based compensation. The Bank accounts for stock-based compensation under the fair value recognition provisions of FASB Statement No. 123(R), "Share-Based Payment." Statement No. 123(R) replaces Statement No. 123, supersedes APB Opinion No. 25 and requires compensation costs related to share-based payment transactions to be recognized in the financial statements over the period that an employee provides service in exchange for the award. Statement No. 123(R) was effective for all companies on January 1, 2006. Share-based compensation expense of \$47,598 and \$100,596 is included in the accompanying statement of operations for the years ended December 31, 2008 and 2007, respectively. There were no tax benefits recognized on the stock compensation expense.

#### Comprehensive Loss

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income (loss). 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 (loss), are components of comprehensive income (loss).

The components of other comprehensive income (loss) are as follows for the years ended December 31, 2008 and 2007:

	<u>2008</u>	<u>2007</u>
Unrealized holding gains (losses) on securities available for sale	\$(132,461)	\$61,234
Reclassification adjustment for realized losses included in the statement of operations	<u>96,960</u>	<u>-</u>
	<u>\$ (35,501)</u>	<u>\$61,234</u>

#### Off-Balance Sheet Financial Instruments

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

#### Segment Reporting

The Bank acts as an independent, community, financial services provider, and offers traditional banking and related financial services to individual, business and government customers. The Bank offers a full array of commercial and retail financial services, including the taking of time, savings and demand deposits; the making of commercial, consumer and home equity loans; and the provision of other financial services.

Management does not separately allocate expenses, including the cost of funding loan demand, between the commercial and retail operations of the Bank. As such, discrete financial information is not available and segment reporting would not be meaningful.

# ***Highlands State Bank***

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## **Notes to Financial Statements**

**December 31, 2008 and 2007**

### **Note 1 - Summary of Significant Accounting Policies (Continued)**

#### **Earnings (Loss) Per Common Share**

Basic earnings (loss) per share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Bank relate solely to outstanding stock options, and are determined using the treasury stock method. Potential common shares were not dilutive due to the net loss incurred by the Bank for the years ended December 31, 2008 and 2007.

#### **Recent Accounting Pronouncements**

In December 2007, the FASB issued Statement No. 141(R), *Business Combinations*. This Statement establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree. The Statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This new pronouncement will impact the Bank's accounting for business combinations after January 1, 2009.

Also in December 2007, the FASB issued Statement No. 160, *Non-controlling Interests in Consolidated Financial Statements – an amendment of ARB No. 51* (“SFAS 160”). SFAS 160 establishes accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. The guidance will become effective for fiscal years beginning after December 15, 2008. The Bank believes that this new pronouncement will have an immaterial impact on the Bank's financial statements in future periods.

In February 2008, the FASB issued FASB Staff Position 140-3, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions* (“FSP 140-3”). FSP 140-3 addresses the issue of whether or not these transactions should be viewed as two separate transactions or as one “linked” transaction. FSP 140-3 includes a “rebuttable presumption” that presumes linkage of the two transactions unless the presumption can be overcome by meeting certain criteria. FSP 140-3 will be effective for fiscal years beginning after November 15, 2008 and will apply only to original transfers made after that date; early adoption will not be allowed. The Bank believes that this new pronouncement will have an immaterial impact on the Bank's financial statements in future periods.

In March 2008, the FASB issued Statement No 161, *Disclosures about Derivative Instruments and Hedging Activities-and amendment of FASB Statement No. 133* (Statement 161). Statement No. 161 requires entities that utilize derivative instruments to provide qualitative disclosures about their objectives and strategies for using such instruments, as well as any details of credit-risk-related contingent features contained within derivatives. Statement 161 also requires entities to disclose additional information about the amounts and location of derivatives located within the financial statements, how the provisions of SFAS 133 has been applied, and the impact that hedges have on an equity's financial position, financial performance, and cash flows. Statement 161 is effective for fiscal years and interim periods beginning after November 15, 2008, with earlier application encouraged. The Bank adopted Statement No. 161 on January 1, 2009. The adoption of this statement did not have any effect on the Bank's financial position or results of operations.

# Highlands State Bank

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## Notes to Financial Statements

December 31, 2008 and 2007

### Note 1 - Summary of Significant Accounting Policies (Continued)

#### Recent Accounting Pronouncements (Continued)

In April 2008, the FASB issued FASB Staff Position 142-3, *Determination of the Useful Life of Intangible Assets* ("FSP 142-3"). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Assets* ("SFAS 142"). The intent of FSP 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141R, and other GAAP. FSP 142-3 is effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The Bank expects that FSP 142-3 will not have an impact on its financial statements.

In June 2008, the FASB issued Staff Position (FSP) EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*. This FSP clarifies all outstanding unvested share-based payment awards that contain rights to nonforfeitable dividends participating securities in undistributed earnings with common shareholders. Awards of this nature are considered participating securities and the two-class method of computing basic and diluted earnings per share must be applied. This FSP is effective for fiscal years beginning after December 15, 2008 and interim periods within those years. The Bank adopted Staff Position (FSP) EITF 03-6-1 on January 1, 2009. The adoption of this staff position did not have any effect on the Bank's financial position or results of operations.

In September 2008, the FASB issued FSP 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161* (FSP 133-1 and FIN 45-4). FSP 133-1 and FIN 45-4 amends and enhances disclosure requirements for sellers of credit derivatives and financial guarantees. It also clarifies that the disclosure requirements of SFAS No. 161 are effective for quarterly periods beginning after November 15, 2008, and fiscal years that include those periods. FSP 133-1 and FIN 45-4 is effective for reporting periods (annual or interim) ending after November 15, 2008. The Bank adopted FSP 133-1 and FIN 45-4 on January 1, 2009. The adoption of this staff position did not have any effect on the Bank's financial position or results of operations.

In November 2008, the SEC released a proposed roadmap regarding the potential use by the U.S. issuers of financial statements prepared in accordance with International Financial Reporting Standards (IFRS). IFRS is a comprehensive series of accounting standards published by the International Accounting Standards Board ("IASB"). Under the proposed roadmap, the Bank may be required to prepare financial statements in accordance with IFRS as early as 2014. The SEC will make a determination in 2011 regarding the mandatory adoption of IFRS. The Bank is currently assessing the impact that this potential change would have on its financial statements, and will continue to monitor the development of the potential implementation of IFRS.

In April 2009, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) No. FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (FSP FAS 157-4). FASB Statement 157, *Fair Value Measurements*, defines fair value as the price that would be received to sell the asset or transfer the liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. FSP FAS 157-4 provides additional guidance on determining when the volume and level of activity for the asset or liability has significantly decreased. The FSP also includes guidance on identifying circumstances when a transaction may not be considered orderly.

#### Note 1 - Summary of Significant Accounting Policies (Continued)

##### Recent Accounting Pronouncements (Continued)

FSP FAS 157-4 provides a list of factors that a reporting entity should evaluate to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability. When the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability, further analysis of the information from that market is needed and significant adjustments to the related prices may be necessary to estimate fair value in accordance with Statement 157.

This FSP clarifies that when there has been a significant decrease in the volume and level of activity for the asset or liability, some transactions may not be orderly. In those situations, the entity must evaluate the weight of the evidence to determine whether the transaction is orderly. The FSP provides a list of circumstances that may indicate that a transaction is not orderly. A transaction price that is not associated with an orderly transaction is given little, if any, weight when estimating fair value.

This FSP is effective for interim and annual reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. An entity early adopting FSP FAS 157-4 must also early adopt FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*. The Bank is currently reviewing the effect this new pronouncement will have on its financial statements.

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (FSP FAS 115-2 and FAS 124-2). FSP FAS 115-2 and FAS 124-2 clarify the interaction of the factors that should be considered when determining whether a debt security is other-than-temporarily impaired. For debt securities, management must assess whether (a) it has the intent to sell the security and (b) it is more likely than not that it will be required to sell the security prior to its anticipated recovery. These steps are done before assessing whether the entity will recover the cost basis of the investment. Previously, this assessment required management to assert it has both the intent and the ability to hold a security for a period of time sufficient to allow for an anticipated recovery in fair value to avoid recognizing an other-than-temporary impairment. This change does not affect the need to forecast recovery of the value of the security through either cash flows or market price.

In instances when a determination is made that an other-than-temporary impairment exists but the investor does not intend to sell the debt security and it is not more likely than not that it will be required to sell the debt security prior to its anticipated recovery, FSP FAS 115-2 and FAS 124-2 changes the presentation and amount of the other-than-temporary impairment recognized in the income statement. The other-than-temporary impairment is separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings.

The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income.

# ***Highlands State Bank***

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## **Notes to Financial Statements**

**December 31, 2008 and 2007**

### **Note 1 - Summary of Significant Accounting Policies (Continued)**

#### **Recent Accounting Pronouncements (Continued)**

This FSP is effective for interim and annual reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. An entity early adopting FSP FAS 115-2 and FAS 124-2 must also early adopt FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*. The Bank is currently reviewing the effect this new pronouncement will have on its financial statements.

In April 2009, the FASB issued FSP No. FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (FSP FAS 107-1 and APB 28-1). FSP FAS 107-1 and APB 28-1 amends FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. This FSP also amends APB Opinion No. 28, *Interim Financial Reporting*, to require those disclosures in summarized financial information at interim reporting periods.

This FSP is effective for interim and annual reporting periods ending after June 15, 2009, with early adoption permitted for periods ending after March 15, 2009. An entity early adopting FSP FAS 107-1 and APB 28-1 must also early adopt FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* and FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*. The Bank is currently reviewing the effect this new pronouncement will have on its financial statements.

### **Note 2 - Acquisition of Noble Community Bank**

Effective at the close of business on December 31, 2008, Highlands completed its acquisition of Noble Community Bank (“Noble”), a de novo bank headquartered in Sparta, New Jersey. Noble commenced operations on August 29, 2005. Noble, with \$46.0 million in total assets, \$31.5 million in loans and \$36.9 million in deposits as of December 31, 2008, merged into Highlands. The acquisition expands the Bank’s branch network in Sussex County, New Jersey with an office in Sparta.

The acquisition was consummated pursuant to the Agreement and Plan of Merger, dated as of August 5, 2008, by and among Highlands and Noble. Under the Purchase Agreement, Highlands acquired 100% of the outstanding shares of Noble which was merged with and into Highlands. Each outstanding share of Noble common stock was converted into 0.7953 shares of Highlands common stock. Highlands issued 693,103 shares of common stock in the merger transaction.

Under the terms of the merger agreement, Noble was permitted to grant members of its board of directors stock options to purchase 33,949 shares of Noble common stock at an exercise price of \$7.953 per share. These options were assumed by the Highlands in the merger and will be subject to the terms of Highlands existing stock options plans. As adjusted for the exchange ratio of 0.7953, these optionholders, in the aggregate, have the option to purchase 27,000 shares of Highlands common stock at \$10.00 per share through April 20, 2016. The options vested immediately. The fair value of these stock options was \$10,813 and was determined using the Black-Scholes option pricing model.

# Highlands State Bank

## Notes to Financial Statements

December 31, 2008 and 2007

### Note 2 - Acquisition of Noble Community Bank (Continued)

The purchase price of Noble includes the value of Highlands common stock issued in the amount of \$4,761,618, in exchange for all the common stock of Noble. The value of the common shares issued was determined based on the fair value of Highlands common stock of \$6.87 per share as determined by an independent fair value appraisal process performed concurrently with the signing of the definitive merger agreement.

The acquisition has been accounted for using the purchase method of accounting in accordance with SFAS No. 141, "Business Combinations," which requires that Highlands' financial statements include Noble's results of operations beginning January 1, 2009. The following table summarizes the fair values of Noble's assets acquired and liabilities assumed at the date of acquisition.

<u>Balance Sheet Acquired</u>	<u>December 31, 2008</u>
<b>Assets</b>	
Cash and cash equivalents	\$ 1,518,600
Securities available for sale	11,521,851
Loans receivable	31,997,820
Allowance for loan losses	<u>468,512</u>
Net Loans	31,529,308
Other assets	<u>1,418,818</u>
<b>Total Assets</b>	<u>45,988,577</u>
<b>Liabilities</b>	
Noninterest-bearing deposits	2,583,670
Interest-bearing deposits	34,339,149
Borrowings	4,529,526
Other liabilities	<u>371,555</u>
<b>Total Liabilities</b>	<u>41,823,900</u>
<b>Net Assets Acquired</b>	<u><u>\$ 4,164,677</u></u>

# Highlands State Bank

## Notes to Financial Statements

December 31, 2008 and 2007

### Note 2 - Acquisition of Noble Community Bank (Continued)

The following table provides the calculation of the goodwill at December 31, 2008:

<b>Purchase Price</b>	
Noble common stock outstanding	871,753
Exchange ratio	<u>0.7953</u>
Highlands common stock issued	693,103
Market value of Highlands common share	<u>\$ 6.87</u>
Purchase price assigned to shares exchanged for stock	\$4,761,618
Purchase price assigned to cash for fractional shares	1,389
Transaction costs and fair value of vested stock options	<u>158,587</u>
<b>Total Purchase Price</b>	<u>4,921,594</u>
<b>Net Assets Acquired</b>	
Seller stockholders' equity	4,660,886
Estimated adjustments to reflect assets acquired at fair value:	
Loans	(309,981)
Operating lease	(63,155)
Estimated amount allocated to liabilities assumed at fair value:	
Time deposits	(93,547)
Borrowings	<u>(29,526)</u>
Fair value of net assets acquired	<u>4,164,677</u>
<b>Goodwill Resulting from Acquisition</b>	<u>\$ 756,917</u>

The fair value of certain assets (loans) and certain liabilities (fixed rate time deposits) was determined using a discounted cash flow analysis and applying a discount rate which uses assumptions that marketplace participants would use in estimating fair values. In other instances, it was assumed that the historical book value of certain assets and liabilities represented a reasonable proxy of fair value. Since Noble is a de novo banking operation, it is assumed that there is no core deposit intangible related to the acquisition due to the limited time of existence and the limited "stability" of the deposit base of Noble. It was determined that there were no other categories of identifiable intangible assets arising from the Noble acquisition. It was also determined that there were no material purchase accounting adjustments needed with respect to SOP 03-03, "Accounting for Certain Loans and Debt Securities Acquired in a Transfer."

# Highlands State Bank

## Notes to Financial Statements

December 31, 2008 and 2007

### Note 2 - Acquisition of Noble Community Bank (Continued)

The following pro forma combined results of operations for the years ended December 31, 2008 and 2007, give effect to the acquisition as if the merger had been completed on January 1, 2007. The pro forma results show the combination of Noble's results into Highlands' statements of operations. While adjustments have been made for the estimated effect of purchase accounting, the pro forma results do not reflect the actual result the combined company would have achieved had the combination occurred at the beginning of the period.

	<b>Pro Forma Year Ended December 31, 2008</b>	<b>Pro Forma Year Ended December 31, 2007</b>
Net interest income	<b>\$3,190,407</b>	\$2,325,482
Net loss	<b>(2,185,920)</b>	(1,693,678)

Goodwill of \$756,917 was recorded in connection with the acquisition of Noble. The Bank currently has one reporting segment, banking, which will be used to evaluate potential impairment of goodwill in the future.

Goodwill related to the merger with Noble is not deductible for tax purposes. Due to the net operating losses previously incurred by the banks, deferred tax assets are reduced by a valuation allowance until such time as, in the opinion of management, it is more likely than not that some portion of the deferred tax assets will be realized. Therefore, no deferred tax component has been recorded related to this transaction.

Noble has a net operating loss ("NOL") for tax purposes which will carry forward for the benefit of Highlands in future years. As of December 31, 2008, the NOL for Noble was approximately \$3,300,000. As it becomes evident that the Bank will be able to utilize the NOL from Noble, it would be recognized going forward. IRS Section 382 applies a limitation as to how much of the carryforward NOL can be used in any one year and must be utilized within a specified period (20 years). As Highlands is able to utilize the NOL of Noble in future periods, the impact of this reduction in Highlands' tax liability would be recorded as a reduction of goodwill.

The following table summarizes the impact of the accretion of the fair value adjustments made in connection with the combination on Highlands' results of operations for the following years:

<b>Projected Future Amounts for the Years Ended December 31</b>	<b>Net Interest Income Accretion</b>	<b>Occupancy Net Accretion</b>	<b>Net Increase in Income before Income Taxes</b>
2009	\$113,117	\$ 8,238	\$121,355
2010	55,158	8,238	63,396
2011	43,167	8,238	51,405
2012	41,100	8,238	49,338
2013	40,014	8,238	48,252
2014 and thereafter	108,512	21,965	130,477

# Highlands State Bank

## Notes to Financial Statements

December 31, 2008 and 2007

### Note 2 - Acquisition of Noble Community Bank (Continued)

The following methods and periods were used for the accretion of the fair value adjustments:

Loans	- level yield method over the life of the loans.
Investment securities	- straight line method over a one year period.
Premises	- straight line method over ninety two months, the remaining term of the lease.
Time deposits	- level yield method over the life of the certificates.

### Note 3 - Securities Available for Sale

The amortized cost, gross unrealized gains and losses, and estimated fair value of securities available for sale at December 31, 2008 and 2007 are as follows:

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
<b>December 31, 2008:</b>				
U.S. Government agencies and sponsored agencies	\$15,367,824	\$100,481	\$ -	\$15,468,305
Mortgage-backed securities	3,394,124	115,344	-	3,509,468
Other	807,601	-	189,542	618,059
	<u>\$19,569,549</u>	<u>\$215,825</u>	<u>\$189,542</u>	<u>\$19,595,832</u>
<b>December 31, 2007:</b>				
U.S. Government agencies and sponsored agencies	\$3,992,931	\$17,014	\$1,087	\$4,008,858
Mortgage-backed securities	3,009,884	45,311	-	3,055,195
Other	300,000	546	-	300,546
	<u>\$7,302,815</u>	<u>\$62,871</u>	<u>\$1,087</u>	<u>\$7,364,599</u>

# Highlands State Bank

## Notes to Financial Statements

December 31, 2008 and 2007

### Note 3 - Securities Available for Sale (Continued)

The amortized cost and fair value of securities at December 31, 2008 by contractual maturity are shown below. Expected maturities may differ from contractual maturities because the borrowers may have the right to prepay obligations with or without penalties.

	Available for Sale	
	Amortized Cost	Fair Value
Due within one year	\$ 1,500,534	\$ 1,526,971
Due after one year through five years	1,750,000	1,759,586
Due after five years through ten years	1,902,634	1,904,485
Due after ten years	11,022,257	10,895,322
Mortgage-backed securities	3,394,124	3,509,468
	<u>\$19,569,549</u>	<u>\$19,595,832</u>

The tables below shows the Bank's securities, their gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2008 and 2007:

	Less than Twelve Months		Twelve Months or More		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
<b>December 31, 2008:</b>						
Other	<u>\$613,498</u>	<u>\$189,542</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$613,498</u>	<u>\$189,542</u>
<b>December 31, 2007:</b>						
U.S. Government agencies and sponsored agencies	<u>\$ -</u>	<u>\$ -</u>	<u>\$997,117</u>	<u>\$1,087</u>	<u>\$997,117</u>	<u>\$ 1,087</u>

At December 31, 2008, the Bank had eight securities in an unrealized loss position. These eight securities consist of individual trust preferred securities issued by large financial institutions. The decline in fair value is due in large part to the lack of an active trading market for these securities and rating agency downgrades. None of the issuers have defaulted on interest payments. Management concluded that these securities were not other-than-temporarily impaired at December 31, 2008. The Bank has the intent and ability to hold such investments until maturity or market price recovery. Future deterioration in the credit quality of these large financial institutions could result in impairment charges in the future.

The Bank held Fannie Mae perpetual preferred stock at December 31, 2008 with a cost basis of \$100,000. These securities were subject to an other-than-temporary impairment ("OTTI") charge. On September 7, 2008, the Federal Housing Finance Agency placed both Fannie Mae and Freddie Mac under conservatorship. Although this action did not eliminate the equity in Fannie Mae and Freddie Mac represented by the perpetual preferred stock, it has negatively impacted the value of the perpetual preferred stock. The fair value of these securities at December 31, 2008 was \$3,040 and the OTTI charge taken in the year ended December 31, 2008 was \$96,960. There was no tax benefit recognized on this impairment charge for the year ended December 31, 2008.

# Highlands State Bank

## Notes to Financial Statements

December 31, 2008 and 2007

### Note 4 - Loans Receivable

The composition of loans receivable at December 31, 2008 and 2007 are as follows:

	<u>2008</u>	<u>2007</u>
Commercial real estate	<b>\$34,856,357</b>	\$14,683,425
Commercial	<b>11,462,870</b>	4,199,435
Construction	<b>4,690,357</b>	66,014
Residential real estate	<b>10,142,551</b>	851,932
Home equity	<b>29,167,132</b>	11,390,263
Consumer	<b>198,838</b>	120,726
<b>Total Loans</b>	<b><u>90,518,105</u></b>	<u>31,311,795</u>
Allowance for loan losses	<b>(1,147,192)</b>	(304,144)
Net deferred loan (fees) costs	<b>84,793</b>	15,221
	<b><u>(1,062,399)</u></b>	<u>(288,923)</u>
	<b><u>\$89,455,706</u></b>	<u>\$31,022,872</u>

The following is an analysis of the allowance for loan losses for the years ended December 31:

	<u>2008</u>	<u>2007</u>
Balance, beginning	<b>\$ 304,144</b>	\$ 78,513
Provision for loan losses	<b>409,858</b>	225,631
Charge-offs	<b>(35,322)</b>	-
Acquisition of Noble Community Bank	<b>468,512</b>	-
Balance, ending	<b><u>\$1,147,192</u></b>	<u>\$304,144</u>

At December 31, 2008, impaired loans totaled \$1,397,994 and were subject to specific loan allowances in the amount of \$85,575. The average recorded investment in impaired loans totaled approximately \$675,000. No interest income was recognized during the period of impairment. At and during the year ended December 31, 2007, no loans were classified as impaired.

At December 31, 2008, there was \$675,000 in nonaccrual loans and \$593,071 of loans greater than 90 days past due and still accruing interest.

At December 31, 2007, there were no non-accrual loans and no loans greater than 90 days past due and still accruing interest.

# Highlands State Bank

## Notes to Financial Statements

December 31, 2008 and 2007

### Note 5 - Financial Instruments with Off-Balance Sheet Risk

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

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

The contract or notional amounts of financial instruments where contract amounts represent credit risk at December 31, 2008 and 2007 are as follows:

	<u>December 31,</u> <u>2008</u>	<u>December 31,</u> <u>2007</u>
Outstanding loan and credit line commitments	<b>\$25,664,000</b>	\$8,949,000
Outstanding letters of credit	<b>678,000</b>	506,000

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

Outstanding letters of credit written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. These standby letters of credit expire within the next twelve months. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending other loan commitments. The Bank requires collateral supporting these letters of credit as deemed necessary. Outstanding letters of credit at December 31, 2008 were \$678,000, of which \$455,000 were secured by collateral. Outstanding letters of credit at December 31, 2007 were \$506,000, of which \$456,000 were secured by collateral. The current amount of the liability as of December 31, 2008 and 2007 for guarantees under standby letters of credit is not material.

# Highlands State Bank

## Notes to Financial Statements

December 31, 2008 and 2007

### Note 6 - Bank Premises and Equipment

The components of premises and equipment at December 31, 2008 and 2007 are as follows:

	<b>Estimated Useful Lives</b>	<b>2008</b>	<b>2007</b>
Leasehold improvements	2 - 10 years	\$ 852,626	\$286,182
Furniture, fixtures and equipment	5 - 10 years	397,167	194,658
Computer equipment and data processing software	3 - 5 years	182,378	146,746
		<b>1,432,171</b>	627,586
Accumulated depreciation		<b>(259,288)</b>	(159,143)
		<b>\$1,172,883</b>	<b>\$468,443</b>

### Note 7 - Deposits

The components of deposits at December 31, 2008 and 2007 are as follows:

	<b>2008</b>	<b>2007</b>
Demand, non-interest bearing	\$11,298,884	\$ 6,693,759
Demand interest bearing	843,618	362,561
Money market accounts	10,515,213	4,313,609
Savings	22,225,348	14,578,767
Time, \$100,000 and over	24,014,437	2,129,578
Time, other	27,883,825	5,134,220
	<b>\$96,781,325</b>	<b>\$33,212,494</b>

At December 31, 2008, the scheduled maturities of time deposits are as follows:

2009	\$44,537,947
2010	2,430,986
2011	839,388
2012	2,031,820
2013	2,058,121
	<b>\$51,898,262</b>

# Highlands State Bank

## Notes to Financial Statements

December 31, 2008 and 2007

### Note 8 - Lease Commitments

The Bank leases its banking facilities under operating lease agreements expiring through 2016. The Bank is also required to pay a monthly fee for its portion of certain operating expenses, including real estate taxes, insurance, utilities, maintenance and repairs in addition to the base rent. Rent expense for the years ended December 31, 2008 and 2007 totaled \$169,675 and \$162,000, respectively.

One of the lease agreements is with a related party. In 2005, the Bank entered into a ten-year operating lease agreement with this related party for its main banking office. The lease terms are comparable to similarly outfitted office space in the Bank's market. Total rent expense paid to the related party under this lease agreement was \$162,000 and \$162,000 for the years ended December 31, 2008 and 2007, respectively.

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

2009	\$ 383,694
2010	381,269
2011	362,899
2012	367,827
2013	372,903
Thereafter	<u>928,691</u>
	<u><u>\$2,797,283</u></u>

### Note 9 - Borrowings

The Bank has a \$5,000,000 line of credit with Atlantic Central Bankers Bank (ACBB) for federal funds purchased of which \$0- and \$759,000 was outstanding at December 31, 2008 and 2007, respectively. The line of credit expires May 31, 2009. \$2,500,000 of the line of credit is unsecured and \$2,500,000 of the line of credit is secured by securities held by ACBB in safekeeping.

The Bank has \$9,500,000 in borrowings with the Federal Home Loan Bank of New York (FHLB) with a weighted average interest rate of 2.64%.

The FHLB borrowings mature as follows:

2009	\$4,500,000
2010	2,000,000
2012	1,000,000
2013	<u>2,000,000</u>
	9,500,000
Fair value adjustment	<u>29,526</u>
	<u><u>\$9,529,526</u></u>

# ***Highlands State Bank***

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## **Notes to Financial Statements**

**December 31, 2008 and 2007**

### **Note 9 - Borrowings (Continued)**

The \$2,000,000 advance maturing in 2013 contains a convertible option which allows the FHLB at quarterly intervals commencing after each conversion date, to convert the fixed convertible advance into replacement funding for the same or lesser principal based on any advance then offered by the FHLB at their then current market rate. The Bank has the option to repay this advance, if converted, without penalty.

The FHLB borrowings are secured under terms of a blanket collateral agreement by a pledge of qualifying collateral.

### **Note 10 - Stockholders' Equity**

During 2005, the Bank sold 1,000,000 shares of common stock at \$10 per share which resulted in net proceeds of \$9,965,990 (net of offering cost of \$34,010) under an initial stock offering which was fully subscribed.

In conjunction with the Bank's initial stock offering, each stockholder was issued a unit which consisted of one share of the Bank's common stock and a stock purchase warrant to purchase 0.25 shares of the Bank's common stock. Four warrants allowed the holder to purchase one share of common stock at an exercise price of \$10.00. Accordingly, there were 1,000,000 stock warrants issued under the initial stock offering enabling holders to purchase 250,000 shares of the Bank's common stock. The warrants were exercisable through October 11, 2007. Through that date, 380,661 warrants were exercised to purchase 95,159 shares of the Bank's common stock for total proceeds of \$951,590. Warrants that expired without exercise totaled 619,339, representing 154,801 shares of common stock.

In June 2007, the Bank's Board of Directors approved the issuance of new stock warrants (2007 stock warrants) to its stockholders who fully exercised their initial stock warrants on or before October 11, 2007. The 2007 stock warrants are equal to the number of initial stock warrants that had not been exercised. Accordingly, 619,339 initial warrants had lapsed and 619,296 2007 stock warrants, as adjusted for fractional shares, were reissued to those stockholders who fully exercised their initial warrants. Four 2007 stock warrants allow the holder to purchase one share of common stock at an exercise price of \$10.00 per share through October 11, 2008, enabling holders to purchase 154,801 shares of common stock. The 2007 stock warrants were issued based on the proportion of stock owned, with limitations on stockholders who may exceed a 10% ownership interest. It was also approved that if any of the 2007 stock warrants lapse on October 11, 2008 without exercising, those warrants can be reallocated to stockholders who exercised the 2007 stock warrants with the right to exercise such warrants through November 28, 2008. After November 28, 2008, any unexercised 2007 stock warrants shall be reallocated to the Board of Directors with the right to exercise such warrants through December 31, 2008. The reallocations are based on ownership interests. No 2007 stock warrants were exercised through December 31, 2008.

The New Jersey Department of Banking and Insurance, in issuing its charter to the Bank, required an allocation of its initial capital to an expense fund in the amount of \$155,000 to defray anticipated initial losses and a reserve of \$620,000 for contingencies. Accordingly, \$775,000 of the Bank's surplus is reserved for these purposes until the Bank becomes profitable.

# Highlands State Bank

## Notes to Financial Statements

December 31, 2008 and 2007

### Note 11 - Federal Income Taxes

There is no provision for income taxes for the years ended December 31, 2008 and 2007 due to the net operating losses incurred by the Bank since inception. The deferred tax benefit related to such losses has not been recognized due to the uncertainty of realization. Accordingly, a valuation allowance has been recorded on the Bank's net deferred tax assets as shown in the table below.

The components of the net deferred tax asset (liability) at December 31, 2008 and 2007 are as follows:

	<u>2008</u>	<u>2007</u>
Deferred tax assets:		
Organization and start-up costs	\$ 211,736	\$ 110,569
Net operating loss carryforwards	2,336,084	784,966
Allowance for loan losses	433,215	109,727
Non-qualified stock option compensation	<u>76,721</u>	<u>68,853</u>
	3,057,756	1,074,115
Valuation allowance	<u>(2,947,954)</u>	<u>(976,195)</u>
<b>Total Deferred Tax Assets, Net of Valuation Allowance</b>	<u>109,802</u>	<u>97,920</u>
Deferred tax liabilities:		
Cash basis conversion	(84,259)	(62,764)
Depreciation	<u>(25,543)</u>	<u>(35,156)</u>
<b>Total Deferred Tax Liabilities</b>	<u>(109,802)</u>	<u>(97,920)</u>
<b>Net Deferred Tax Asset</b>	<u>\$ -</u>	<u>\$ -</u>

At December 31, 2008, the Bank has available unused net operating loss carryforwards available for federal and state income tax purposes of approximately \$5,800,000, which start to expire in 2025 for federal purposes and 2012 for state purposes.

# Highlands State Bank

## Notes to Financial Statements

December 31, 2008 and 2007

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

The Bank has had, and may be expected to have in the future, banking transactions in the ordinary course of business with its executive officers, directors, principal stockholders, their immediate families and affiliated companies (commonly referred to as related parties), on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with others. Deposits of related parties totaled \$6,829,500 and \$20,947,400 at December 31, 2008 and 2007, respectively. Activity with respect to loans to related parties for the year ended December 31, 2008 is as follows:

	<u>2008</u>
Balance, beginning	\$3,055,045
Loans originated	235,000
Collection of principal	(479,045)
Acquisition of Noble Community Bank	<u>2,588,068</u>
Balance, ending	<u>\$5,399,068</u>

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

### Note 13 - Stock Option Plans

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

The 2006 Plans enable the Board of Directors to grant stock options to executives, other key employees and nonemployee directors. The Bank has reserved 150,000 shares of common stock for issuance upon the exercise of options granted under the 2006 Plans. Such shares may be issued from authorized but unissued shares or previously issued shares that the Bank may hereafter reacquire (treasury stock). The 2006 Plans will terminate ten years from stockholder approval. Options may not be granted with an exercise price that is less than 1) 100% of the fair market value of the Bank's common stock on the date of grant or 2) the par value of the common stock or 3) \$10.00 for any option granted before January 1, 2009. Options may not be granted with a term longer than 10 years. Stock options granted under the Incentive Plan are subject to limitations under Section 422 of the Internal Revenue Code. The Incentive Plan also has special terms for individuals that own more than 10% of the Bank's common stock, of which there is no one at December 31, 2008. Vesting, exercisability, and other conditions related to an option will be waived in the event of a "change in control" of the Bank, as defined in the 2006 Plans. The number of shares available under the 2006 Plans, the number of shares subject to outstanding options and the exercise price of outstanding options will be adjusted to reflect any stock dividend, stock split, merger, reorganization or other event generally affecting the number of the Bank's outstanding shares. At December 31, 2008, there were 21,000 shares available for grant under the 2006 Plans.

# Highlands State Bank

## Notes to Financial Statements

December 31, 2008 and 2007

### Note 13 - Stock Option Plans (Continued)

The following is a summary of the Bank's stock option activity and related information for its 2006 Plans for the years ended December 31, 2008 and 2007:

	<u>Options</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Remaining Contractual Term</u>	<u>Aggregate Intrinsic Value</u>
Outstanding at December 31, 2006	99,000	\$10.00		
Forfeited	(3,000)	10.00		
Outstanding at December 31, 2007	96,000	10.00		
Granted	6,000	10.00		
Acquisition of Noble Community Bank	27,000	10.00		
Outstanding at December 31, 2008	<u>129,000</u>	<u>\$10.00</u>	<u>7.3 years</u>	<u>\$ -</u>
Exercisable at December 31, 2008	<u>107,667</u>	<u>\$10.00</u>	<u>7.3 years</u>	<u>\$ -</u>

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions for grants in 2008: dividend yield of 0%, risk-free interest rate of 2.30%, expected life of 3.75 years, and expected volatility of 20%. The volatility percentage was based on the average expected volatility of similar public financial institutions in the Bank's market area. The weighted average fair value of options granted in 2008 was \$0.40.

Total share-based compensation cost for the years ended December 31, 2008 and 2007 related to the Bank's stock option plans was \$47,598 and \$100,596, respectively. There were no tax benefits recognized related to the share-based compensation expense due to the net operating loss incurred.

As of December 31, 2008, there was \$11,155 of unrecognized compensation cost related to nonvested stock options. That cost is expected to be recognized on a graded vesting method over a weighted average period of 1.0 year.

### Note 14 - Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet the minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank'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, risk-weightings and other factors.

# Highlands State Bank

## Notes to Financial Statements

December 31, 2008 and 2007

### Note 14 - Regulatory Matters (Continued)

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets and of Tier 1 capital to average assets. Management believes, as of December 31, 2008, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2008, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category.

The Federal Deposit Insurance Corporation requires that the Bank maintain a ratio of Tier 1 leverage capital to total assets of at least 8% during the first three years of operation which ended October 31, 2008.

The Bank's actual capital amounts and ratios at December 31, 2008 and 2007 are presented below:

	Actual		For Capital Adequacy Purposes				To be Well Capitalized under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio		
(Dollar Amounts in Thousands)								
<b>December 31, 2008</b>								
Total capital (to risk-weighted assets)	\$12,783	12.4 %	\$28,245	≥8.0 %	\$210,306	≥10.0 %		
Tier 1 capital (to risk-weighted assets)	11,637	11.3	≥4,123	≥4.0	≥ 6,184	≥ 6.0		
Tier 1 capital (to adjusted average assets)	11,637	10.2	≥4,569	≥4.0	≥ 5,711	≥ 5.0		
<b>December 31, 2007</b>								
Total capital (to risk-weighted assets)	\$8,944	25.3 %	\$22,827	≥8.0 %	\$23,533	≥10.0 %		
Tier 1 capital (to risk-weighted assets)	8,640	24.5	≥1,413	≥4.0	≥2,120	≥ 6.0		
Tier 1 capital (to adjusted average assets)	8,640	20.6	≥3,355	≥8.0	≥3,355	≥ 8.0		

The Bank is subject to certain restrictions on the amount of dividends that it may declare due to regulatory considerations.

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

Management uses its best judgment in estimating the fair value of the Bank's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Bank could have realized in a sales transaction on the dates indicated. The estimated fair value amounts have been measured as of year end and have not been re-evaluated or updated for purposes of these financial statements subsequent to year end. As such, the estimated fair values of these financial instruments subsequent to December 31, 2008 may be different than the amounts reported at year end.

In September 2006, the FASB issued Statement No. 157, "Fair Value Measurements" ("SFAS 157"), which defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. SFAS 157 applies to other accounting pronouncements that require or permit fair value measurements. The Bank adopted SFAS 157 effective for its fiscal year beginning January 1, 2008.

# Highlands State Bank

## Notes to Financial Statements

December 31, 2008 and 2007

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

In December 2007, the FASB issued FASB Staff Position (FSP) No. SFAS 157-2, “*Effective Date of FASB Statement No. 157*” (“FSP 157-2”). This FSP delays the effective date of SFAS 157 for all non-financial assets and liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008 and interim periods within those fiscal years. As such, the Bank only partially adopted the provisions of SFAS 157, and will begin to account and report for non-financial assets and liabilities in 2009. In October 2008, the FASB issued FASB Staff Position 157-3, “*Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active*” (“FSP 157-3”), to clarify the application of the provisions of SFAS 157 in an inactive market and how an entity would determine fair value in an inactive market. FSP 157-3 is effective immediately and applies to our December 31, 2008 financial statements. The adoption of SFAS 157, FSP 157-2 and FSP 157-3 had no impact on the amounts reported in the financial statements.

The primary effect of SFAS 157 on the Bank was to expand the required disclosures pertaining to the methods used to determine fair values.

SFAS 157 establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under SFAS 157 are as follows:

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

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

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

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

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2008 are as follows:

Description	December 31, 2008	(Level 1)	(Level 2)	(Level 3)
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
Securities available for sale	<u>\$19,595,832</u>	<u>\$ -</u>	<u>\$19,595,832</u>	<u>\$ -</u>

# Highlands State Bank

## Notes to Financial Statements

December 31, 2008 and 2007

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

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2008 are as follows:

Description	December 31, 2008	(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
Impaired loans	\$1,312,419	\$ -	\$ -	\$1,312,419

The following information should not be interpreted as an estimate of the fair value of the entire Bank since a fair value calculation is only provided for a limited portion of the Bank's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Bank's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Bank's financial instruments at December 31, 2008.

#### Cash and Cash Equivalents (Carried at Cost)

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

#### Time Deposits in Other Banks (Carried at Cost)

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

#### Securities Available for Sale (Carried at Fair Value)

The fair value of securities available for sale are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. For certain securities which are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence (Level 3). In the absence of such evidence, management's best estimate is used. Management's best estimate consists of both internal and external support on certain Level 3 investments. Internal cash flow models using a present value formula that includes assumptions market participants would use along with indicative exit pricing obtained from broker/dealers (where available) were used to support fair values of certain Level 3 investments.

# ***Highlands State Bank***

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## **Notes to Financial Statements**

**December 31, 2008 and 2007**

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

#### **Loans Receivable (Carried at Cost)**

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

#### **Impaired Loans (Generally Carried at Fair Value)**

Impaired loans are those that are accounted for under FASB Statement No. 114, "*Accounting by Creditors for Impairment of a Loan*" ("SFAS 114"), in which the Bank has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value consists of the loan balances of \$1,397,994, net of a valuation allowance of \$85,575.

#### **Restricted Investment in Bank Stock (Carried at Cost)**

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

#### **Accrued Interest Receivable and Payable (Carried at Cost)**

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

#### **Deposit Liabilities (Carried at Cost)**

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

#### **Borrowings (Carried at Cost)**

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

#### **Off-Balance Sheet Financial Instruments (Disclosed at Cost)**

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

# Highlands State Bank

## Notes to Financial Statements

December 31, 2008 and 2007

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

The following table summarizes the carrying amount and fair value estimates of the Bank's financial instruments at December 31, 2008:

	<b>Carrying or Notional Amount</b>	<b>Fair Value</b>
	(In Thousands)	
<b>Financial Assets:</b>		
Cash and cash equivalents	\$ 5,920	\$ 5,920
Time deposits in other banks	1,386	1,386
Securities available for sale	19,596	19,596
Loans receivable, net	89,456	88,689
Restricted investment in bank stock	622	622
Accrued interest receivable	559	559
<b>Financial Liabilities:</b>		
Demand and savings deposits	44,883	44,883
Time deposits	51,898	52,180
Borrowings	9,530	9,530
Accrued interest payable	239	239
<b>Off-Balance Financial Instruments:</b>		
Commitments to extend credit	-	-
Letters of credit	-	-

### Note 16 - Subsequent Event

In October 2008, the United States Treasury Department announced a voluntary Capital Purchase Program, a part of the Troubled Asset Relief Program (TARP), to encourage U.S. financial institutions to build capital to increase the flow of financing to U.S. businesses and consumers and to support the U.S. economy. Highlands State Bank applied for these capital funds prior to December 31, 2008 and received approval in January 2009.

On May 8, 2009, the Bank issued to the Treasury (i) 3,091 shares of the Bank's Series 2009A Preferred Stock and (ii) a warrant to purchase 155 shares of the Bank's Series 2009B Preferred Stock for an aggregate purchase price of \$3,091,000 in cash ("TARP funds"). The warrant was exercised as a cashless exercise on May 8, 2009 and 155 shares of Series 2009B Preferred Stock were issued. Both series of preferred stock qualify as a Tier 1 capital. Series 2009A Preferred Stock will pay cumulative dividends of 5% per annum for the first five years and 9% per annum thereafter. Series 2009B Preferred Stock will pay dividends of 9% per annum.