

Highlands Community Bank Audit Committee Charter

MISSION STATEMENT

The Audit Committee shall assist the Board of Directors in fulfilling its oversight responsibilities. The Audit Committee shall review the financial reporting process, the system of internal control, the audit process, and the company's process for monitoring compliance with laws and regulations with the Board of Directors, Management, and the Internal and External Auditors. To effectively perform his or her role, each committee member shall obtain an understanding of the detailed responsibilities of committee membership as well as the company's business, operations, and risks.

Independence is defined under the Code of Profession Conduct (Rule 101) as a highly subjective term because it concerns an individual's ability to act with integrity and objectivity. Integrity relates to honesty, while objectivity is the ability to be neutral during the conduct of the engagement and the preparation of the report.

ORGANIZATION

Committee Composition

The Audit committee shall be comprised of three or more directors as determined by the Board, each of whom shall be independent directors, and free from any relationship that, in the opinion of the Board, would interfere with the exercise of his or her independent judgment as a member of the Committee. All members should have a working familiarity with basic finance and accounting practices, and at least one member of the Committee shall have accounting or related financial management expertise. Committee members may enhance their familiarity with finance and accounting by participating in educational programs conducted by the Corporation or an outside consultant.

Unless a Chair is elected by the full Board, the members of the Committee may designate a Chair by majority vote of the full Committee membership.

Frequency of Meetings

The Audit Committee shall hold four regular meetings each year. Any member of the Committee, the Internal Auditor or the External Auditor can make a request to the Chairperson for special meetings. For both regular and special meetings, a quorum must be present in order to transact official business.

ROLES & RESPONSIBILITIES

Internal Control

- Evaluate whether management is setting the appropriate tone at the top by communicating the importance of internal control and ensuring that all individuals possess an understanding of their roles and responsibilities
- Focus on the extent to which internal and external auditors review computer systems and applications, the security of such systems and applications, and the contingency plan for processing financial information in the event of a systems breakdown
- Gain an understanding of whether internal control recommendations made by internal and external auditors have been implemented by management
- Ensure that the internal auditors keep the audit committee informed about fraud, illegal acts, deficiencies in internal control, and certain other matters

Financial Reporting

General

- Review significant accounting and reporting issues, including recent professional and regulatory pronouncements, and understand their impact on the financial statements
- Ask management and the internal and external auditors about significant risks and exposures and the plans to minimize such risks

Annual Financial Statements

- Review the annual financial statements and determine whether they are complete and consistent with the information known to committee members; assess whether the financial statements reflect appropriate accounting principles
- Pay particular attention to complex and/or unusual transactions such as restructuring changes and derivative disclosures
- Focus on judgmental areas such as those involving valuation of assets and liabilities, including, for example, the accounting for and disclosure of loan losses; warranty, product, and environmental liability; litigation reserves; and other commitments and contingencies
- Meet with management and the external auditors to review the financial statements and the results of the audit

- Consider Management's handling of proposed audit adjustments identified by the external auditors
- Review Management's Discussion and Analysis and other sections of the annual report before its release and consider whether the information is adequate and consistent with member's knowledge about the company and its operations
- Ensure that the external auditors communicate certain required matters to the committee

Interim Financial Statements

- Be briefed on how management develops and summarizes quarterly financial information, the extent of internal audit involvement, the extent to which the external auditors review quarterly financial information, and whether that review is performed on a pre- or post-issuance basis
- Meet with management and, if a pre-issuance review was completed, with the external auditors, either telephonically or in person, to review the interim financial statements and the results of the review (this may be done by the committee Chairperson or the entire committee)
- To gain insight into fairness of the interim statements and disclosures, obtain explanations from management and from internal and external auditors on whether;
 - Actual financial results for the quarter or interim period varied significantly from budgeted or projected results
 - Changes in financial ratios and relationships in the interim financial statements are consistent with changes in the company's operations and financing practices
 - Generally accepted accounting principles have been consistently applied
 - There are any actual or proposed changes in accounting or financial reporting practices
 - There are any significant or unusual events or transactions
 - The company's financial and operating controls are functioning effectively
 - The company has complied with the terms of loan agreements or security indentures
- Ensure that the external auditors communicate certain required matters to the committee

Compliance with Laws and Regulations

- Review the effectiveness of the system for monitoring compliance with laws and regulations, and the results of management's investigation and follow-up (including disciplinary action) on any fraudulent acts or accounting irregularities
- Periodically obtain updates from management, general counsel, and tax director regarding compliance
- Be satisfied that all regulatory compliance matters have been considered in the preparation of the financial statements
- Review the findings of any examinations by regulatory agencies, such as the Virginia Bureau of Financial Institutions, the Federal Reserve Bank or Securities and Exchange Commission

Internal Audit

- Review the activities and organizational structure of the internal audit function
- Review the qualifications of the internal audit function and concur in the appointment, replacement, assignment, or dismissal of the director of internal audit
- Review the effectiveness of the internal audit function

External Audit

- Review the external auditors' proposed audit scope and approach
- Review the performance of the external auditors and recommend to the board of directors the appointment or discharge of the external auditors
- Review and confirm the independence of the external auditors by reviewing the nonaudit services provided and the auditors' assertion on their independence in accordance with professional standards

Other Responsibilities

- Meet with external auditors, director of internal audit and management in separate executive sessions to discuss any matters that the committee or these groups believe should be discussed privately

- Ensure that significant findings and recommendations made by the internal and external auditors are received and discussed on a timely basis
- If necessary, institute special investigations and, if appropriate, hire special counsel or experts to assist
- Perform other oversight functions as requested by the full board
- Review and update the charter, receive approval of changes from the board

REPORTING RESPONSIBILITIES

- Regularly update the board of directors about committee activities and make appropriate recommendations