HERITAGE FINANCIAL CORP /WA/
Form 10-K
March 06, 2013
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2012

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File No. 0-29480

HERITAGE FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Washington **(State or other jurisdiction of** **incorporation or organization)**	**91-1857900** **(IRS Employer** **Identification No.)**
201 Fifth Avenue SW, Olympia, Washington **(Address of principal executive offices)**	**98501** **(Zip Code)**

(360) 943-1500

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock	**NASDAQ Stock Market LLC**

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨ Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant was $204,600,054 and was based upon the last sales price as quoted on the NASDAQ Stock Market for June 30, 2012.

The registrant had 15,117,253 shares of common stock outstanding as of February 21, 2013.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive Proxy Statement for the 2013 Annual Meeting of Shareholders will be incorporated by reference into Part III of this Form 10-K.

HERITAGE FINANCIAL CORPORATION

FORM 10-K

December 31, 2012

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PART I

ITEM 1. BUSINESS

General

Heritage Financial Corporation (the Company) is a bank holding company that was incorporated in the State of Washington in August 1997. We were organized for the purpose of acquiring all of the capital stock of Heritage Savings Bank upon our reorganization from a mutual holding company form of organization to a stock holding company form of organization. Effective September 1, 2004, Heritage Savings Bank switched its charter from a state chartered savings bank to a state chartered commercial bank and changed its legal name from Heritage Savings Bank to Heritage Bank. Effective September 1, 2005, Central Valley Bank (acquired by the Company in March 1999) changed its charter from a nationally chartered commercial bank to a state chartered commercial bank.

In June 2006, the Company completed the acquisition of Western Washington Bancorp and its wholly owned subsidiary, Washington State Bank, N.A. Washington State Bank, N.A. was merged into Heritage Bank on the date of acquisition. Effective July 30, 2010, Heritage Bank entered into a definitive agreement with the Federal Deposit Insurance Corporation (the FDIC), pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Cowlitz Bank, a Washington state-chartered commercial bank headquartered in Longview, Washington (the Cowlitz Acquisition). The Cowlitz Acquisition included nine branches of Cowlitz Bank, including its division Bay Bank, which opened as branches of Heritage Bank on August 2, 2010. The acquisition also included the Trust Services Division of Cowlitz Bank. Effective November 5, 2010, Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Pierce Commercial Bank, a Washington state-chartered commercial bank headquartered in Tacoma, Washington (the Pierce Commercial Acquisition). The Pierce Commercial Acquisition included one branch, which opened as a branch of Heritage Bank on November 8, 2010. On September 14, 2012, the Company announced that it had entered into a definitive agreement along with Heritage Bank, to acquire Northwest Commercial Bank (NCB), a full service commercial bank headquartered in Lakewood, Washington that operated two branch locations in Washington State (Northwest Commercial Acquisition). The acquisition of NCB was completed on January 9, 2013, at which time NCB was merged with and into Heritage Bank.

We are primarily engaged in the business of planning, directing, and coordinating the business activities of our wholly owned subsidiaries: Heritage Bank and Central Valley Bank (the Banks). The deposits of the Banks are insured by the FDIC. Heritage Bank conducts business from its main office in Olympia, Washington and its twenty-seven branch offices located in western Washington and the greater Portland, Oregon area. The number of branches includes an additional branch from the Northwest Commercial Acquisition which opened as a Heritage Bank branch on January 10, 2013. Central Valley Bank conducts business from its main office in Toppenish, Washington and its five branch offices located in Yakima and Kittitas counties of Washington State.

Our business consists primarily of lending and deposit relationships with small businesses and their owners in our market areas, and attracting deposits from the general public. We also make real estate construction and land development loans, one-to-four family residential loans, and consumer loans and originate for sale or investment purposes first mortgage loans on residential properties located in western and central Washington State and the greater Portland, Oregon area.

The Company was a participant in the U.S. Department of the Treasury s (Treasury) Troubled Asset Relief Program (TARP) Capital Purchase Plan, pursuant to which the Company sold (i) 24,000 shares of the Company s Fixed Rate Cumulative Perpetual Preferred Stock, Series A (Series A Preferred Stock) and (ii) a warrant (the Warrant) to purchase 276,074 shares of the Company s common stock at $13.04 per share for an aggregate purchase price of $24.0 million in cash. Effective December 22, 2010, the Company redeemed all of the Series A Preferred Stock held by the Treasury. Effective August 17, 2011, the Company repurchased the

Warrant and has no other obligations under TARP. For additional information, see Note 13 of the Notes to Consolidated Financial Statements included in Item 8. Financial Statements and Supplementary Data.

Market Areas

We offer financial services to meet the needs of the communities we serve through our community-oriented financial institutions. Headquartered in Olympia, Thurston County, Washington, we conduct business through Heritage Bank and Central Valley Bank. Heritage Bank conducts business from its main office in Olympia, Washington and its twenty-seven branch offices, including the branch acquired in the Northwest Commercial Acquisition, located in western Washington and the greater Portland, Oregon area. Mortgage loan operations are performed in one office located in Thurston County. Central Valley Bank operates six full service offices, with five in Yakima County and one in Kittitas County.

Lending Activities

General. Lending activities are conducted through Heritage Bank and Central Valley Bank. Our focus is on commercial business lending. We also originate consumer loans, real estate construction and land development loans and one-to-four family residential loans. Most of our one-to-four family residential loans are originated for sale in the secondary market, although some of these loans are retained in our loan portfolio. Commercial and industrial loans, including owner occupied commercial real estate loans, totaled $465.7 million, or 53.3% of total originated loans, as of December 31, 2012 and $440.5 million, or 52.5% of total originated loans, as of December 31, 2011 and non-owner occupied commercial real estate totaled $265.8 million, or 30.4% of total originated loans, as of December 31, 2012 and $251.0 million, or 30.0% of total originated loans, as of December 31, 2011. One-to-four family residential loans totaled $38.8 million, or 4.4% of total originated loans, at December 31, 2012, and $38.0 million, or 4.5% of total originated loans, at December 31, 2011. Real estate construction and land development loans totaled $77.3 million, or 8.8% of total originated loans, at December 31, 2012, and $77.3 million, or 9.3% of total originated loans, at December 31, 2011.

We lend under policies that are reviewed and approved annually by our board of directors. In addition, we have established internal lending guidelines that are updated as needed. These policies and guidelines address underwriting standards, structure and rate considerations, and compliance with laws, regulations and internal lending limits. We conduct post-approval reviews on selected loans and routinely engage external loan specialists to perform reviews of our loan portfolio to check for credit quality, proper documentation and compliance with laws and regulations.

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The following table provides information about our originated loan portfolio by type of loan for the dates indicated. These balances are prior to deduction for the allowance for loan losses.

	December 31,									
	2012		2011		2010		2009		2008	
	Balance	% of Total Originated Loans	Balance	% of Total Originated Loans	Balance	% of Total Originated Loans	Balance	% of Total Originated Loans	Balance	% of Total Originated Loans
	(Dollars in thousands)									
Originated Loans:										
Commercial business:										
Commercial and industrial(1)(2)	$ 465,734	53.3%	$ 440,471	52.5%	$ 392,301	52.8%	$ 408,622	52.8%	$ 410,657	50.9%
Non-owner occupied commercial real estate(1)	265,835	30.4	251,049	30.0	221,739	29.9	194,613	25.2	190,706	23.5
Total commercial business	731,569	83.7	691,520	82.5	614,040	82.7	603,235	78.0	601,363	74.4
One-to-four family residential(3)	38,848	4.4	37,960	4.5	47,505	6.5	53,623	7.0	57,231	7.1
Real estate construction and land development:										
One-to-four family residential	25,175	2.9	22,369	2.7	29,377	4.0	46,060	6.0	71,159	8.8
Five or more family residential and commercial properties	52,075	5.9	54,954	6.6	28,588	3.8	49,665	6.4	59,572	7.3
Total real estate construction and land development(4)	77,250	8.8	77,323	9.3	57,965	7.8	95,725	12.4	130,731	16.1
Consumer	28,914	3.3	32,981	3.9	23,832	3.2	21,261	2.8	21,255	2.6
Gross originated loans	876,581	100.2	839,784	100.2	743,342	100.2	773,844	100.2	810,580	100.2
Less: deferred loan fees	(2,096)	(0.2)	(1,860)	(0.2)	(1,323)	(0.2)	(1,597)	(0.2)	(1,854)	(0.2)
Total originated loans	$ 874,485	100.0%	$ 837,924	100.0%	$ 742,019	100.0%	$ 772,247	100.0%	$ 808,726	100.0%

(1) Commercial and industrial loans include owner-occupied commercial real estate
(2) During the year ended December 31, 2009 certain loan balances previously categorized as commercial business were reclassified as real estate construction and land development five or more family residential and commercial properties. The amounts reclassified were $33.2 million as of December 31, 2008.
(3) Excludes loans held for sale of $1.7 million, $1.8 million, $764,000, $825,000, and $304,000 as of December 31, 2012, 2011, 2010, 2009, and 2008, respectively.
(4) Balances are net of undisbursed loan proceeds.

The following table provides information about our purchased covered loan portfolio by type of loan for the years ended December 31, 2012, 2011 and 2010. There were no purchased covered loans for the years ended December 31, 2009 and 2008. These balances are the recorded investment balance and are prior to deduction for the allowance for loan losses.

	December 31,					
	2012		2011		2010	
	Balance	% of Total Originated Loans	Balance	% of Total Originated Loans	Balance	% of Total Originated Loans
	(Dollars in thousands)					
Purchased Covered Loans:						
Commercial business:						
Commercial and industrial(1)	$ 60,577	68.6%	$ 76,674	70.1%	$ 92,265	71.7%
Non-owner occupied commercial real estate(1)	13,028	14.7	15,753	14.4	17,576	13.6
Total commercial business	73,605	83.3	92,427	84.5	109,841	85.3
One-to-four family residential	5,027	5.7	5,197	4.8	6,224	4.8

Real estate construction and land development:						
One-to-four family residential	4,433	5.0	5,786	5.3	5,876	4.6
Total real estate construction and land development(2)	4,433	5.0	5,786	5.3	5,876	4.6
Consumer	5,265	6.0	5,947	5.4	6,774	5.3
Gross purchased covered loans	$ 88,330	100.0%	$ 109,357	100.0%	$ 128,715	100.0%

(1) Commercial and industrial loans include owner-occupied commercial real estate
(2) Balances are net of undisbursed loan proceeds.

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The following table provides information about our purchased non-covered loan portfolio by type of loan for the years ended December 31, 2012, 2011 and 2010. There were no purchased non-covered loans for the years ended December 31, 2009 and 2008. These balances are the recorded investment balance and are prior to deduction for the allowance for loan losses.

	December 31,					
	2012		2011		2010	
	Balance	% of Total Originated Loans	Balance	% of Total Originated Loans	Balance	% of Total Originated Loans
	(Dollars in thousands)					
Purchased Non-Covered Loans:						
Commercial business:						
Commercial and industrial(1)	$ 37,974	59.2%	$ 52,659	59.8%	$ 77,815	59.4%
Non-owner occupied commercial real estate(1)	11,019	17.2	12,833	14.5	18,435	14.0
Total commercial business	48,993	76.4	65,492	74.3	96,250	73.4
One-to-four family residential	3,040	4.7	2,743	3.1	4,986	3.8
Real estate construction and land development:						
One-to-four family residential	513	0.8	1,381	1.6	3,816	2.9
Five or more family residential and commercial properties	864	1.4	1,078	1.2	1,244	1.0
Total real estate construction and land development(2)	1,377	2.2	2,459	2.8	5,060	3.9
Consumer	10,713	16.7	17,420	19.8	24,753	18.9
Gross purchased non-covered loans	$ 64,123	100.0%	$ 88,114	100.0%	$ 131,049	100.0%

(1) Commercial and industrial loans include owner-occupied commercial real estate
(2) Balances are net of undisbursed loan proceeds.

The following table presents at December 31, 2012 (i) the aggregate contractual maturities of loans in the named categories of our originated loan portfolio and (ii) the aggregate amounts of fixed rate and variable or adjustable rate loans in the named categories that mature after one year.

	Maturing			
	Within 1 year	Over 1-5 years	After 5 years	Total
	(In thousands)			
Commercial business	$ 155,867	$ 186,047	$ 389,655	$ 731,569
Real estate construction and land development	61,821	11,076	4,353	77,250
Total	$ 217,688	$ 197,123	$ 394,008	$ 808,819
Fixed rate loans		$ 113,519	$ 157,606	$ 271,125
Variable or adjustable rate loans		83,604	236,402	320,006
Total		$ 197,123	$ 394,008	$ 591,131

Commercial Business Lending

We offer different types of commercial business loans. The types of commercial business loans offered are business lines of credit, term equipment financing and term owner-occupied commercial real estate loans. We also originate loans that are guaranteed by the Small Business Administration (SBA), for which Heritage Bank

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is a preferred lender. Before extending credit to a business we inspect and examine the borrower s management ability, financial history, including cash flow of the borrower and all guarantors, and the liquidation value of the collateral. Emphasis is placed on having a comprehensive understanding of the borrower s global cash flow and performing necessary financial due diligence.

At December 31, 2012 we had $731.6 million, or 83.7%, of our total originated loans receivable in commercial business loans with an average loan size of approximately $312,000.

We originate commercial real estate loans within our primary market areas with a preference for owner-occupied commercial real estate loans. Our underwriting standards require that commercial real estate loans not exceed 75% of the lower of appraised value at origination or cost of the underlying collateral. Cash flow coverage to debt servicing requirements is generally a minimum of 1.10 times for five or more family residential loans and 1.15 times for commercial real estate loans. Cash flow coverage is calculated using an underwriting interest rate equal to the note rate plus 2%.

Commercial real estate loans typically involve a greater degree of risk than one-to-four family residential loans. Payments on loans secured by commercial real estate properties are dependent on successful operation and management of the properties and repayment of these loans may be affected by adverse conditions in the real estate market or the economy. We seek to minimize these risks by determining the financial condition of the borrower, the quality and value of the collateral, and the management of the property securing the loan. We also generally obtain personal guarantees from the owners of the collateral after a thorough review of personal financial statements. In addition, we review our commercial real estate loan portfolio annually for performance of individual loans, and stress-test loans for potential changes in interest rates, occupancy, and collateral values.

See Item 1A. Risk Factors Our loan portfolio is concentrated in loans with a higher risk of loss Repayment of our commercial business loans consisting of commercial and industrial loans as well as owner-occupied and non-owner occupied commercial real estate loans, is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value. See also Item 1A. Risk Factors Our non-owner occupied loan portfolio is concentrated in loans with a higher risk of loss Our commercial real estate loans, which includes five or more family residential real estate loans, involve higher principal amounts than other loans and repayment of these loans may be dependent on factors outside our control or the control of our borrowers.

One-to-Four Family Residential Loans

The majority of our one-to-four family residential loans are secured by single-family residences located in our primary market areas. Our underwriting standards require that one-to-four family residential loans generally are owner-occupied and do not exceed 80% of the lower of appraised value at origination or cost of the underlying collateral. Terms typically range from 15 to 30 years. We generally sell a significant portion of our one-to-four family residential loans in the secondary market. Management determines to what extent we will retain or sell these loans and other fixed rate mortgages in order to control the Banks interest rate sensitivity position, growth and liquidity.

See Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Asset/Liability Management.

Real Estate Construction and Land Development

We originate one-to-four family residential construction loans for the construction of custom homes (where the home buyer is the borrower). We also provide financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. Because of the higher risks present in the residential construction industry, our lending to builders is limited to those who have demonstrated a favorable record of performance and who are building in markets that management understands.

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We further endeavor to limit our construction lending risk through adherence to strict underwriting guidelines and procedures. Speculative construction loans are short term in nature and priced with a variable rate of interest. We require builders to have tangible equity in each construction project and have prompt and thorough documentation of all draw requests, and we inspect the project prior to paying any draw requests.

See Item 1A. Risk Factors Our loan portfolio is concentrated in loans with a higher risk of loss Our real estate construction and land development loans are based upon estimates of costs and value associated with the completed project. These estimates may be inaccurate.

Origination and Sales of One-to-Four Family Residential Loans

Consistent with our asset/liability management strategy, we sell a significant portion of our one-to-four family residential loans into the secondary market. Commitments to sell these mortgage loans generally are made during the period between the taking of the loan application and the closing of the mortgage loan. Most of these sale commitments are made on a best efforts basis whereby we are only obligated to sell the mortgage if the mortgage loan is approved and closed. As a result, management believes that market risk is minimal. In addition, some of our mortgage loan production is brokered to other lenders prior to funding.

When we sell mortgage loans, we typically sell the servicing of the loans (i.e., collection of principal and interest payments). However, we serviced a minimal $49,000, $84,000 and $115,000 in mortgage loans for others as of December 31, 2012, 2011 and 2010, respectively.

The following table presents summary information concerning our origination and sale of our one-to-four family residential loans and the gains from the sale of loans.

	Year Ended December 31,				
	2012	2011	2010	2009	2008
	(In thousands)				
One-to-four family residential loans:					
Originated(1)	$ 35,730	$ 23,865	$ 18,605	$ 34,183	$ 24,115
Sold	21,187	15,888	16,187	25,338	16,463
Gains on sales of loans, net(2)	$ 295	$ 285	$ 226	$ 288	$ 265

(1) Includes loans originated for the purpose of inclusion in our loan portfolio or for the purpose of sale in the secondary market.
(2) Excludes gains on sales of SBA loans.

Commitments and Contingent Liabilities

In the ordinary course of business, we enter into various types of transactions that include commitments to extend credit that are not included in our Consolidated Financial Statements. We apply the same credit standards to these commitments as we use in all our lending activities and have included these commitments in our lending risk evaluations. Our exposure to credit loss under commitments to extend credit is represented by the amount of these commitments.

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The following table presents outstanding commitments to extend credit, including letters of credit, at the dates indicated:

	December 31, 2012	December 31, 2011
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 126,162	$ 138,118
Owner-occupied commercial real estate	2,151	2,328
Non-owner occupied commercial real estate	7,006	6,225
Total commercial business	135,319	146,671
One-to-four family residential		
Real estate construction and land development:		
One-to-four family residential	4,662	4,247
Five or more family residential and commercial properties	26,301	15,305
Total real estate construction and land development	30,963	19,552
Consumer	34,525	37,251
Total outstanding commitments	$ 200,807	$ 203,474

Delinquencies and Nonperforming Assets

Delinquency Procedures. We send a borrower a delinquency notice 15 days after the due date when the borrower fails to make a required payment on a loan. If the delinquency is not brought current, additional delinquency notices are mailed at 30 and 45 days for commercial loans. Additional written and oral contacts are made with the borrower between 60 and 90 days after the due date.

If a real estate loan payment is past due for 45 days or more, the collection manager may perform a review of the condition of the property if suspect. We may negotiate and accept a repayment program with the borrower, accept a voluntary deed in lieu of foreclosure or, when considered necessary, begin foreclosure proceedings. If foreclosed on, real property is sold at a public sale and we bid on the property to protect our interest. A decision as to whether and when to begin foreclosure proceedings is based on such factors as the amount of the outstanding loan relative to the value of the property securing the original indebtedness, the extent of the delinquency, and the borrower s ability and willingness to cooperate in resolving the delinquency.

Real estate acquired by us is classified as other real estate owned until it is sold. When property is acquired, it is recorded at the estimated fair value (less costs to sell) at the date of acquisition, not to exceed net realizable value, and any resulting write-down is charged to the allowance for loan losses. Upon acquisition, all costs incurred in maintaining the property are expensed. Costs relating to the development and improvement of the property, however, are capitalized to the extent of the property s net realizable value.

Delinquencies in the commercial business loan portfolio are handled by the assigned loan officer. Generally, notices are sent and personal contact is made with the borrower when the loan is 15 days past due. Loan officers are responsible for collecting loans they originate or which are assigned to them. Depending on the nature of the loan and the type of collateral securing the loan, we may negotiate and accept a modified payment program or take other actions as circumstances warrant.

Classification of Loans. Federal regulations require that our Banks periodically evaluate the risks inherent in their respective loan portfolios. In addition, the Division of Banks of the Washington State Department of Financial Institutions (Division) and the FDIC have the authority to identify problem loans and, if appropriate, require them to be reclassified. There are three classifications for problem loans: Substandard, Doubtful, and Loss. Substandard loans have one or more defined weaknesses and are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. Doubtful loans have the weaknesses of Substandard loans, with additional characteristics that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values questionable. There is a high probability of some loss in loans classified as Doubtful. A loan classified as Loss is considered uncollectible and of such little value that continuance as a loan of the institution is not warranted. If a loan or a portion of the loan is classified as Loss, the institution must charge-off this amount. We also have loans we classify as Watch and Other Assets Especially Mentioned (OAEM). Loans classified as Watch are performing assets but have elements of risk that require more monitoring than other performing loans. Loans classified as OAEM are assets that continue to perform but have shown deterioration in credit quality and require close monitoring.

The Banks routinely test their problem loans for potential impairment. A loan is considered impaired when, based on current information and events, it is probable that the Banks will be unable to collect all amounts due according to the original contractual terms of the loan agreement. Problem loans that may be impaired are identified using the Banks normal loan review procedures, which include post-approval reviews, monthly reviews by credit administration of criticized loan reports, scheduled internal reviews, underwriting during extensions and renewals and the analysis of information routinely received on a borrower s financial performance.

Impairment is measured using the present value of expected future cash flows, discounted at the loan s effective interest rate, unless the loan is collateral dependent, in which case impairment is measured using the fair value of the collateral after deducting appropriate collateral disposition costs. Furthermore, when it is practically expedient, impairment is measured by the fair market price of the loan.

Subsequent to an initial measure of impairment, if there is a significant change in the amount or timing of a loan s expected future cash flows or a change in the value of collateral or market price of a loan, based on new information received, the impairment is recalculated. However, the net carrying value of a loan never exceeds the recorded investment in the loan.

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Nonperforming Assets. Nonperforming assets consist of nonaccrual loans and other real estate owned. The following table provides information about our originated nonaccrual loans, restructured loans, and other real estate owned for the indicated dates.

	2012	2011	December 31, 2010 (Dollars in thousands)	2009	2008
Nonaccrual originated loans:					
Commercial business	$ 5,492	$ 8,266	$ 10,667	$ 9,728	$ 1,176
One-to-four family residential	389				
Real estate construction and land development	6,420	14,947	15,816	25,108	2,221
Consumer	157	125			
Total nonaccrual originated loans(1)(2)	12,458	23,338	26,483	34,836	3,397
Noncovered other real estate owned	5,406	3,710	3,030	704	2,031
Total nonperforming originated assets	$ 17,864	$ 27,048	$ 29,513	$ 35,540	$ 5,428
Restructured originated performing loans:					
Commercial business	$ 14,237	$ 12,606	$ 394	$ 425	$
One-to-four family residential	422	835			
Real estate construction and land development	361	364			
Consumer	19				
Total restructured originated performing loans(3)	$ 15,039	$ 13,805	$ 394	$ 425	$
Accruing originated loans past due 90 days or more(4)	$ 214	$ 1,328	$ 1,313	$ 277	$ 664
Potential problem originated loans(5)	$ 28,270	$ 29,742	$ 56,088	$ 53,086	$ 43,061
Allowance for loan losses on originated loans	$ 19,125	$ 22,317	$ 22,062	$ 26,164	$ 15,423
Nonperforming originated loans to total originated loans(6)	1.28%	2.57%	3.14%	4.21%	0.42%
Allowance for loan losses on originated loans to total originated loans	2.19%	2.66%	2.97%	3.38%	1.91%
Allowance for loan losses on originated loans to nonperforming originated loans(6)	170.44%	103.52%	94.73%	79.34%	454.02%
Nonperforming originated assets to total originated assets(6)	1.39%	2.14%	2.38%	3.32%	0.57%

(1) $9.3 million, $11.7 million, $8.7 million and $17.0 million of originated nonaccrual loans were considered troubled debt restructures at December 31, 2012, 2011, 2010 and 2009, respectively. There were no troubled debt restructures at December 31, 2008.

(2) $1.2 million, $1.8 million, $3.2 million and $2.3 million of originated nonaccrual loans were guaranteed by government agencies at December 31, 2012, 2011, 2010 and 2009, respectively. There were no nonaccrual loans guaranteed by government agencies at December 31, 2008.

(3) $679,000 and $592,000 of originated performing restructured loans were guaranteed by government agencies at December 31, 2012 and 2011. There were no originated performing restructured loans guaranteed by government agencies at December 31, 2010, 2009 and 2008.

(4) There were no accruing originated loans past due 90 days or more that were guaranteed by government agencies at December 31, 2012, 2009, and 2008. $6,000 and $92,000 of accruing originated loans past due 90 days or more were guaranteed by government agencies at December 31, 2011 and 2010, respectively.

(5) $3.2 million, $2.8 million, $5.4 million and $7.2 million of originated potential problem loans were guaranteed by government agencies at December 31, 2012, 2011, 2010 and 2009, respectively. There were no potential problem originated loans guaranteed by government agencies at December 31, 2008.

(6) Excludes portions guaranteed by government agencies.

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Nonaccrual Loans. Our Consolidated Financial Statements are prepared on the accrual basis of accounting, including the recognition of interest income on our loan portfolio, unless a loan is placed on nonaccrual status. Loans are considered to be impaired and are placed on nonaccrual status when there are serious doubts about the collectability of principal or interest. Our policy is to place a loan on nonaccrual status when the loan becomes past due for 90 days or more, is less than fully collateralized, and is not in the process of collection. Payments received on nonaccrual loans generally are applied first to principal and then to interest only after all principal has been collected.

Nonaccrual originated loans decreased to $12.5 million, or 1.28% of total originated loans, at December 31, 2012 from $23.3 million, or 2.57% of total originated loans, at December 31, 2011 due to the loan resolution efforts of our credit department. During the year ended December 31, 2012, there were $3.9 million in net charge-offs of originated loans of which $2.1 million related to nonperforming commercial business loans and $1.2 million related to nonperforming real estate construction and land development loans. In addition, $7.4 million of loans were transferred to other real estate owned during the year ended December 31, 2012. This decrease in total nonperforming originated loans was partially offset by $1.3 million in additions to nonperforming originated loans which were outstanding as of December 31, 2012.

Nonperforming originated assets decreased to $17.9 million, or 1.39% of total originated assets, at December 31, 2012 from $27.0 million, or 2.14% of total originated assets, at December 31, 2011 due to a decrease in nonperforming originated loans discussed above offset partially by an increase in other real estate owned.

Originated restructured performing loans as of December 31, 2012 and December 31, 2011 were $15.0 million and $13.8 million, respectively. The increase in originated restructured performing loans was primarily due to the addition of 14 commercial and industrial loans that were modified during the year and were considered troubled debt restructured loans with an outstanding principal balance of $2.4 million at December 31, 2012.

Originated potential problem loans as of December 31, 2012 and December 31, 2011 were $28.3 million and $29.7 million, respectively. Potential problem loans are those loans that are currently accruing interest and are not considered impaired, but which we are monitoring because the financial information of the borrower causes us concerns as to their ability to comply with their loan repayment terms. Loans that are past due 90 days or more and still accruing interest are both well secured and in the process of collection.

Troubled Debt Restructured Loans. A troubled debt restructured loan (TDR) is a restructuring in which the Banks, for economic or legal reasons related to a borrower s financial difficulties, grant a concession to a borrower that it would not otherwise consider. The majority of the Banks TDRs are a result of granting extensions to troubled credits which have already been adversely classified. We grant such extensions to reassess the borrower s financial status and develop a plan for repayment. Certain modifications with extensions also include interest rate reductions, which is the second most prevalent concession. The interest rate reductions can be for a period of time or over the remainder of the life of the loan. We may also bifurcate troubled credits into a good loan and a bad loan, whereas the good loan continues to accrue under the modified terms. We perform bifurcations to limit potential losses. The remainders of the Banks TDRs are the result of converting revolving lines of credits to amortizing loans, changing amortizing loans to interest-only loans with balloon payments, or re-amortizing the loan over a longer period of time. These modifications would all be considered a concession for a borrower that could not obtain financing outside of the Banks. We do not forgive principal for a majority of our TDRs, but in those situations where principal is forgiven, the entire amount of such principal forgiveness is immediately charged off to the extent not done so prior to the modification. We sometimes delay the timing on the repayment of a portion of principal (principal forbearance) and charge-off the amount of forbearance if that amount is not considered fully collectible. We also consider insignificant delays in payments when determining if a loan should be classified as a TDR.

TDRs are considered impaired and are separately measured for impairment under Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) 310-10-35, whether on accrual or nonaccrual status. At December 31, 2012 and December 31, 2011, the balance of accruing TDRs was $15.0 million and $13.8 million, respectively. The related allowance for loan losses on the accruing TDRs was $2.1 million as of December 31, 2012 and $1.4 million as of December 31, 2011. At December 31, 2012, non-accruing TDRs were $9.3 million and had a related allowance for loan losses of $2.0 million. At December 31, 2011, non-accruing TDRs of $11.7 million had a related allowance for loan losses of $1.8 million.

A loan may have the TDR classification removed if (a) the restructured interest rate was greater than or equal to the interest rate of a new loan with comparable risk at the time of the restructure, and (b) the loan is no longer impaired based on the terms of the restructured agreement. The Banks policy is that the borrower must demonstrate six consecutive monthly payments in accordance with the modified loan before it can be reviewed for removal of TDR classification under the second criteria. However, the loan must be reported as a TDR in at least one of the Company s Annual Report on Form 10-K.

Potential Problem Loans. Potential problem loans are those loans that are currently accruing interest and are not considered impaired, but which we are monitoring because the financial information of the borrower causes us concerns as to their ability to comply with their loan repayment terms. Loans that are past due 90 days or more and still accruing interest are both well secured and in the process of collection. Originated potential problem loans decreased $1.5 million to $28.3 million at December 31, 2012 from $29.7 million at December 31, 2011.

Analysis of Allowance for Loan Losses

Management maintains an allowance for loan losses (ALL) to provide for estimated probable credit losses inherent in the loan portfolio. The adequacy of the ALL is monitored through our ongoing quarterly loan quality assessments.

We assess the estimated credit losses inherent in our loan portfolio by considering a number of elements including:

- Historical loss experience in a number of homogeneous segments of the loan portfolio;
- The impact of environmental factors, including:
  - Levels of and trends in delinquencies and impaired loans;
  - Levels and trends in charge-offs and recoveries;
  - Effects of changes in risk selection and underwriting standards, and other changes in lending policies, procedures and practices;
  - Experience, ability, and depth of lending management and other relevant staff;
  - National and local economic trends and conditions;
  - External factors such as competition, legal, and regulatory requirements; and
  - Effects of changes in credit concentrations.

We calculate an appropriate ALL for the non-classified and classified performing loans in our loan portfolio by applying historical loss factors for homogeneous classes of the portfolio, adjusted for changes to the above-noted environmental factors. We may record specific provisions for impaired loans, including loans on nonaccrual status and TDRs, after a careful analysis of each loan s credit and collateral factors. Our analysis of an appropriate ALL combines the provisions made for our non-classified loans, classified loans, and the specific provisions made for each impaired loan.

While we believe we use the best information available to determine the allowance for loan losses, results of operations could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance. A further decline in local and national economic conditions, or other factors, could

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result in a material increase in the allowance for loan losses and may adversely affect the Company s financial condition and results of operations. In addition, the determination of the amount of the allowance for loan losses is subject to review by bank regulators, as part of their routine examination process, which may result in the establishment of additional allowance allocations based upon their judgment of information available to them at the time of their examination.

The following table provides information regarding changes in our allowance for originated loan losses at and for the indicated periods:

	Year Ended December 31,				
	2012	2011	2010	2009	2008
	(Dollars in thousands)				
Originated loans outstanding at end of period(1)	$ 874,485	$ 837,924	$ 742,019	$ 772,247	$ 808,726
Average originated loans receivable during period(1)	$ 855,923	$ 833,441	$ 717,159	$ 787,527	$ 795,752
Allowance for loan losses on originated loans at beginning of period	$ 22,317	$ 22,062	$ 26,164	$ 15,423	$ 10,374
Provision for loan losses on originated loans	695	5,180	11,990	19,390	7,420
Charge-offs:					
Commercial business	(3,702)	(2,690)	(8,106)	(2,668)	(144)
One-to-four family residential	(349)	(15)	(169)	(189)	(280)
Real estate construction and land development	(1,280)	(2,948)	(8,344)	(5,774)	(1,818)
Consumer	(293)	(316)	(73)	(192)	(165)
Total charge-offs	(5,624)	(5,969)	(16,692)	(8,823)	(2,407)
Recoveries:					
Commercial business	1,579	821	243	1	1
One-to-four family residential			15	1	
Real estate construction and land development	125	201	285	50	
Consumer	33	22	57	122	35
Total recoveries	1,737	1,044	600	174	36
Net charge-offs	(3,887)	(4,925)	(16,092)	(8,649)	(2,371)
Allowance for originated loan losses at end of period	$ 19,125	$ 22,317	$ 22,062	$ 26,164	$ 15,423
Ratio of net charge-offs during period to average originated loans receivable	(0.45)%	(0.59)%	(2.24)%	(1.10)%	(0.30)%

(1) Excludes loans held for sale.

The following table shows the allocation of the allowance for loan losses for originated loans at the indicated periods. The allocation is based upon an evaluation of defined loan problems, historical loan loss ratios, and industry wide and other factors that affect loan losses in the categories shown below:

	December 31,									
	2012		2011		2010		2009		2008	
	Allowance for Loan Losses	% of Total Originated Loans(1)	Allowance for Loan Losses	% of Total Originated Loans(1)	Allowance for Loan Losses	% of Total Originated Loans(1)	Allowance for Loan Losses	% of Total Originated Loans(1)	Allowance for Loan Losses	% of Total Originated Loans(1)
	(Dollars in thousands)									
Commercial business	$ 12,554	83.5%	$ 12,888	82.3%	$ 14,350	82.5%	$ 12,137	77.8%	$ 2,785	74.2%
One-to-four family residential	637	4.4	416	4.5	500	6.5	550	7.0	5,797	7.1
Real estate construction	4,316	8.8	7,556	9.3	5,435	7.8	12,892	12.4	6,587	16.1
Consumer	748	3.3	547	3.9	846	3.2	361	2.8	254	2.6
Unallocated	870		910		931		224			
Total allowance for originated loan losses	$ 19,125	100.0%	$ 22,317	100.0%	$ 22,062	100.0%	$ 26,164	100.0%	$ 15,423	100.0%

(1) Represents total originated loans outstanding in each category as a percent of gross originated loans.

Investment Activities

At December 31, 2012, our investment securities portfolio totaled $154.4 million, which consisted of $144.3 million of securities available for sale and $10.1 million of securities held to maturity. This compares with a total portfolio of $156.7 million at December 31, 2011, which was comprised of $144.6 million of securities available for sale and $12.1 million of securities held to maturity. The composition of the two investment portfolios by type of security, at each respective date, is presented in Note 6 to the Notes to Consolidated Financial Statements.

Our investment policy is established by the Board of Directors and monitored by the Audit and Finance Committee of the Board of Directors. It is designed primarily to provide and maintain liquidity, generate a favorable return on investments without incurring undue interest rate and credit risk, and complements our Banks lending activities. The policy dictates the criteria for classifying securities as either available for sale or held to maturity. The policy permits investment in various types of liquid assets permissible under applicable regulations, which include U.S. Treasury obligations, U.S. Government agency obligations, some certificates of deposit of insured banks, mortgage backed and mortgage related securities, corporate notes, municipal bonds, and federal funds. Investment in non-investment grade bonds and stripped mortgage backed securities are not permitted under the policy.

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The following table provides information regarding our investment securities available for sale at the dates indicated.

	December 31,					
	2012		2011		2010	
	Fair Value	% of Total Investments	Fair Value	% of Total Investments	Fair Value	% of Total Investments
	(Dollars in thousands)					
U.S. Treasury and U.S. Government-sponsored agencies	$ 11,035	7.7%	$ 31,307	21.7%	$ 41,429	33.1%
Municipal securities	47,360	32.8	33,423	23.1	20,213	16.1
Corporate securities			8,097	5.6	10,276	8.2
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	85,898	59.5	71,775	49.6	53,257	42.6
Total	$ 144,293	100.0%	$ 144,602	100.0%	$ 125,175	100.0%

The following table provides information regarding our investment securities available for sale, by contractual maturity, at December 31, 2012.

	Less Than One Year		Over One to Five Years		Over Five to Ten Years		Over Ten Years	
	Fair Value	Weighted Average Yield(1)	Fair Value	Weighted Average Yield(1)	Fair Value	Weighted Average Yield(1)	Fair Value	Weighted Average Yield(1)
	(Dollars in thousands)							
U.S. Treasury and U.S. Government-sponsored agencies	$ 10,535	1.27%	$	%	$	%	$ 500	1.00%
Municipal securities	1,415	3.47	6,287	4.05	22,432	3.96	17,226	4.36
Mortgage backed securities and collateralized mortgage obligations-residential:								
U.S. Government-sponsored agencies			105	5.42	13,363	4.22	72,430	4.55
Total	$ 11,950	1.53%	$ 6,392	4.07%	$ 35,795	4.06%	$ 90,156	4.50%

(1) Taxable equivalent weighted average yield.

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The following table provides information regarding our investment securities held to maturity at the dates indicated.

	December 31, 2012		2011		2010	
	Amortized Cost	% of Total Investments	Amortized Cost	% of Total Investments	Amortized Cost	% of Total Investments
	(Dollars in thousands)					
U.S. Treasury and U.S. Government-sponsored agencies	$ 1,740	17.2%	$ 1,799	14.9%	$ 1,858	13.5%
Municipal securities	2,946	29.2	3,566	29.5	3,410	24.8
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	4,245	42.0	5,412	44.7	6,592	47.9
Private residential collateralized mortgage obligations	1,168	11.6	1,316	10.9	1,908	13.8
Total	$ 10,099	100.0%	$ 12,093	100.0%	$ 13,768	100.0%

The following table provides information regarding our investment securities held to maturity, by contractual maturity, at December 31, 2012.

	Less Than One Year		Over One to Five Years		Over Five to Ten Years		Over Ten Years	
	Fair Value	Weighted Average Yield(1)	Fair Value	Weighted Average Yield(1)	Fair Value	Weighted Average Yield(1)	Fair Value	Weighted Average Yield(1)
	(Dollars in thousands)							
U.S. Treasury and U.S. Government-sponsored agencies	$	%	$ 113	5.05%	$ 1,911	3.74%	$	%
Municipal securities	225	5.74	1,269	4.81	1,435	4.79	229	5.32
Mortgage backed securities and collateralized mortgage obligations-residential:								
U.S. Government-sponsored agencies			43	8.02	26	2.22	4,453	3.50
Private residential collateralized mortgage obligations							1,306	3.50
Total	$ 225	5.74%	$ 1,425	4.93%	$ 3,372	4.17%	$ 5,988	3.57%

(1) Taxable equivalent weighted average yield.

The Banks are required to maintain an investment in the stock of the Federal Home Loan Bank (FHLB) of Seattle in an amount equal to the greater of $500,000 or 0.50% of residential mortgage loans and pass-through securities or an advance requirement to be confirmed on the date of the advance and 5.0% of the outstanding balance of mortgage loans sold to the FHLB of Seattle. At December 31, 2012 the Banks were required to maintain an investment in the stock of FHLB of Seattle of at least $1.2 million and the Banks had an investment in FHLB stock carried at a cost basis (par value) of $5.5 million.

Consistent with its accounting policy, the Company evaluated its investment in FHLB of Seattle stock for other-than-temporary impairment. The Company took into consideration that in September 2012, the FHLB of Seattle announced that it had been reclassified as adequately capitalized by its regulator, the Federal Housing

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Finance Agency. Based on the Company s evaluation of the underlying investment, including the long-term nature of the investment, the liquidity position of the FHLB of Seattle, the actions being taken by the FHLB of Seattle to address its regulatory situation and the Company s intent and ability to hold the investment for a period of time sufficient to recover the par value, the Company did not recognize an other-than-temporary impairment loss on its FHLB of Seattle stock during the year ended December 31, 2012. Despite improvements in the FHLB of Seattle s regulatory situation, any deterioration in the FHLB of Seattle s financial position may result in future impairment losses.

Deposit Activities and Other Sources of Funds

General. Our primary sources of funds are deposits, loan repayments and borrowings. Scheduled loan repayments are a relatively stable source of funds, while deposits and unscheduled loan prepayments, which are influenced significantly by general interest rate levels, interest rates available on other investments, competition, economic conditions, and other factors are not. Customer deposits remain an important source of funding, but these balances have been influenced in the past by adverse market conditions in the industry and may be affected by future developments such as interest rate fluctuations and new competitive pressures. In addition to customer deposits management may utilize brokered deposits on an as-needed basis.

Borrowings may also be used on a short-term basis to compensate for reductions in other sources of funds (such as deposit inflows at less than projected levels). Borrowings may also be used on a longer-term basis to support expanded lending activities and match the maturity of repricing intervals of assets. In addition, since 2009 the Company has utilized repurchase agreements as a supplement to other funding sources.

During the year ended December 31 2012, non-maturity deposits (total deposits less certificate of deposit accounts) increased $22.6 million, or 2.8%, to $829.0 million. As a result, the percentage of certificate of deposit accounts to total deposits decreased to 25.8% at December 31, 2012 from 29.0% at December 31, 2011.

Deposit Activities. We offer a variety of deposit accounts designed to attract both short-term and long-term deposits. These accounts include noninterest demand accounts, negotiable order of withdrawal (NOW) accounts, money market accounts, savings accounts and certificates of deposit (CDs). These accounts, with the exception of noninterest demand accounts, generally earn interest at rates established by management based on competitive market factors and management s desire to increase or decrease certain types or maturities of deposits. The major categories of deposit accounts are described below.

Noninterest Demand Deposits. Noninterest demand deposits are noninterest bearing and may be charged service fees based on activity and balances.

NOW Accounts. NOW accounts are interest bearing and may be charged service fees based on activity and balances. NOW accounts pay interest, but require a higher minimum balance to avoid service charges.

Money Market Accounts. Money market accounts pay a variable interest rate that is tiered depending on the balance maintained in the account. Minimum opening balances vary.

Savings Accounts. We offer savings accounts that allow for unlimited deposits and withdrawals, provided that a $100 minimum balance is maintained.

CDs. We offer several types of CDs with maturities ranging from three months to five years, which require a minimum deposit of $2,500. Negotiable CDs are offered in amounts of $100,000 or more for terms of 30 days to five years.

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The following table provides the balances outstanding for each major category of deposits for the periods indicated:

	December 31, 2012 Amount	2012 Percent	2011 Amount	2011 Percent	2010 Amount	2010 Percent
	(Dollars in thousands)					
Noninterest demand deposits	$ 247,048	22.1%	$ 230,993	20.4%	$ 194,583	17.1%
NOW accounts	303,487	27.2	304,818	26.8	287,247	25.3
Money market accounts	157,728	14.1	166,913	14.7	150,953	13.3
Savings accounts	120,781	10.8	103,716	9.1	100,552	8.8
Total non-maturity deposits	829,044	74.2	806,440	71.0	733,335	64.5
CDs	288,927	25.8	329,604	29.0	402,941	35.5
Total deposits	$ 1,117,971	100.0%	$ 1,136,044	100.0%	$ 1,136,276	100.0%

The following table provides the average balances outstanding and the weighted average interest rates for each major category of deposits for the years indicated:

	Year ended December 31, 2012 Average Balance	2012 Average Yield/Rate	2011 Average Balance	2011 Average Yield/Rate	2010 Average Balance	2010 Average Yield/Rate
	(Dollars in thousands)					
NOW accounts and money market accounts	$ 466,268	0.27%	$ 453,509	0.41%	$ 376,245	0.58%
Savings accounts	113,119	0.18	103,170	0.35	89,978	0.56
CDs	306,772	0.98	355,167	1.20	351,191	1.62
Total interest bearing deposits	886,159	0.50	911,846	0.71	817,414	1.02
Noninterest demand deposits	237,888		205,862		150,906	
Total deposits	$ 1,124,047	0.40%	$ 1,117,708	0.58%	$ 968,320	0.87%

The following table shows the amount and maturity of certificates of deposit of $100,000 or more:

	December 31, 2012 (In thousands)
Remaining maturity:	
Three months or less	$ 30,623
Over three months through six months	24,120
Over six months through twelve months	30,895
Over twelve months	79,250
Total	$ 164,888

Borrowings. Deposits are the primary source of funds for our lending and investment activities and our general business purposes. We rely upon advances from the FHLB to supplement our supply of lendable funds and meet deposit withdrawal requirements. The FHLB of Seattle serves as one of our secondary sources of liquidity. Advances from the FHLB of Seattle are typically secured by our first lien single family mortgage loans, commercial real estate loans and stock issued by the FHLB, which is owned by us. At December 31, 2012, the Banks maintained an uncommitted credit facility with the FHLB of Seattle in a collective amount of $156.3 million and an uncommitted credit facility with the Federal Reserve Bank of San Francisco in a collective amount of $61.1 million, of which there were no advances or borrowings outstanding. The Banks also maintain advance lines with Zions Bank, Wells Fargo Bank, US Bank and Pacific Coast Bankers Bank to purchase federal funds in a collective amount of up to $57.8 million as of December 31, 2012. At December 31, 2012 we had securities sold under agreement to repurchase of $16.0 million which were secured by available for sale investment securities.

The FHLB functions provide credit for member financial institutions. As members, we are required to own capital stock in the FHLB and are authorized to apply for advances on the security of such stock and certain of our mortgage loans and other assets (principally securities which are obligations of, or guaranteed by, the United States) provided certain standards related to creditworthiness have been met. Advances are made pursuant to several different programs. Each credit program has its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based either on a fixed percentage of an institution s net worth or on the FHLB s assessment of the institution s creditworthiness. Under its current credit policies, the FHLB of Seattle limits advances to 20% of assets for Heritage Bank and Central Valley Bank.

The following table is a summary of FHLB advances for the periods indicated:

	Year ended December 31,		
	2012	**2011**	**2010**
	(Dollars in thousands)		
Balance at period end	$	$	$
Average balance during the period			1,330
Maximum amount outstanding at any month end			17,486
Average interest rate:			
During the period			1.67%
At period end			

There were no federal funds purchased for the years ended December 31, 2012, 2011 and 2010.

Supervision and Regulation

We are subject to extensive Federal and Washington State legislation, regulation, and supervision. These laws and regulations are primarily intended to protect depositors, the FDIC and shareholders. The laws and regulations affecting banks and bank holding companies have changed significantly particularly in connection with the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). See Other Regulatory Developments The Dodd-Frank Act herein for a discussion of this legislation. Any change in applicable laws, regulations, or regulatory policies may have a material effect on our business, operations, and prospects. We cannot predict the nature or the extent of the effects on our business and earnings that any fiscal or monetary policies or new Federal or State legislation may have in the future.

The following is a brief discussion of certain laws and regulations applicable to Heritage Financial and the Banks which is qualified in its entirety by reference to the actual laws and regulations.

Heritage Financial. We are subject to regulation as a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended, and are supervised by the Board of Governors of the Federal Reserve System (Federal Reserve). The Federal Reserve has the authority to order bank holding companies to cease and desist from unsound practices and violations of conditions imposed on them. The Federal Reserve is also empowered to assess civil money penalties against companies and individuals who violate the Bank Holding Company Act or orders or regulations thereunder in amounts up to $1.0 million per day. The Federal Reserve may order termination of non-banking activities by non-banking subsidiaries of bank holding companies, or divestiture of ownership and control of a non-banking subsidiary by a bank holding company. Some violations may also result in criminal penalties. The FDIC is authorized to exercise comparable authority under the Federal Deposit Insurance Act and other statutes for state nonmember banks such as Heritage Bank and Central Valley Bank.

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The Federal Reserve has a policy that a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. The Dodd-Frank Act and earlier Federal Reserve policy provide that a bank holding company should serve as a source of strength to its subsidiary banks by having the ability to provide financial assistance to its subsidiary banks during periods of financial distress. A bank holding company s failure to meet its obligation to serve as a source of strength to its subsidiary banks will generally be considered by the Federal Reserve to be an unsafe and unsound banking practice or a violation of the Federal Reserve s regulations or both. The Dodd-Frank Act requires new regulations to be promulgated concerning the source of strength. The Federal Deposit Insurance Act requires an undercapitalized bank to develop a capital restoration plan, approved by the FDIC, with a guaranty by the company having control of the bank, of the bank s compliance with the plan.

We are required to file annual and periodic reports with the Federal Reserve and provide additional information as the Federal Reserve may require. The Federal Reserve may examine us, and any of our subsidiaries, and charge us for the cost of the examination.

We, and any subsidiaries which we may control, are considered affiliates within the meaning of the Federal Reserve Act, and transactions between our bank subsidiaries and affiliates are subject to numerous restrictions. With some exceptions, we and our subsidiaries are prohibited from tying the provision of various products or services, such as extensions of credit, to other products or services offered by us, or our affiliates.

Bank regulations require bank holding companies and banks to maintain a minimum leverage ratio of core capital to adjusted quarterly average total assets of at least 3%. In addition, banking regulators have adopted risk-based capital guidelines under which risk percentages are assigned to various categories of assets and off-balance sheet items to calculate a risk-adjusted capital ratio. Tier 1 capital generally consists of common stockholders equity (which does not include unrealized gains and losses on securities), less goodwill and certain identifiable intangible assets. Tier 2 capital includes Tier 1 capital plus the allowance for loan losses and subordinated debt, both subject to some limitations. Regulatory risk-based capital guidelines require Tier 1 capital of 4% of risk-adjusted assets and minimum total capital ratio (combined Tier 1 and Tier 2) of 8% of risk-adjusted assets. The Dodd-Frank Act requires new capital regulations to be adopted; however, the adoption of the capital regulations as proposed in December 2011 have been delayed. For additional information, see Capital Adequacy below.

Subsidiaries. Heritage Bank and Central Valley Bank are Washington-chartered commercial banks, the deposits of which are insured by the FDIC. Heritage Bank and Central Valley Bank are subject to regulation by the FDIC and the Division.

Applicable Federal and State statutes and regulations which govern a bank s operations relate to minimum capital requirements, required reserves against deposits, investments, loans, legal lending limits, mergers and consolidation, borrowings, issuance of securities, payment of dividends, establishment of branches, and other aspects of its operations, among other things. The Division and the FDIC also have authority to prohibit banks under their supervision from engaging in what they consider to be unsafe and unsound practices.

The Banks are required to file periodic reports with the FDIC and the Division, and are subject to periodic examinations and evaluations by those regulatory authorities. Based upon these evaluations, the regulators may revalue the assets of an institution and require that it establish specific reserves to compensate for the differences between the determined value and the book value of such assets. These examinations must be conducted every 12 months, except that well-capitalized banks may be examined every 18 months. The FDIC and the Division may each accept the results of an examination by the other in lieu of conducting an independent examination.

Dividends paid by the Banks provide substantially all of our cash flow. Applicable Federal and Washington State regulations restrict capital distributions by our Banks, including dividends. Such restrictions are tied to the institution s capital levels after giving effect to such distributions. For an additional discussion of restrictions on the payment of dividends, see Part II of Item 5. Market for the Registrant s Common Equity, Related Stockholder Matters and Issuer Purchased of Equity Securities herein.

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Capital Adequacy. The Federal Reserve and FDIC have issued substantially similar risk-based and leverage capital guidelines applicable to bank holding companies and banks. In addition, these regulatory agencies may from time to time require that a bank holding company or bank maintain capital above the minimum levels, based on its financial condition or actual or anticipated growth.

The Federal Reserve s risk-based guidelines for bank holding companies establish a two-tier capital framework. Tier 1 capital generally consists of common stockholders equity (which does not include unrealized gains and losses on securities), less goodwill and certain identifiable intangible assets. Tier 2 capital includes Tier 1 capital plus the allowance for loan losses and subordinated debt, both subject to some limitations. The sum of Tier 1 and Tier 2 capital represents qualifying total capital, at least 50% of which must consist of Tier 1 capital.

Risk-based capital ratios are calculated by dividing Tier 1 and total capital by risk-weighted assets. Assets and off-balance sheet exposures are assigned to one of four categories of risk-weights, based primarily on relative credit risk. The minimum Tier 1 risk- based capital ratios under these guidelines at December 31, 2012 were 4% and 8%, respectively. At December 31, 2012, we had consolidated Tier 1 risk-based capital and total risk-based capital of 18.7% and 19.9%, respectively.

The Federal Reserve s leverage capital guidelines establish a minimum leverage ratio determined by dividing Tier 1 capital by adjusted average total assets. The minimum leverage ratio is 3% for bank holding companies that meet certain specified criteria, including having the highest regulatory rating. All other bank holding companies generally are required to maintain a leverage ratio of at least 4%. At December 31, 2012, we had a consolidated leverage ratio of 13.6%.

In connection with the enactment of the Dodd-Frank Act in June 2012, the Federal Reserve, FDIC and the Office of the Comptroller of the Currency approved proposed rules that would substantially amend the regulatory risk-based capital rules applicable to the Company and the Banks. The proposed rules implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. Basel III refers to various documents released by the Basel Committee on Banking Supervision. The proposed rules were subject to a public comment period that has expired and there is no date set for the adoption of final rules.

The proposed rules include new minimum risk-based capital and leverage ratios, which would be phased in during 2013 and 2014, and would refine the definitions of what constitutes capital for purposes of calculating those ratios. The proposed new minimum capital level requirements applicable to the Company and the Banks under the proposals would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4%. The proposed rules would also establish a capital conservation buffer of 2.5% above each of the new regulatory minimum capital ratios would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions.

The proposed rules also implement other revisions to the current capital rules such as recognition of all unrealized gains and losses on available for sale debt and equity securities, and provide that instruments that will no longer qualify as capital would be phased out over time.

The federal bank regulatory agencies also proposed revisions to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions, including the Banks, if their capital levels begin to show signs of weakness. These revisions would take effect January 1, 2015. Under the prompt corrective action requirements, insured depository institutions would be required to meet the following increased capital level requirements in order to qualify as well capitalized: (i) a new common equity Tier 1 risk-based

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capital ratio of 6.5%; (ii) a Tier 1 risk-based capital ratio of 8% (increased from 6%); (iii) a total risk-based capital ratio of 10% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 5% (unchanged from the current rules).

The proposed rules set forth certain changes for the calculation of risk-weighted assets and utilize an increased number of credit risk and other exposure categories and risk weights. In addition, the proposed rules also address: (i) a proposed alternative standard of creditworthiness consistent with Section 939A of the Dodd-Frank Act; (ii) revisions to recognition of credit risk mitigation; (iii) rules for risk weighting of equity exposures and past due loans; and (iv) revised capital treatment for derivatives and repo-style transactions.

In particular, the proposed rules would expand the risk-weighting categories from the current four categories (0%, 20%, 50% and 100%) to a much larger and more risk-sensitive number of categories, generally ranging from 0% for U.S. government and agency securities, to 600% for certain equity exposures. Higher risk weights would apply to a variety of exposure categories. Specifics include, among others:

- Applying a 150% risk weight instead of a 100% risk weight for certain high volatility commercial real estate acquisition, development and construction loans.

- For residential mortgage exposures, the current approach of a 50% risk weight for high-quality seasoned mortgages and a 100% risk-weight for all other mortgages is replaced with a risk weight of between 35% and 200% depending upon the mortgage s loan-to-value ratio and whether the mortgage is a category 1 or category 2 residential mortgage exposure (based on eight criteria that include, among others, the term, seniority of the lien, use of negative amortization, balloon payments and certain rate increases).

- Assigning a 150% risk weight to exposures (other than residential mortgage exposures) that are 90 days past due.

- Providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable (currently set at 0%).

- Providing for a 100% risk weight for claims on securities firms.

- Eliminating the current 50% cap on the risk weight for OTC derivatives.

The FDIC may impose additional restrictions on institutions that are undercapitalized and generally is authorized to reclassify an institution into a lower capital category and impose the restrictions applicable to such category if the institution is engaged in unsafe or unsound practices or is in an unsafe or unsound condition. An institution is deemed well capitalized if it has at least a 5% Tier 1 capital ratio, a 6.0% Tier 1 risk-based capital ratio and 10.0% total risk-based capital ratio. At December 31, 2012, the Banks were considered well capitalized institutions. For a complete description of the Company s and the Banks required and actual capital levels as of December 31, 2012, see Note 15 of the Notes to Consolidated Financial Statements included in Item 8. Financial Statements and Supplementary Data.

Prompt Corrective Action. Federal statutes establish a supervisory framework based on five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. An institution s category depends upon where its capital levels are in relation to relevant capital measures, which include a risk-based capital measure, a leverage ratio capital measure and certain other factors. The federal banking agencies have adopted regulations that implement this statutory framework. Under these regulations, an institution is treated as well capitalized if its ratio of total capital to risk-weighted assets is 10% or more, its ratio of core capital to risk-weighted assets is 6% or more, its ratio of core capital to adjusted total assets (leverage ratio) is 5% or more, and it is not subject to any federal supervisory order or directive to meet a specific capital level. In order to be adequately capitalized, an institution must have a total risk-based capital ratio of not less than 8%, a core capital to risk-weighted assets ratio of not less than 4%, and a leverage ratio of not less than 4%. An institution that is not well capitalized is subject to certain restrictions on brokered deposits, including restrictions on the rates it can offer on its deposits generally. Any institution which is neither well capitalized nor adequately capitalized is considered undercapitalized.

Undercapitalized institutions are subject to certain prompt corrective action requirements, regulatory controls and restrictions which become more extensive as an institution becomes more severely undercapitalized. Failure by either Heritage Bank and Central Valley Bank to comply with applicable capital requirements would, if unremedied, result in progressively more severe restrictions on its activities and lead to enforcement actions, including, but not limited to, the issuance of a capital directive to ensure the maintenance of required capital levels and, ultimately, the appointment of the FDIC as receiver or conservator. Banking regulators will take prompt corrective action with respect to depository institutions that do not meet minimum capital requirements. Additionally, approval of any regulatory application filed for their review may be dependent on compliance with capital requirements.

As of December 31, 2012, the Banks met the requirements to be classified as well-capitalized.

Federal law generally bars institutions which are not well capitalized from soliciting or accepting brokered deposits bearing interest rates significantly higher than prevailing market rates.

Deposit Insurance and Other FDIC Programs. The deposits of the Banks are insured up to applicable limits by the Deposit Insurance Fund (DIF), which is administered by the FDIC. The FDIC is an independent federal agency that insures the deposits, up to applicable limits, of depository institutions. As insurer of the Banks deposits, the FDIC has supervisory and enforcement authority over Heritage Bank and Central Valley Bank and this insurance is backed by the full faith and credit of the United States government. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of and to require reporting by institutions insured by the FDIC. It also may prohibit any institution insured by the FDIC from engaging in any activity determined by regulation or order to pose a serious risk to the institution and the DIF. The FDIC also has the authority to initiate enforcement actions and may terminate the deposit insurance if it determines that an institution has engaged in unsafe or unsound practices or is in an unsafe or unsound condition.

As a result of a decline in the reserve ratio (the ratio of the net worth of the DIF to estimated insured deposits) and concerns about expected failure costs and available liquid assets in the DIF, the FDIC adopted a rule requiring each insured institution to prepay on December 30, 2009 the estimated amount of its quarterly assessments for the fourth quarter of 2009 and all quarters through the end of 2012 (in addition to the regular quarterly assessment for the third quarter due on December 30, 2009). The prepaid amount is recorded as an asset with a zero risk weight and the institution will continue to record quarterly expenses for deposit insurance. For purposes of calculating the prepaid amount, assessments are measured at the institution s assessment rate as of September 30, 2009, with a uniform increase of three basis points effective January 1, 2011, and are based on the institution s assessment base for the third quarter of 2009, with growth assumed quarterly at annual rate of 5%. If events cause actual assessments during the prepayment period to vary from the prepaid amount, institutions will pay excess assessments in cash, or receive a rebate of prepaid amounts not exhausted after collection of assessments due on June 13, 2013, as applicable. Collection of the prepayment does not preclude the FDIC from changing assessment rates or revising the risk-based assessment system in the future. The rule includes a process for exemption from the prepayment for institutions whose safety and soundness would be affected adversely.

The Dodd-Frank Act requires the FDIC s deposit insurance assessments to be based on assets instead of deposits. The FDIC issued rules, effective as of the second quarter of 2011, which specify that the assessment base for a bank is equal to its total average consolidated assets less average tangible capital. The FDIC assessment rates range from approximately five basis points to 35 basis points, depending on applicable adjustments for unsecured debt issued by an institution and brokered deposits (and to further adjustment for institutions that hold unsecured debt of other FDIC-insured institutions), until such time as the FDIC s reserve ratio equals 1.15%. Once the FDIC s reserve ratio reaches 1.15% and the reserve ratio for the immediately prior assessment period is less than 2.0%, the applicable assessment rates may range from three basis points to 30 basis points (subject to adjustments as described above). If the reserve ratio for the prior assessment period is equal to, or greater than 2.0% and less than 2.5%, the assessment rates may range from two basis points to 28 basis points and if the prior assessment period is greater than 2.5%, the assessment rates may range from one basis point to 25 basis points (in each case subject to adjustments as described above. No institution may pay a dividend if it is in default on its federal deposit insurance assessment.

As insurer, the FDIC is authorized to conduct examinations of and to require reporting by FDIC-insured institutions. It also may prohibit any FDIC-insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious threat to the DIF. The FDIC also has the authority to take enforcement actions against banks and savings associations.

Other Regulatory Developments. Significant federal banking legislation has been enacted in recent years. The following summarizes some of the recent significant federal banking legislation.

The Dodd-Frank Act: On July 21, 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act implements far-reaching changes across the financial regulatory landscape, including provisions that, among other things, has or will:

- Centralized responsibility for consumer financial protection by creating a new agency within the Federal Reserve Board, the Bureau of Consumer Financial Protection, with broad rulemaking, supervision and enforcement authority for a wide range of consumer protection laws that applies to all banks and thrifts. Smaller financial institutions, including the Banks, are subject to the supervision and enforcement of their primary federal banking regulator with respect to the federal consumer financial protection laws.

- Required the federal banking regulators to promulgate new capital regulations and seek to make their capital requirements countercyclical, so that capital requirements increase in times of economic expansion and decrease in times of economic contraction.

- Provided for new disclosure and other requirements relating to executive compensation and corporate governance.

- Made permanent the $250,000 limit for federal deposit insurance and provide unlimited federal deposit insurance until January 1, 2013 for noninterest bearing demand transaction accounts at all insured depository institutions.

- Effective July 21, 2011, repealed the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.

- Required all depository institution holding companies to serve as a source of financial strength to their depository institution subsidiaries in the event such subsidiaries suffer from financial distress.

Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on the Company and the financial services industry more generally. The elimination of the prohibition on the payment of interest on demand deposits could materially increase our interest expense, depending on our competitors responses. Provisions in the legislation that require revisions to the capital requirements of the Company and the Banks could require the Company and the Banks to seek additional sources of capital in the future.

Sarbanes-Oxley Act. On July 30, 2002, the Sarbanes-Oxley Act of 2002 was signed into law in response to public concerns regarding corporate accountability in connection with various accounting scandals. The stated goals of the Sarbanes-Oxley Act 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. The Sarbanes-Oxley Act generally applies to all companies that file or are required to file periodic reports with the Securities and Exchange Commission (SEC), under the Securities Exchange Act of 1934.

The Sarbanes-Oxley Act includes very specific additional disclosure requirements and corporate governance rules, requires the SEC and securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules. The Sarbanes-Oxley Act 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. Our policies and procedures have been updated to comply with the requirements of the Sarbanes-Oxley Act.

Financial Services Reform Legislation. On November 12, 1999, the Gramm-Leach-Bliley Act (GLBA) was enacted into law. The GLBA removes various barriers imposed by the Glass-Steagall Act of 1933, specifically those prohibiting banks and bank holding companies from engaging in the securities and insurance business. The GLBA also expands the bank holding company act framework to permit bank holding companies with subsidiary banks meeting certain capital and management requirements to elect to become a financial holding company .

Financial holding companies may engage in a full range of financial activities, including not only banking, insurance, and securities activities, but also merchant banking and additional activities determined to be financial in nature or complementary to an activity that is financial in nature. The GLBA also provides that the list of permissible financial activities will be expanded as necessary for a financial holding company to keep abreast of competitive and technological changes.

In addition, the GLBA expands the activities in which insured state banks may engage. Under the GLBA, insured state banks are given the ability to engage in financial activities through a subsidiary, as long as the bank and its affiliates meet and comply with certain requirements. First, each bank must be well capitalized . Second, the bank must comply with certain capital deduction and financial statement requirements provided under the GLBA. Third, the bank must comply with certain financial and operational safeguards provided under the GLBA. Fourth, the bank must comply with the limits imposed by the GLBA on transactions with affiliates.

Website Access to Company Reports

We post publicly available reports required to be filed with the SEC on our website, www.HF-WA.com, as soon as reasonably practicable after filing such reports with the SEC. The required reports are available free of charge through our website.

Code of Ethics

We have adopted Code of Ethics that applies to our principal executive officer, principal financial officer and controller. We have posted the text of our code of ethics at www.HF-WA.com in the section titled Investor Information: Corporate Governance. Any waivers of the code of the ethics will be publicly disclosed to shareholders.

Competition

We compete for loans and deposits with other commercial banks, credit unions, mortgage bankers, and other institutions in the scope and type of services offered, interest rates paid on deposits, pricing of loans, and number and locations of branches, among other things. Many of our competitors have substantially greater resources than we do. Particularly in times of high or rising interest rates, we also face significant competition for investors funds from short-term money market securities and other corporate and government securities.

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We compete for loans principally through the range and quality of the services we provide, interest rates and loan fees, and the locations of our Banks branches. We actively solicit deposit-related clients and compete for deposits by offering depositors a variety of savings accounts, checking accounts, cash management and other services.

Employees

We had 363 full-time equivalent employees at December 31, 2012. We believe that employees play a vital role in the success of a service company. Employees are provided with a variety of benefits such as medical, vision, dental and life insurance, a retirement plan, and paid vacations and sick leave. None of our employees are covered by a collective bargaining agreement.

Executive Officers

The following table set forth certain information with respect to the executive officers of the Company.

Name	Age as of December 31, 2012	Position	Has Served the Company, Heritage Bank or Central Valley Bank Since
Brian L. Vance	58	President and Chief Executive Officer of Heritage; Chief Executive Officer of Heritage Bank; Vice Chairman and Chief Executive Officer of Central Valley Bank	1996
Jeffrey J. Deuel	54	Executive Vice President, Heritage; President and Chief Operating Officer of Heritage Bank	2010
Donald J. Hinson	51	Executive Vice President and Chief Financial Officer of Heritage, Heritage Bank and Central Valley Bank	2005
D. Michael Broadhead	67	President of Central Valley Bank	1986
David A. Spurling	59	Senior Vice President and Chief Credit Officer of Heritage Bank	1999

The business experience of each executive officer is set forth below.

Brian L. Vance is the President and Chief Executive Officer of Heritage; Chief Executive Officer of Heritage Bank and the Vice Chairman and Chief Executive Officer of Central Valley Bank. Mr. Vance was named President and Chief Executive Officer of Heritage and Heritage Bank, and Vice Chairman and Chief Executive Officer of Central Valley Bank in 2006. In 2003, Mr. Vance was appointed President and Chief Executive Officer of Heritage Bank and in 1998, Mr. Vance was named President and Chief Operating Officer of Heritage Bank. Mr. Vance joined Heritage Bank in 1996 as its Executive Vice President and Chief Credit Officer. Prior to joining Heritage Bank, Mr. Vance was employed for 24 years with West One Bank, a bank with offices in Idaho, Utah, Oregon and Washington. Prior to leaving West One, he was Senior Vice President and Regional Manager of Banking Operations for the south Puget Sound region.

Jeffrey J. Deuel became President and Chief Operating Officer of Heritage Bank in 2012. Mr. Deuel joined Heritage Bank in February 2010 as Executive Vice President. In November 2010, Mr. Deuel was named Executive Vice President and Chief Operating Officer of Heritage Bank and Executive Vice President of the Company. Mr. Deuel came to the Company with 28 years of banking experience and most recently held the position of Executive Vice President Commercial Operations with JPMorgan Chase, formerly Washington Mutual. Prior to joining Washington Mutual Mr. Deuel was based in Philadelphia where he worked for Bank

United, First Union Bank, CoreStates Bank, and First Pennsylvania Bank. During his career Mr. Deuel held a variety of leadership positions in commercial banking including lending, retail and support services, corporate strategies, credit administration, and portfolio management.

Donald J. Hinson became Executive Vice President and Chief Financial Officer of Heritage Bank in 2012. In 2007 Mr. Hinson was appointed the Senior Vice President and Chief Financial Officer of Heritage, Heritage Bank and Central Valley Bank. Mr. Hinson joined Heritage Bank in 2005 as Vice President and Controller. Prior to that, he served in the banking audit practice of local and national accounting firms of Knight, Vale and Gregory and RSM McGladrey from 1994 to 2005.

D. Michael Broadhead joined Central Valley Bank in 1986 and has been President of Central Valley Bank since 1990. The Company acquired Central Valley Bank in March 1999. Previously, Mr. Broadhead held positions with Farmers Home Administration and First Bank and Trust of Idaho. Prior to leaving First Bank and Trust of Idaho, he held the position of Chief Executive Officer.

David A. Spurling became Senior Vice President and Chief Credit Officer of Heritage Bank in 2007. Mr. Spurling joined Heritage Bank in 2001 as a commercial lender, followed by a role as a commercial team leader. He began his banking career as a middle market lender at Seafirst Bank, followed by positions as a commercial lender at Bank of America in Small Business Banking and as a regional manager for Bank of America s government-guaranteed lending division. Mr. Spurling holds a Master s Degree in Business Administration from the University of Washington and is Credit Risk Certified by the Risk Management Association.

ITEM 1A. RISK FACTORS

We assume and manage a certain degree of risk in order to conduct our business strategy. The following provides a discussion of certain risks that management believes are specific to our business. This discussion should not be viewed as an all inclusive list or in any particular order.

Our strategy of pursuing acquisitions and de novo branching exposes us to financial, execution and operational risks that could adversely affect us.

We are pursuing a strategy of supplementing organic growth by acquiring other financial institutions or their businesses that we believe will help us fulfill our strategic objectives and enhance our earnings. There are risks associated with this strategy, however, including the following:

- we may be exposed to potential asset quality issues or unknown or contingent liabilities of the banks, businesses, assets and liabilities we acquire. If these issues or liabilities exceed our estimates, our results of operations and financial condition may be materially negatively affected;

- prices at which acquisitions can be made fluctuate with market conditions. We have experienced times during which acquisitions could not be made in specific markets at prices we considered acceptable and expect that we may continue to experience this condition in the future;

- the acquisition of other entities generally requires integration of systems, procedures and personnel of the acquired entity into our company to make the transaction economically successful. This integration process is complicated and time consuming and can also be disruptive to the customers of the acquired business. If the integration process is not conducted successfully and with minimal effect on the acquired business and its customers, we may not realize the anticipated economic benefits of an acquisition within the expected time frame, and we may lose customers or employees of the acquired business. We may also experience greater than anticipated customer losses even if the integration process is successful. These risks are present in our completed FDIC-assisted transactions involving our assumption of deposits and the acquisition of assets of Cowlitz Bank and Pierce Commercial Bank and in the recently completed acquisition of Northwest Commercial Bank;

to finance an acquisition, we may borrow funds, thereby increasing our leverage and diminishing our liquidity, or raise additional capital, which could dilute the interests of our existing shareholders.

we completed two acquisitions during 2010 and one in January 2013 that enhanced our rate of growth. We may not be able to continue to sustain our past rate of growth or to grow at all in the future;

we expect our net income will increase following our acquisitions, however, we also expect our general and administrative expenses and consequently our efficiency ratios will also increase. Ultimately, we would expect our efficiency ratio to improve; however, if we are not successful in our integration process, this may not occur, and our acquisitions or branching activities may not be accretive to earnings in the short or long-term; and

the purchase and assumption agreement and the shared-loss agreements we entered into with the FDIC in connection with the Cowlitz and Pierce Commercial Acquisitions, have specific, detailed and cumbersome compliance, servicing, notification and reporting requirements. Our failure to comply with the terms of the agreements or to properly service the loans and real estate owned under the requirements of the shared-loss agreements may cause individual loans or large pools of loans to lose eligibility for loss share payments from the FDIC. This could result in material losses that are currently not anticipated.

Our business strategy includes significant growth plans, and our financial condition and results of operations could be negatively affected if we fail to grow or fail to manage our growth effectively.

We intend to pursue a significant growth strategy for our business. We regularly evaluate potential acquisitions and expansion opportunities. If appropriate opportunities present themselves, we expect to engage in selected acquisitions of financial institutions in the future, including FDIC-assisted transactions, branch acquisitions, or other business growth initiatives or undertakings. There can be no assurance that we will successfully identify appropriate opportunities, that we will be able to negotiate or finance such activities or that such activities, if undertaken, will be successful.

Our growth initiatives may require us to recruit experienced personnel to assist in such initiatives, which will increase our compensation costs. In addition, the failure to identify and retain such personnel would place significant limitations on our ability to successfully execute our growth strategy. To the extent we expand our lending beyond our current market areas, we also could incur additional risk related to those new market areas. We may not be able to expand our market presence in our existing market areas or successfully enter new markets.

If we do not successfully execute our acquisition growth plan, it could adversely affect our business, financial condition, results of operations, reputation and growth prospects. In addition, if we were to conclude that the value of an acquired business had decreased and that the related goodwill had been impaired, that conclusion would result in an impairment of goodwill charge to us, which would adversely affect our results of operations. While we believe we have the executive management resources and internal systems in place to successfully manage our future growth, there can be no assurance that suitable growth opportunities will be available or that we will successfully manage our growth. See -If the goodwill we have recorded in connection with acquisitions becomes impaired, our earnings and capital could be reduced and -Our strategy of pursuing acquisitions and de novo branching exposes us to financial, execution and operational risks that could adversely affect us for additional risks related to our acquisition strategy.

Failure to comply with the terms of the shared-loss agreements with the FDIC may result in significant losses.

In connection with the Cowlitz Bank Acquisition, Heritage Bank entered into shared-loss agreements with the FDIC that significantly reduce the Bank s credit loss exposure. The purchase and assumption agreement and the shared-loss agreements for the Cowlitz Bank Acquisition have specific, detailed and cumbersome compliance, servicing, notification and reporting requirements. Our failure to comply with the terms of the agreements or to properly service the loans and other real estate owned under the requirements of the shared-loss agreement may cause individual loans or large pools of loans to lose eligibility for loss share payments from the FDIC. This could result in material losses that are currently not anticipated.

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We may engage in additional FDIC-assisted transactions, which could present additional risks to our business.

We may have additional opportunities to acquire the assets and liabilities of failed banks in FDIC-assisted transactions. Although these FDIC-assisted transactions typically provide for FDIC assistance to an acquirer to mitigate certain risks, such as sharing exposure to loan losses and providing indemnification against certain liabilities of the failed institution, we are (and would be in future transactions) subject to many of the same risks we would experience in acquiring another bank in a negotiated transaction, including risks associated with maintaining customer relationships and failure to realize the anticipated acquisition benefits in the amounts and within the timeframes we expect. In addition, because these acquisitions are structured in a manner that would not allow us the time and access to information normally associated with preparing for and evaluating a negotiated acquisition, we may face additional risks in FDIC-assisted transactions, including additional pressure on management resources, management of problem loans, problems related to integration of personnel and operating systems, and the resulting impact to our capital resources that may require us to raise additional capital. We may not be successful in overcoming these risks or any other problems encountered in connection with FDIC-assisted transactions. Our inability to overcome these risks could have a material adverse effect on our business, financial condition and results of operations.

We operate in a highly regulated environment and may be adversely affected by changes in federal and state laws and regulations, including new financial reform legislation recently enacted by Congress that is expected to increase our costs of operations.

We are subject to extensive examination, supervision and comprehensive regulation by the Federal Reserve and Heritage Bank and Central Valley Bank are subject to examination, supervision and comprehensive regulation by the FDIC and the Division. The Federal Reserve, FDIC and Division govern the activities in which we may engage, primarily for the protection of depositors and the Deposit Insurance Fund. These regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the ability to impose restrictions on an institution s operations, reclassify assets, determine the adequacy of an institution s allowance for loan losses and determine the level of deposit insurance premiums assessed.

Additionally, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act) has significantly changed the bank regulatory structure and has affected the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting and implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years.

Certain provisions of the Dodd-Frank Act are expected to have a near term impact on our operations. For example, a provision of the Dodd-Frank Act eliminates the federal prohibitions on paying interest on demand deposits, thus allowing businesses to have interest bearing checking accounts. Depending on competitive responses, this significant change to existing law could have an adverse impact on our interest expense.

The Dodd-Frank Act also broadens the base for FDIC insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution. The Dodd-Frank Act also permanently increased the maximum amount of deposit insurance for banks, savings institutions and credit unions to $250,000 per depositor.

The Dodd-Frank Act requires publicly traded companies to give stockholders a non-binding vote on executive compensation and so-called golden parachute payments and authorizes the SEC to promulgate rules that would allow stockholders to nominate their own candidate using a company s proxy materials. The legislation also directs the Federal Reserve to promulgate rules prohibiting excessive compensation paid to bank holding company executives, regardless of whether the company is publicly traded.

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The Dodd-Frank Act creates a new Consumer Financial Protection Bureau with broad powers to supervise and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit unfair, deceptive or abusive acts and practices. The Consumer Financial Protection Bureau has examination and enforcement authority over all banks and savings institutions with more than $10 billion in assets. Financial institutions such as Heritage Bank and Central Valley Bank with $10 billion or less in assets will continue to be examined for compliance with the consumer laws by their primary bank regulators.

It is difficult to predict at this time what specific impact the Dodd-Frank Act and the yet to be written implementing rules and regulations will have on community banks. However, it is expected that at a minimum they will increase our operating and compliance costs and could increase our interest expense. Any additional changes in our regulation and oversight, whether in the form of new laws, rules or regulations, could make compliance more difficult or expensive or otherwise materially adversely affect our business, financial condition or prospects.

As the Company and Banks continue to monitor developments under the Dodd-Frank Act and to assess the ultimate impact of the legislation and yet to be written implementing rules and regulations on community banks, at a minimum we expect to experience an increase in our operating and compliance costs, which is expected to continue and further impact our interest expense.

The short-term and long-term impact of the changing regulatory capital requirements and anticipated new capital rules is uncertain.

In June 2012, the Federal Reserve, FDIC and the OCC proposed rules that would substantially amend the regulatory risk-based capital rules applicable to the us, Heritage Bank and Central Valley Bank. The proposed rules were subject to a public comment period that has expired and there is no date set for the adoption of final rules.

Various provisions of the Dodd-Frank Act increase the capital requirements of bank holding companies, such as Heritage Financial Corporation. The leverage and risk-based capital ratios of these entities may not be lower than the leverage and risk-based capital ratios for insured depository institutions. The proposed rules include new minimum risk-based capital and leverage ratios, which would be phased in during 2013 and 2014, and would refine the definition of what constitutes capital for purposes of calculating those ratios. The proposed new minimum capital level requirements applicable to us, Heritage Bank and Central Valley Bank under the proposals would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. The proposed rules would also establish a capital conservation buffer of 2.5% above the new regulatory minimum capital ratios, and would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions. While the proposed Basel III changes and other regulatory capital requirements will likely result in generally higher regulatory capital standards, it is difficult at this time to predict when or how any new standards will ultimately be applied to us, Heritage Bank and Central Valley Bank.

In addition, in the current economic and regulatory environment, regulators of banks and bank holding companies have become more likely to impose capital requirements on bank holding companies and banks that are more stringent than those required by applicable existing regulations.

The application of more stringent capital requirements for us, Heritage Bank and Central Valley Bank could, among other things, result in lower returns on invested capital, require the raising of additional capital, and result in regulatory actions if we were to be unable to comply with such requirements. Furthermore, the imposition of liquidity requirements in connection with the implementation of Basel III could result in our having to lengthen the term of our funding, restructure our business models, and/or increase our holdings of liquid assets. Implementation of changes to asset risk weightings for risk based capital calculations, items included or deducted in calculating regulatory capital and/or additional capital conservation buffers could result in management modifying its business strategy and could limit our ability to make distributions, including paying out dividends or buying back shares.

Our loan portfolio is concentrated in loans with a higher risk of loss.

Repayment of our commercial business loans, consisting of commercial and industrial loans as well as owner-occupied and non-owner occupied commercial real estate loans, is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value. We offer different types of commercial loans to a variety of businesses with a focus on real estate related industries and businesses in agricultural, healthcare, legal, and other professions. The types of commercial loans offered are business lines of credit, term equipment financing and term real estate loans. We also originate loans that are guaranteed by the Small Business Administration, or SBA, and are a preferred lender of the SBA. Commercial business lending involves risks that are different from those associated with real estate lending. Real estate lending is generally considered to be collateral based lending with loan amounts established on predetermined loan to collateral values and liquidation of the underlying real estate collateral being viewed as the primary source of repayment in the event of borrower default. Our commercial business loans are primarily made based on our assessment of the cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The borrowers cash flow may be unpredictable, and collateral securing these loans may fluctuate in value. Although commercial business loans are often collateralized by equipment, inventory, accounts receivable, or other business assets, the liquidation of collateral in the event of default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories may be obsolete or of limited use, among other things. Accordingly, the repayment of commercial business loans depends primarily on the cash flow and creditworthiness of the borrower and secondarily on the underlying collateral provided by the borrower. In addition, as part of our commercial business lending activities, we originate agricultural loans. Payments on agricultural loans are typically dependent on the profitable operation or management of the related farm property. The success of the farm may be affected by many factors outside the control of the borrower, including adverse weather conditions that prevent the planting of a crop or limit crop yields, declines in market prices for agricultural products and the impact of government regulations. In addition, many farms are dependent on a limited number of key individuals whose injury or death may significantly affect the successful operation of the farm. If the cash flow from a farming operation is diminished, the borrower s ability to repay the loan may be impaired.

At December 31, 2012, our originated commercial business loans (consisting of commercial and industrial loans, owner-occupied commercial real estate loans and non-owner occupied commercial real estate loans) totaled $731.6 million, or approximately 83.7% of our total originated loan portfolio.

Our non-owner occupied commercial real estate loans, which includes five or more family residential real estate loans, involve higher principal amounts than other loans and repayment of these loans may be dependent on factors outside our control or the control of our borrowers. We originate commercial and five or more family residential real estate loans for individuals and businesses for various purposes, which are secured by commercial properties. These loans typically involve higher principal amounts than other types of loans, and repayment is dependent upon income generated, or expected to be generated, by the property securing the loan in amounts sufficient to cover operating expenses and debt service, which may be adversely affected by changes in the economy or local market conditions. For example, if the cash flow from the borrower s project is reduced as a result of leases not being obtained or renewed, the borrower s ability to repay the loan may be impaired.

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Commercial and five or more family residential real estate loans also expose us to greater credit risk than loans secured by residential real estate because the collateral securing these loans typically cannot be sold as easily as residential real estate. In addition, many of our commercial and five or more family residential real estate loans are not fully amortizing and contain large balloon payments upon maturity. Such balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment. If we foreclose on a commercial and five or more family residential real estate loan, our holding period for the collateral typically is longer than for one-to-four family residential mortgage loans because there are fewer potential purchasers of the collateral. Additionally, commercial and five or more family residential real estate loans generally have relatively large balances to single borrowers or related groups of borrowers. Accordingly, if we make any errors in judgment in the collectability of our commercial and five or more family residential real estate loans, any resulting charge-offs may be larger on a per loan basis than those incurred with our residential or consumer loan portfolios.

As of December 31, 2012, our non-owner occupied commercial real estate loans totaled $265.8 million, or 30.4% of our total originated loan portfolio.

Our real estate construction and land development loans are based upon estimates of costs and value associated with the completed project. These estimates may be inaccurate. Construction lending can involve a higher level of risk than other types of lending because funds are advanced partially based upon the value of the project, which is uncertain prior to the project s completion. Because of the uncertainties inherent in estimating construction costs as well as the market value of a completed project and the effects of governmental regulation of real property, our estimates with regards to the total funds required to complete a project and the related loan-to-value ratio may vary from actual results. As a result, construction loans often involve the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project and the ability of the borrower to sell or lease the property or refinance the indebtedness. If our estimate of the value of a project at completion proves to be overstated, it may have inadequate security for repayment of the loan and may incur a loss.

As of December 31, 2012, our originated real estate construction and land development loans totaled $77.3 million, or 8.8% of our total originated loan portfolio. Of these loans, $25.2 million, or 2.9%, were one-to-four family residential construction related and $52.1 million, or 5.9%, were five-or-more family residential and commercial construction related. Approximately $6.4 million, or 8.3%, of our total originated construction loans were nonperforming at December 31, 2012.

Our allowance for loan losses may prove to be insufficient to absorb losses in our loan portfolio.

Lending money is a substantial part of our business. Every loan carries a certain risk that it will not be repaid in accordance with its terms or that any underlying collateral will not be sufficient to assure repayment. This risk is affected by, among other things:

- cash flow of the borrower and/or the project being financed;
- the changes and uncertainties as to the future value of the collateral, in the case of a collateralized loan;
- the character and creditworthiness of a particular borrower;
- changes in economic and industry conditions; and
- the duration of the loan.

We maintain an allowance for loan losses on our loans, which is a reserve established through a provision for loan losses charged against income, which we believe is appropriate to provide for probable losses in our loan portfolio. The amount of this allowance is determined by our management through a periodic review and consideration of several factors, including, but not limited to:

our general reserve, based on our historical default and loss experience;

our specific reserve, based on our evaluation of nonperforming loans and their underlying collateral or discounted cash flows; and

current macroeconomic factors and management s expectation of future events.

The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Continuing deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in the allowance for loan losses. If current weak conditions in the housing and real estate markets continue, we expect we will continue to experience further delinquencies and credit losses. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for possible loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. In addition, if charge-offs in future periods exceed the allowance for loan losses we will need additional provisions to increase the allowance for loan losses. Any increases in the allowance for loan losses will result in a decrease in net income and possibly capital, and may have a material adverse effect on our financial condition and results of operations.

If our allowance for loan losses is not adequate, we may be required to make further increases in our provision for loan losses and to charge-off additional loans, which could adversely affect our results of operations and our capital.

For the year ended December 31, 2012 we recorded a total provision for loan losses of $2.0 million compared to $14.4 million for the year ended December 31, 2011. The provision related to the originated portfolio was $695,000 and $5.2 for the years ended December 31, 2012 and 2011, respectively. Our provision for loan losses on purchased loans was $1.3 million and $9.3 million for the years ended December 31, 2012 and 2011, respectively. We also recorded net loan charge-offs of $4.3 million for the year ended December 31, 2012 compared to $5.6 million for the year ended December 31, 2011. The net charge-offs related to the originated portfolio was $3.9 million and $4.9 million for the years ended December 31, 2012 and 2011, respectively. Recently, we have been experiencing decreasing loan delinquencies and decreasing loan charge-offs. Generally, our nonperforming loans and assets reflect operating difficulties of individual borrowers resulting from weakness in the local economy. The deterioration in the general economy has been a significant contributing factor to our current level of delinquencies and nonperforming loans. The economy has significantly impacted our commercial and industrial loan portfolio, which represented 36.6% of our nonaccrual originated loans at December 31, 2012. Slower sales and excess inventory in the housing market has been the primary cause of the increase in foreclosures for one-to-four family residential construction loans, which represented 24.6% of our nonperforming originated loans at December 31, 2012. At December 31, 2012 our total nonperforming originated loans were $12.5 million, or 1.28% of total originated loans, compared to $23.3 million or 2.57% of total originated loans at December 31, 2011. Moreover, if weak economic conditions persist, we expect that we could experience significantly higher delinquencies and loan charge-offs. As a result, we may be required to make further increases in our provision for loan losses in the future, which could adversely affect our financial condition and results of operations, perhaps materially.

The current economic condition in the market areas we serve may continue to adversely impact our earnings and could increase the credit risk associated with our loan portfolio.

Substantially all of our loans are to businesses and individuals in the states of Washington and Oregon, and a continuing decline in the economies of our primary market areas of the Pacific Northwest could have a material adverse effect on our business, financial condition, results of operations and prospects. In particular, in the current downturn, the Puget Sound and Portland, Oregon areas have experienced substantial home price declines, increased foreclosures and above-average unemployment rates. Many large Pacific Northwest businesses have implemented substantial employee layoffs and scaled back plans for future growth. The Yakima Valley also has similarly experienced an increased unemployment rate and a continued decline in housing prices.

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Continued weakness or a further deterioration in economic conditions in the market areas we serve could result in the following consequences, any of which could have a materially adverse impact on our business, financial condition and results of operations:

- loan delinquencies, problem assets and foreclosures may increase;
- we may increase our provision for loan losses;
- demand for our products and services may decline possibly resulting in a decrease in our total loans;
- collateral for loans made may decline further in value, exposing us to increased risk of loss on existing loans;
- the net worth and liquidity of loan guarantors may decline, impairing their ability to honor commitments to us; and
- the amount of our deposits may decrease and the composition of our deposits may be adversely affected.

If the goodwill we have recorded in connection with acquisitions becomes impaired, our earnings and capital could be reduced.

Accounting standards require that we account for acquisitions using the purchase method of accounting. Under purchase accounting, if the purchase price of an acquired company exceeds the fair value of its net assets, the excess is carried on the acquirer s balance sheet as goodwill. In accordance with generally accepted accounting principles, our goodwill is evaluated for impairment on an annual basis or more frequently if events or circumstances indicate that a potential impairment exists. Such evaluation is based on a variety of factors, including the quoted price of our common stock, market prices of common stock of other banking organizations, common stock trading multiples, discounted cash flows, and data from comparable acquisitions. At December 31, 2012, we had goodwill with a carrying amount of $13.0 million.

Declines in our stock price or a prolonged weakness in the operating environment of the financial services industry may result in a future impairment charge. Any such impairment charge could have a material adverse affect on our operating results and capital.

Fluctuating interest rates can adversely affect our profitability.

Our profitability is dependent to a large extent upon net interest income, which is the difference (or spread) between the interest earned on loans, securities and other interest-earning assets and the interest paid on deposits, borrowings, and other interest-bearing liabilities. Because of the differences in maturities and repricing characteristics of our interest-earning assets and interest-bearing liabilities, changes in interest rates do not produce equivalent changes in interest income earned on interest-earning assets and interest paid on interest-bearing liabilities. Accordingly, fluctuations in interest rates could adversely affect our interest rate spread, and, in turn, our profitability.

The tightening of available liquidity could limit our ability to replace deposits and fund loan demand, which could adversely affect our earnings and capital levels.

A tightening of the credit markets and the inability to obtain adequate funding to replace deposits and fund continued loan growth may negatively affect asset growth and, consequently, our earnings capability and capital levels. In addition to any deposit growth, maturity of investment securities and loan payments, we rely from time to time on advances from the Federal Home Loan Bank of Seattle, or FHLB, and certain other wholesale funding sources to fund loans and replace deposits. In the event of a further downturn in the economy, these additional funding sources could be negatively affected which could limit the funds available to us. Our liquidity position could be significantly constrained if we were unable to access funds from the FHLB or other wholesale funding sources.

Increases in deposit insurance premiums and special FDIC assessments will negatively impact our earnings.

The Dodd-Frank Act established 1.35% of total insured deposits as the minimum reserve ratio. The FDIC has adopted a plan under which it will meet this ratio by the statutory deadline of September 30, 2020, which has increased assessments. The Dodd-Frank Act requires the FDIC to offset the effect on institutions with assets less than $10 billion of the increase in the minimum reserve ratio to 1.35% from the former minimum of 1.15%. The FDIC has not announced how it will implement this offset. In addition to the statutory minimum ratio, the FDIC must set a designated reserve ratio, which may exceed the statutory minimum. The FDIC has set 2.0% as the designated reserve ratio.

As required by the Dodd-Frank Act, the FDIC has adopted final regulations under which insurance premiums are based on an institution s total assets minus its tangible equity instead of its deposits. While our FDIC insurance premiums initially may be reduced by these regulations, it is possible that our future insurance premiums will increase under the final regulations.

Our growth or future losses may require us to raise additional capital in the future, but that capital may not be available when it is needed or the cost of that capital may be very high; further, the resulting dilution of our equity may adversely affect the market price of our common stock.

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. At some point we may need to raise additional capital to support continued internal growth and growth through acquisitions. Our ability to raise additional capital, however, will depend on conditions in the capital markets at that time, which are outside our control, and on our financial condition and performance. If we are able to raise capital it may not be on terms that are acceptable to us. If we cannot raise additional capital when needed, our ability to further expand our operations through internal growth and acquisitions could be materially impaired and our financial condition and liquidity could be materially and adversely affected. Accordingly, we cannot make assurances that we will be able to raise additional capital when needed.

We are not restricted from issuing additional common stock or preferred stock, including any securities that are convertible into or exchangeable for, or that represent the right to receive, common stock or preferred stock or any substantially similar securities. The market price of our common stock could decline as a result of sales of a large number of shares of common stock or preferred stock or similar securities in the market or from the perception that such sales could occur.

Our board of directors is authorized generally to cause us to issue additional common stock, as well as series of preferred stock, without any action on the part of our shareholders except as may be required under the listing requirements of the NASDAQ Stock Market. In addition, the board has the power, without shareholder approval, to set the terms of any such series of preferred stock that may be issued, including voting rights, dividend rights and preferences over the common stock with respect to dividends or upon the liquidation, dissolution or winding-up of our business and other terms.

In addition, if we issue preferred stock in the future that has a preference over the common stock with respect to the payment of dividends or upon liquidation, dissolution or winding-up, or if we issue preferred stock with voting rights that dilute the voting power of the common stock, the rights of holders of the common stock or the market price of the common stock could be adversely affected.

Continued deterioration in the financial position of the Federal Home Loan Bank of Seattle may result in future impairment losses of our investment in Federal Home Loan Bank stock.

At December 31, 2012, we owned $5.5 million of stock of the FHLB of Seattle. As a condition of membership at the FHLB, we are required to purchase and hold a certain amount of FHLB stock. Our stock purchase requirement is based, in part, upon the outstanding principal balance of advances from the FHLB and is calculated in accordance with the Capital Plan of the FHLB. Our FHLB stock has a par value of $100, is carried at cost, and is subject to impairment testing. In December 2008, the FHLB has announced that it had a risk-based capital deficiency under the regulations of the Federal Housing Finance Agency, or the FHFA, its primary regulator, and that it would suspend future dividends and the repurchase and redemption of outstanding common stock. As a result, the FHLB has not paid a dividend since the fourth quarter of 2008. In addition, the FHLB communicated that it believes the calculation of risk-based capital under the current rules of the FHFA significantly overstates the market risk of the FHLB s private-label mortgage-backed securities in the current market environment and that it has enough capital to cover the risks reflected in its balance sheet. As a result, we have not recorded an other-than-temporary impairment on our investment in FHLB stock. In addition, on October 25, 2010, the FHLB received a consent order from the FHFA, which it has been operating under since that time. In September 2012, the FHLB of Seattle announced that its financial condition had improved, that it continues to address the requirements of the Consent Agreement and that it met all minimum financial metrics required under the Consent Agreement. Further, the FHLB of Seattle reported that the FHFA had reclassified the FHLB of Seattle to be adequately capitalized and that the FHFA had authorized the FHLB Seattle to repurchase up to $25 million of excess capital stock per quarter at par ($100 per share) as long as its financial condition does not deteriorate. Any dividends on, or repurchases of, the FHLB of Seattle stock continue to require consent of the FHFA. After receiving FHFA approval, the FHLB of Seattle repurchased $24.1 million in excess capital stock in late September 2012. We will continue to monitor the financial condition of the FHLB as it relates to, among other things, the recoverability of our investment.

New or changing tax, accounting, and regulatory rules and interpretations could significantly impact strategic initiatives, results of operations, cash flows, and financial condition.

The financial services industry is extensively regulated. Federal and state banking regulations are designed primarily to protect the deposit insurance funds and consumers, not to benefit a company s stockholders. Regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the imposition of restrictions on the operation of an institution, the classification of assets by the institution and the adequacy of an institution s allowance for loan losses. Additionally, actions by regulatory agencies or significant litigation against us could require us to devote significant time and resources to defending our business and may lead to penalties that materially affect us. These regulations, along with the currently existing tax, accounting, securities, insurance, and monetary laws, regulations, rules, standards, policies, and interpretations control the methods by which financial institutions conduct business, implement strategic initiatives and tax compliance, and govern financial reporting and disclosures. These laws, regulations, rules, standards, policies, and interpretations are constantly evolving and may change significantly over time. For information regarding the significant federal and state banking regulations that affect us, see Item 1. Business Supervision and Regulation.

We rely heavily on the proper functioning of our technology.

We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer relationship management, general ledger, deposit, loan and other systems. While we have policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our 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 our information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

We rely on third-party service providers for much of our communications, information, operating and financial control systems technology. If any of our third-party service providers experience financial, operational or technological difficulties, or if there is any other disruption in our relationships with them, we may be required to locate alternative sources of such services, and we cannot assure that we could negotiate terms that are as favorable to us, or could obtain services with similar functionality, as found in our existing systems, without the need to expend substantial resources, if at all. Any of these circumstances could have an adverse effect on our business.

Changes in accounting standards may affect how we record and report our performance.

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. From time to time there are changes in the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be difficult to predict and can materially impact how we report and record our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, resulting in a retrospective adjustment to prior financial statements.

We are dependent on key personnel and the loss of one or more of those key personnel may materially and adversely affect our prospects.

Competition for qualified employees and personnel in the banking industry is intense and there are a limited number of qualified persons with knowledge of, and experience in, the community banking industry where we conduct our business. The process of recruiting personnel with the combination of skills and attributes required to carry out our strategies is often lengthy. Our success depends to a significant degree upon our ability to attract and retain qualified management, loan origination, finance, administrative, marketing and technical personnel and upon the continued contributions of our management and personnel. In particular, our success has been and continues to be highly dependent upon the abilities of key executives, including our President and Chief Executive Officer, Mr. Brian L. Vance, and certain other employees. The loss of key personnel could adversely affect our ability to successfully conduct our business.

ITEM 1B. UNRESOLVED STAFF COMMENTS

There are no unresolved staff comments from the Securities and Exchange Commission.

ITEM 2. PROPERTIES

Our executive offices and the main office of Heritage Bank are located in approximately 22,000 square feet of the headquarters building and adjacent office space and main branch office which are owned by Heritage Bank and located in downtown Olympia. At December 31, 2012, Heritage Bank had ten offices located in Tacoma and surrounding areas of Pierce County (all but five of which are owned), five offices located in Thurston County (all of which are owned with one office located on leased land), four offices in King County (all of which are leased), one office in Mason County (which is owned), one office in Clark County (which is leased), four offices in Cowlitz County (all of which are owned with the exception of one leased office) and two offices in Multnomah Country (all of which are leased). Central Valley Bank had six offices, five located in Yakima County and one in Kittitas County (all of which are owned with one on leased land).

ITEM 3. LEGAL PROCEEDINGS

We, and our Banks, are not a party to any material pending legal proceedings other than ordinary routine litigation incidental to the business of the Banks.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

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PART II

ITEM 5. MARKET FOR THE REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the NASDAQ Global Select Market under the symbol HFWA. At December 31, 2012, we had approximately 1,112 shareholders of record (not including the number of persons or entities holding stock in nominee or street name through various brokerage firms) and 15,117,980 outstanding shares of common stock. This total does not reflect the number of persons or entities who hold stock in nominee or street name through various brokerage firms. The last reported sales price on February 8, 2013 was $14.09 per share. The following table provides sales information per share of our common stock as reported on the NASDAQ Global Select Market for the indicated quarters.

	2012 Quarter ended,			
	March 31	June 30	September 30	December 31
High	$ 14.56	$ 14.65	$ 15.57	$ 15.23
Low	$ 12.25	$ 12.37	$ 13.44	$ 13.50

	2011 Quarter ended,			
	March 31	June 30	September 30	December 31
High	$ 15.12	$ 14.86	$ 13.15	$ 13.57
Low	$ 13.50	$ 12.53	$ 10.20	$ 10.24

Quarterly, the Company reviews the potential payment of cash dividends to common shareholders. The timing and amount of cash dividends paid on our common stock depends on the Company s earnings, capital requirements, financial condition and other relevant factors.

The dividend activities for the year ended December 31, 2012 and subsequent through the date of this filing are listed below:

Declared	Cash Dividend per Share	Record Date	Paid
February 1, 2012	$0.06	February 10, 2012	February 24, 2012
April 26, 2012	$0.08	May 10, 2012	May 24, 2012
June 26, 2012	$0.20	July 10, 2012	July 24, 2012
July 25, 2012	$0.08	August 14, 2012	August 24, 2012
October 30, 2012	$0.08	November 9, 2012	November 21, 2012
November 30, 2012	$0.30	November 26, 2012	December 6, 2012
January 30, 2013	$0.08	February 8, 2013	February 22, 2013

The primary source for dividends paid to our shareholders is dividends paid to us from Heritage Bank and Central Valley Bank. There are regulatory restrictions on the ability of our subsidiary banks to pay dividends. Under federal regulations, the dollar amount of dividends the Banks may pay depends upon their capital position and recent net income. Generally, if an institution satisfies its regulatory capital requirements, it may make dividend payments up to the limits prescribed under state law and FDIC regulations. However, an institution that has converted to a stock form of ownership, as Heritage Bank has done, may not declare or pay a dividend on, or repurchase any of, its common stock if the effect thereof would cause the regulatory capital of the institution to be reduced below the amount required for the liquidation account which was established in connection with the mutual stock conversion.

As a bank holding company, our ability to pay dividends is subject to the guidelines of the Federal Reserve Board regarding capital adequacy and dividends. The Federal Reserve Board s policy is that a bank holding company should pay cash dividends only to the extent that its net income for the past year is sufficient to cover both the cash dividends and a rate of earnings retention that is consistent with the holding company s capital needs, asset quality and overall financial condition, and that it is inappropriate for a bank holding company experiencing serious financial problems to borrow funds to pay dividends. Under Washington law, we are prohibited from paying a dividend if, after making such dividend payment, we would be unable to pay our debts as they become due in the usual course of business, or if our total liabilities, plus the amount that would be needed, in the event we were to be dissolved at the time of the dividend payment, to satisfy preferential rights on dissolution of holders of preferred stock ranking senior in right of payment to the capital stock on which the applicable distribution is to be made exceed our total assets.

The Company has had various stock repurchase programs since March 1999. In August 2011, the Board of Directors approved the ninth stock repurchase plan, allowing the Company to repurchase up to 5% of the then outstanding shares, or approximately 782,000 shares over a period of twelve months. During the year ended December 31, 2012, the Company repurchased 389,627 shares at an average price of $13.45 per share under this plan. In total, the Company repurchased 590,832 shares at an average price of $12.83 per share under this plan. On August 30, 2012, the Board of Directors approved the Company s tenth stock repurchase plan, authorizing the repurchase of up to 5% of the Company s outstanding shares or approximately 757,000 shares. For the year ended December 31, 2012, 52,900 shares have been repurchased at an average price of $13.88 per share under this plan. The Company also repurchased 3,419 shares at an average price of $14.08 to pay withholding taxes on the vesting of restricted stock for the year ended December 31, 2012.

The following table sets forth information about the Company s purchases of its outstanding common stock during the quarter ended December 31, 2012.

Period	Total Number of Shares Purchased(1)	Average Price Paid Per Share(1)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
October 1, 2012 October 31, 2012	263	$ 14.23	6,608,448	757,000
November 1, 2012 November 30, 2012	44,689	13.86	6,652,648	712,800
December 1, 2012 December 31, 2012	8,748	13.83	6,661,348	704,100
Total	53,700	$ 13.86	6,661,348	704,100

(1) Common shares repurchased by the Company between September 1, 2012 and December 31, 2012 included the cancellation of 800 shares of restricted stock to pay withholding taxes at an average price per share of $14.08.

The information regarding the Company s equity compensation plan is contained under Part III, Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters of this Form 10-K and is incorporated by reference herein.

Stock Performance Graph

The chart shown below depicts total return to stockholders during the period beginning December 31, 2007 and ending December 31, 2012. Total return includes appreciation or depreciation in market value of the Company s common stock as well as actual cash and stock dividends paid to common stockholders. Indices shown below, for comparison purposes only, are the Total Return Index for the NASDAQ Stock Market (U.S. Companies), which is a broad nationally recognized index of stock performance by publicly traded companies

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and the NASDAQ Bank Index, which is an index that contains securities of NASDAQ-listed companies classified according to the Industry Classification Benchmark as banks. The chart assumes that the value of the investment in Heritage s common stock and each of the three indices was $100 on December 31, 2007, and that all dividends were reinvested in Heritage common stock.

	Year Ended December 31,					
Index	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Heritage Financial Corporation	$ 100.00	$ 64.75	$ 73.45	$ 74.20	$ 69.14	$ 85.55
NASDAQ Composite	100.00	60.02	87.24	103.08	102.26	120.42
NASDAQ Bank	100.00	78.46	65.67	74.97	67.10	79.64

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth certain information concerning our consolidated financial position and results of operations at and for the dates indicated and have been derived from our audited Consolidated Financial Statements. The information below is qualified in its entirety by the detailed information included elsewhere herein and should be read along with Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations and Item 8. Financial Statements and Supplementary Data.

	Year Ended December 31,				
	2012	**2011**	**2010**	**2009**	**2008**
	(Dollars in thousands, except per share amounts)				
Operations Data:					
Interest income	$ 69,109	$ 74,120	$ 59,522	$ 53,341	$ 56,948
Interest expense	4,534	6,582	8,511	11,645	18,606
Net interest income	64,575	67,538	51,011	41,696	38,342
Provision for loan losses	2,016	14,430	11,990	19,390	7,420
Noninterest income	7,272	5,746	18,779	5,988	6,358
Noninterest expense	50,392	49,703	38,011	28,216	27,953

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	Year Ended December 31,				
	2012	2011	2010	2009	2008
	(Dollars in thousands, except per share amounts)				
Income tax expense (benefit)	6,178	2,633	6,435	(503)	2,976
Net income	13,261	6,518	13,354	581	6,351
Net income (loss) applicable to common shareholders	13,261	6,518	11,668	(739)	6,208
Earnings (loss) per common share(1)					
Basic	0.87	0.42	1.05	(0.10)	0.93
Diluted	0.87	0.42	1.04	(0.10)	0.93
Dividend payout ratio to common shareholders(2)	92.0%	90.5%		(100.0)%	60.2%
Performance Ratios:					
Net interest spread(3)	5.03%	5.23%	4.56%	4.25%	4.11%
Net interest margin(4)	5.17%	5.41%	4.78%	4.57%	4.59%
Efficiency ratio(5)	70.14%	67.82%	54.46%	59.17%	62.53%
Return on average assets	0.98%	0.48%	1.16%	0.06%	0.71%
Return on average common equity	6.52%	3.17%	8.15%	(0.72)%	6.98%

	December 31,				
	2012	2011	2010	2009	2008
	(Dollars in thousands)				
Balance Sheet Data:					
Total assets	$ 1,345,540	$ 1,368,985	$ 1,367,684	$ 1,014,859	$ 946,145
Originated loans receivable, net	855,360	815,607	719,957	746,083	793,303
Purchased covered loans receivable, net	83,978	105,394	128,715		
Purchased noncovered loans receivable, net	59,006	83,479	131,049		
Loans receivable, net	998,344	1,004,480	979,721	746,083	793,303
Loans held for sale	1,676	1,828	764	825	304
FDIC indemnification asset	7,100	10,350	16,071		
Deposits	1,117,971	1,136,044	1,136,276	840,128	824,480
FHLB advances					
Securities sold under agreement to repurchase	16,021	23,091	19,027	10,440	
Stockholders equity	198,938	202,520	202,279	158,498	113,147
Book value per common share	13.16	13.10	12.99	12.21	13.40
Equity to assets ratio	14.8%	14.8%	14.8%	15.6%	12.0%
Capital Ratios:					
Total risk-based capital ratio	19.9%	20.3%	21.5%	20.7%	13.7%
Tier 1 risk-based capital ratio	18.7%	19.0%	20.2%	19.4%	12.5%
Leverage ratio	13.6%	13.8%	13.9%	14.6%	11.0%
Asset Quality Ratios:					
Nonperforming originated loans to total originated loans (6)	1.28%	2.57%	3.14%	4.21%	0.42%
Allowance for loan losses on originated loans to total originated loans (6)	2.19%	2.66%	2.97%	3.38%	1.91%
Allowance for loan losses on originated loans to nonperforming originated loans (6)	170.44%	103.52%	94.73%	79.34%	454.02%
Nonperforming originated assets to total originated assets (6)	1.39%	2.14%	2.38%	3.32%	0.57%
Other Data:					
Number of banking offices	33	33	31	20	20
Number of full-time equivalent employees	363	354	321	222	217

(1) Effective January 1, 2009, the Company adopted FASB ASC 03-6-1. Earnings per share data for the prior periods have been revised to reflect the retrospective adoption of the FASB ASC.
(2) Dividend payout ratio is declared dividends per common share divided by basic earnings (loss) per common share.
(3) Net interest spread is the difference between the average yield on interest earning assets and the average cost of net interest bearing liabilities.
(4) Net interest margin is net interest income divided by average interest earning assets.
(5) The efficiency ratio is recurring noninterest expense divided by the sum of net interest income and noninterest income.
(6) Nonperforming originated loan balances exclude portions guaranteed by governmental agencies of $1.2 million, $1.8 million, $3.2 million and $2.3 million as of December 31, 2012, 2011, 2010 and 2009, respectively. There were no governmental guarantees on nonperforming originated loans as of December 31, 2008.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion is intended to assist in understanding the financial condition and results of operations of the Company. The information contained in this section should be read with the December 31, 2012 audited Consolidated Financial Statements and notes to those financial statements included in this Form 10-K.

This Form 10-K may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements often include the words believes, expects, anticipates, estimates, forecasts, intends, plans, targets, probably, projects, outlook or similar expressions or future or conditional verbs such as may, will, should, would and c forward-looking statements are subject to known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from the results anticipated, including:

- our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired, including the Cowlitz Bank, Pierce Commercial Bank and the Northwest Commercial Bank transactions described in this Form 10-K, or may in the future acquire, into our operations and our ability to realize related revenue synergies and cost savings within expected time frames or at all, and any goodwill charges related thereto and costs or difficulties relating to integration matters, including but not limited to customer and employee retention, which might be greater than expected;

- the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets, which may lead to increased losses and non-performing assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses, and require us to increase our allowance for loan losses;

- changes in general economic conditions, either nationally or in our market areas;

- changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources;

- risks related to acquiring assets in or entering markets in which we have not previously operated and may not be familiar;

- fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas;

- results of examinations of us by the Federal Reserve and of our bank subsidiaries by the FDIC, the Division or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our allowance for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings;

- legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules as a result of Basel III;

- our ability to control operating costs and expenses;

the impact of the Dodd-Frank Act and implementing regulations;

further increases in premiums for deposit insurance;

the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;

difficulties in reducing risk associated with the loans on our consolidated statement of financial condition;

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- staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges;
- failure or security breach of computer systems on which we depend;
- our ability to retain key members of our senior management team;
- costs and effects of litigation, including settlements and judgments;
- our ability to implement our expansion strategy of pursuing acquisitions and de novo branching;
- our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired or may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto;
- increased competitive pressures among financial service companies;
- changes in consumer spending, borrowing and savings habits;
- the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions;
- adverse changes in the securities markets;
- inability of key third-party providers to perform their obligations to us;
- changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; and
- other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and the other risks described elsewhere in this Form 10-K.

Some of these and other factors are discussed in this Form 10-K under the caption Item 1A. Risk Factors and elsewhere in this Form 10-K. Such developments could have a material adverse impact on our business, financial position and results of operations.

Any forward-looking statements are based upon management s beliefs and assumptions at the time they are made. We undertake no obligation to publicly update or revise any forward-looking statements included in this Form 10-K or to update the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, you should not put undue reliance on any forward-looking statements discussed in this Form 10-K.

Critical Accounting Policies

The Company s Consolidated Financial Statements have been prepared in accordance with accounting principles generally accepted in the United States of America. Companies may apply certain critical accounting policies requiring management to make subjective or complex judgments, often as a result of the need to estimate the effect of matters that are inherently uncertain.

The Company considers its most critical accounting estimates to be the allowance for loan losses, estimations of expected cash flows related to purchased impaired loans, other than temporary impairments in the market value of investments and consideration of potential impairment of goodwill.

Allowance for Loan Losses. The allowance for loan losses is established through a provision for loan losses charged against earnings. The balance of the allowance for loan losses is maintained at the amount management believes will be appropriate to absorb known and inherent losses in the loan portfolio at the balance sheet date. The allowance for loan losses is determined by applying estimated loss factors to the credit exposure from outstanding loans.

We assess the estimated credit losses inherent in our non-classified and classified loan portfolio by considering a number of elements including:

- historical loss experience in the portfolio;
- levels of and trends in delinquencies and impaired loans;
- levels and trends in charge-offs and recoveries;
- effects of changes in risk selection and underwriting standards, and other changes in lending policies, procedures and practices;
- experience, ability, and depth of lending management and other relevant staff;
- national and local economic trends and conditions;
- external factors such as competition, legal, and regulatory; and
- effects of changes in credit concentrations.

We calculate an allowance for the non-classified and classified portion of our loan portfolio based on an appropriate percentage loss factor that is calculated based on the above-noted elements and trends. We may record specific provisions for each impaired loan after a careful analysis of that loan s credit and collateral factors. Our analysis of an allowance combines the provisions made for our non-classified loans, classified loans, and the specific provisions made for each impaired loan.

While we believe we use the best information available to determine the allowance for loan losses, our results of operations could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance. A further decline in local and national economic conditions, or other factors, could result in a material increase in the allowance for loan losses and may adversely affect the Company s financial condition and results of operations. In addition, the determination of the amount of the allowance for loan losses is subject to review by bank regulators, as part of their routine examination process, which may result in the establishment of additional allowance for loan losses based upon their judgment of information available to them at the time of their examination.

For additional information regarding the allowance for loan losses, its relation to the provision for loan losses, risk related to asset quality and lending activity, see Results of Operations for the Years Ended December 31, 2012 and 2011 Provision for Loan Losses below, Part I of Item 1. Business Analysis of Allowance for Loan Losses as well as Note 3 of the Notes to Consolidated Financial Statements included in Item 8. Financial Statements and Supplementary Data.

Estimated Expected Cash Flows related to Purchased Impaired Loans. Loans purchased with evidence of credit deterioration since origination for which it is probable that all contractually required payments will not be collected are accounted for under FASB ASC 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*, formerly AICPA SOP 03-3 *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*. In situations where such loans have similar risk characteristics, loans may be aggregated into pools to estimate cash flows. A pool is accounted for as a single asset with a single interest rate, cumulative loss rate and cash flow expectation.

The cash flows expected over the life of the loan or pool are estimated using an internal cash flow model that projects cash flows and calculates the carrying values of the pools, book yields, effective interest income and impairment, if any, based on pool level events. Assumptions as to default rates, loss severity and prepayment speeds are utilized to calculate the expected cash flows.

Expected cash flows at the acquisition date in excess of the fair value of loans are considered to be accretable yield, which is recognized as interest income over the life of the loan or pool using a level yield method if the timing and amounts of the future cash flows of the pool are reasonably estimable. Subsequent to the acquisition date, any increases in cash flow over those expected at purchase date in excess of fair value are recorded as interest income prospectively. Any subsequent decreases in cash flow over those expected at

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purchase date are recognized by recording an allowance for loan losses. Any disposals of loans, including sales of loans, payments in full or foreclosures result in the removal of the loan from the loan pool at the carrying amount.

Other-Than-Temporary Impairments in the Market Value of Investments. Unrealized losses on investment securities available for sale and held to maturity securities are evaluated at least quarterly to determine whether declines in value should be considered other than temporary and therefore be subject to immediate loss recognition in income. Although these evaluations involve significant judgment, an unrealized loss in the fair value of a debt security is generally deemed to be temporary when the fair value of the security is below the carrying value primarily due to changes in interest rates, there has not been significant deterioration in the financial condition of the issuer, and it is not more likely than not that the Company will be required to sell the security before the anticipated recovery of its remaining carrying value. An unrealized loss in the value of an equity security is generally considered temporary when the fair value of the security is below the carrying value primarily due to current market conditions and not deterioration in the financial condition of the issuer and it is not more likely than not that the Company will be required to sell the security before the anticipated recovery of its remaining carrying value. Other factors that may be considered in determining whether a decline in the value of either a debt or an equity security is other than temporary include ratings by recognized rating agencies; actions of commercial banks or other lenders relative to the continued extension of credit facilities to the issuer of the security; the financial condition, capital strength and near-term prospects of the issuer and recommendations of investment advisors or market analysts. Therefore, continued deterioration of market conditions could result in additional impairment losses recognized within the investment portfolio.

Goodwill. Goodwill represents the excess of the purchase price over the net assets acquired in the purchases of North Pacific Bank and Western Washington Bancorp. The Company s goodwill is assigned to Heritage Bank and is evaluated for impairment at the Heritage Bank level (reporting unit). Goodwill is not amortized, but is reviewed for impairment annually and between annual tests if an event occurs or circumstances change that might indicate the Company s recorded value is more than its implied value. Such indicators may include, among others: a significant adverse change in legal factors or in the general business climate; significant decline in the Company s stock price and market capitalization; unanticipated competition; and an adverse action or assessment by a regulator. Any adverse changes in these factors could have a significant impact on the recoverability of goodwill and could have a material impact on the Company s Consolidated Financial Statements.

When required, the goodwill impairment test involves a two-step process. The first test for goodwill impairment is done by comparing the reporting unit s aggregate fair value to its carrying value. Absent other indicators of impairment, if the aggregate fair value exceeds the carrying value, goodwill is not considered impaired and no additional analysis is necessary. If the carrying value of the reporting unit were to exceed the aggregate fair value, a second test would be performed to measure the amount of impairment loss, if any. To measure any impairment loss the implied fair value would be determined in the same manner as if the reporting unit were being acquired in a business combination. If the implied fair value of goodwill is less than the recorded goodwill an impairment charge would be recorded for the difference.

During 2011, ASU 2011-08 Intangibles Goodwill and Other (Topic 350) was issued. Under the ASU, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. In other words, before the first step of the existing guidance, the entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that the fair value of goodwill is less than carrying value. The qualitative assessment includes adverse events or circumstances identified that could negatively affect the reporting units fair value as well as positive and mitigating events. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step process is unnecessary. While the Company adopted the ASU for the quarter ended December 31, 2011, for the year ended December 31, 2012, the Company completed step one of the two-step process and concluded that the reporting unit s fair value was greater than its carrying value and there was no impairment of goodwill.

Our Strategy

Our primary objective is to be a well-capitalized, profitable community banking organization, with balanced growth while emphasizing lending and deposit relationships with small and medium size businesses along with their owners and the general public. We consider ourselves to be an innovative team providing financial services focusing on the success of our customers. Our stated mission is: Continuously Improve Customer Satisfaction, Employee Empowerment and Shareholder Value. We will seek to achieve our objective through the following strategies:

Expand geographically as opportunities present themselves. We are committed to continuing the controlled expansion of our franchise through strategic acquisitions designed to increase our market share and enhance franchise value. We believe that consolidation across the community bank landscape will continue to take place and further believe that, with our capital and liquidity positions, our approach to credit management and extensive acquisition experience, we are well positioned to take advantage of acquisitions or other business opportunities in our market areas. In markets where we wish to enter or expand our business, we will also consider opening *de novo* branches. In the past, we have successfully integrated acquired institutions and opened *de novo* branches. We plan to acquire or build one to two branches per year in strategic growth locations. We will continue to be disciplined and opportunistic as it pertains to future acquisitions and *de novo* branching focusing on the Pacific Northwest markets we know and understand.

Focus on Asset Quality. A strong credit culture is a high priority for us. We have a well-developed credit approval structure that has enabled us to maintain a standard of asset quality that we believe is conservative while at the same time maintaining our lending objectives. We will continue to focus on loan types and markets that we know well and where we have a historical record of success. We focus on loan relationships that are well diversified in both size and industry types. With respect to commercial business lending, which is our predominant lending activity, we view ourselves as cash-flow lenders obtaining additional support from realistic collateral values, personal guarantees and secondary sources of repayment. We have a problem loan resolution process that is focused on quick detection and feasible solutions. We seek to maintain strong internal controls and subject our loans to periodic internal loan review as well as a third party loan review process.

Maintain Strong Balance Sheet. In addition to our focus on underwriting, we believe that the strength of our balance sheet has allowed us to endure the economic downturn afflicting the Pacific Northwest better than many of our competitors. As of December 31, 2012, the ratio of our allowance for loan losses on originated loans to total originated loans was 2.19% and the ratio of the allowance for loan losses on originated loans to nonperforming originated loans was 170.44%. Our liquidity position is also strong, with $107.1 million in cash and cash equivalents as of December 31, 2012. As of December 31, 2012, the regulatory capital ratios of our subsidiary banks were well in excess of the levels required for well-capitalized status, and our consolidated total risk-based capital, Tier 1 risk-based capital and leverage capital ratios were 19.9%, 18.7% and 13.6%, respectively.

Deposit Growth. Our strategic focus is to continuously grow deposits with emphasis on total relationship banking with our business and retail customers. We continue to seek to increase our market share in the communities we serve by providing exceptional customer service, focusing on relationship development with local businesses and strategic branch expansion. Our primary focus is to maintain a high level of non-maturity deposits to internally fund our loan growth with a low reliance on maturity (certificate) deposits. At December 31, 2012, as a percentage of our total deposits, non-maturity deposits were 74.2%. We maintain state-of-the-art technology-based products, including on-line personal financial management, business cash management, and business remote deposit products that enable us to compete effectively with banks of all sizes. Our retail management team is well-seasoned and has strong ties to the communities we serve with a strong focus on relationship building and customer service.

Emphasize business relationships with a focus on commercial lending. We will continue to provide primarily commercial business, commercial real estate and residential construction loans with an emphasis on owner occupied commercial real estate and commercial business lending, and the deposit balances that accompany these relationships. Our seasoned lending staff has extensive knowledge and can add value through a focused advisory role that we believe strengthens our customer relationships and develops loyalty. We currently have and will seek to maintain a diversified portfolio of lending relationships without concentrations in any industry.

Recruit and retain highly competent personnel to execute our strategies. Our compensation and staff development programs are aligned with our strategies to grow our loans and core deposits while maintaining our focus on asset quality. Our incentive systems are designed to achieve balanced high quality asset growth while maintaining appropriate mechanisms to reduce or eliminate incentive payments when appropriate. Our equity compensation programs and retirement benefits are designed to build and encourage employee ownership at all levels of the Company and we align employee performance objectives with corporate growth strategies and shareholder value. We have a strong corporate culture, which is supported by our commitment to internal development and promotion from within as well as the retention of management and officers in key roles.

Financial Overview

Heritage Financial Corporation is a bank holding company which primarily engages in the business activities of our wholly owned subsidiaries: Heritage Bank and Central Valley Bank. We provide financial services to our local communities with an ongoing strategic focus on our commercial banking relationships, market expansion and asset quality.

During the period from December 31, 2008 through December 31, 2012 our total assets have grown $399.4 million, or 42.2%, to $1.3 billion as of December 31, 2012 with originated loans receivable, net growing $62.1 million, or 7.8%, to $855.4 million as of December 31, 2012. Our emphasis in growing our commercial business loan portfolio resulted in an increase in originated commercial business loans of $130.2 million, or 21.7%, since December 31, 2008. Overall loan increases have benefited from our emphasis in increasing our lending in our market areas, including the acquisitions of Cowlitz Bank and Pierce Commercial Bank in 2010 and the acquisition of Northwest Commercial Bank in January 2013.

Deposits increased $293.5 million, or 35.6%, to $1.12 billion at December 31, 2012 from $824.5 million at December 31, 2008. From December 31, 2008 to December 31, 2012, non-maturity deposits (total deposits less certificate of deposit accounts) increased $351.0 million, or 73.4%. As a result, the percentage of certificate of deposit accounts to total deposits decreased to 25.8% at December 31, 2012 from 42.0% at December 31, 2008.

Stockholders equity has increased by $85.8 million to $198.9 million at December 31, 2012 from $113.1 million at December 31, 2008 due primarily to a combination of earnings and issuances of common stock, partially offset by redemption of preferred stock, repurchases of common stock and declaration of cash dividends. Our annual net income increased by 108.8%, or $6.9 million, to $13.3 million for the year ended December 31, 2012 from $6.4 million for the year ended December 31, 2008 due primarily to an increase of $26.2 million in net interest income that exceeded an increase in noninterest expense of $22.4 million, and a decrease in the provision for loan losses of $5.4 million.

Our core profitability depends primarily on our net interest income, which is the difference between the income we receive on our loan and investment portfolios, and our cost of funds, which consists of interest paid on deposits and borrowed funds. Like most financial institutions, our interest income and cost of funds are affected significantly by general economic conditions, particularly changes in market interest rates and government policies.

Changes in net interest income result from changes in volume, net interest spread, and net interest margin. Volume refers to the average dollar amounts of interest earning assets and interest bearing liabilities. Net interest spread refers to the difference between the average yield on interest earning assets and the average cost of interest bearing liabilities. Net interest margin refers to net interest income divided by average interest earning assets and is influenced by the level and relative mix of interest earning assets and interest bearing and noninterest bearing liabilities.

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The following table provides relevant net interest income information for selected periods. The average daily loan balances presented in the table are net of allowances for loan losses. Nonaccrual loans have been included in the tables as loans carrying a zero yield. Yields on tax-exempt securities and loans have not been presented on a tax-equivalent basis.

	Year Ended December 31,								
	2012			2011			2010		
	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance	Interest Earned/ Paid	Average Yield/ Rate
	(Dollars in thousands)								
Interest Earning Assets:									
Loans	$ 996,186	$ 65,588	6.58%	$ 981,848	$ 70,114	7.14%	$ 810,177	$ 56,054	6.92%
Taxable securities	121,543	2,195	1.81	129,217	2,912	2.25	105,815	2,661	2.52
Nontaxable securities	38,853	1,097	2.83	25,122	821	3.27	13,411	470	3.50
Interest earning deposits and Federal funds sold	86,686	229	0.26	105,836	273	0.26	133,277	337	0.25
FHLB stock	5,578			5,594			4,204		
Total interest earning assets	$ 1,248,846	$ 69,109	5.53%	$ 1,247,617	$ 74,120	5.94%	$ 1,066,884	$ 59,522	5.58%
Noninterest earning assets	105,226			102,691			86,039		
Total assets	$ 1,354,072			$ 1,350,308			$ 1,152,923		
Interest Bearing Liabilities:									
Certificates of deposit	$ 306,772	$ 3,016	0.98%	$ 355,167	$ 4,274	1.20%	$ 351,191	$ 5,677	1.62%
Savings accounts	113,119	204	0.18	103,170	361	0.35	89,978	501	0.56
Interest bearing demand and money market accounts	466,268	1,249	0.27	453,509	1,868	0.41	376,245	2,200	0.58
Total interest bearing deposits	886,159	4,469	0.50	911,846	6,503	0.71	817,414	8,378	1.02
FHLB advances and other borrowings				1		0.30	1,896	48	2.53
Securities sold under agreement to repurchase	18,314	65	0.35	19,301	79	0.41	13,750	85	0.62
Total interest bearing liabilities	$ 904,473	$ 4,534	0.50%	$ 931,148	$ 6,582	0.71%	$ 833,060	$ 8,511	1.02%
Demand and other noninterest bearing deposits	237,888			205,862			150,906		
Other noninterest bearing liabilities	8,310			7,795			2,993		
Preferred stock							22,889		
Stockholders equity	203,401			205,503			165,964		
Total liabilities and stockholders equity	$ 1,354,072			$ 1,350,308			$ 1,152,923		
Net interest income		$ 64,575			$ 67,538			$ 51,011	
Net interest spread			5.03%			5.23%			4.56%
Net interest margin			5.17%			5.41%			4.78%

Average interest earning assets to average interest bearing liabilities	138.08%	133.99%	128.07%

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The following table provides the amount of change in our net interest income attributable to changes in volume and changes in interest rates. Changes attributable to the combined effect of volume and interest rates have been allocated proportionately for changes due specifically to volume and interest rates.

	Year Ended December 31,					
	2012 Compared to 2011 Increase (Decrease) Due to			2011 Compared to 2010 Increase (Decrease) Due to		
	Volume	Rate	Total	Volume	Rate	Total
	(In thousands)					
Interest Earning Assets:						
Loans	$ 944	$ (5,470)	$ (4,526)	$ 12,273	$ 1,786	$ 14,059
Taxable securities	(139)	(578)	(717)	527	(277)	250
Nontaxable securities	388	(112)	276	383	(31)	352
Interest earning deposits and federal funds sold	(50)	6	(45)	(71)	6	(65)
FHLB stock						
Interest income	$ 1,143	$ (6,154)	$ (5,012)	$ 13,112	$ 1,484	$ 14,596
Interest Bearing Liabilities:						
Certificates of deposit	$ (475)	$ (783)	$ (1,258)	$ 48	$ (1,450)	$ (1,402)
Savings accounts	18	(174)	(156)	46	(187)	(141)
Interest bearing demand and money market accounts	34	(653)	(619)	318	(649)	(331)
Total interest bearing deposits	(423)	(1,610)	(2,033)	412	(2,286)	(1,874)
FHLB advances and other borrowings				(6)	(44)	(50)
Securities sold under agreement to repurchase	(4)	(11)	(15)	23	(29)	(6)
Interest expense	$ (427)	$ (1,621)	$ (2,048)	$ 429	$ (2,359)	$ (1,930)
Net Interest Income	$ 1,570	$ (4,533)	$ (2,964)	$ 12,683	$ 3,843	$ 16,526

Results of Operations for the Years Ended December 31, 2012 and 2011

Earnings Summary. Net income applicable to common shareholders of $0.87 per diluted common share was recorded for the year ended December 31, 2012 compared to $0.42 per diluted common share for the year ended December 31, 2011. Net income for the year ended December 31, 2012 was $13.3 million compared to net income of $6.5 million for the same period in 2011. The $6.7 million increase was primarily the result of a $12.4 million decrease in the provision for loan losses and a $2.0 million decrease in interest expense, partially offset by a $5.0 million decrease in interest income and a $3.5 million increase in income tax expense. The Company s efficiency ratio increased to 70.1% for the year ended December 31, 2012 from 67.8% for the year ended December 31, 2011 partially due to increases in the compensation and employee benefits expense and expenses related to the acquisition of Northwest Commercial Bank which closed in January 2013.

Net Interest Income. Net interest income decreased $3.0 million, or 4.4%, to $64.6 million for the year ended December 31, 2012 compared to $67.5 million for the previous year. The decrease in net interest income was due to the decline in net interest margins. Net interest income as a percentage of average earning assets (net interest margin) for the year ended December 31, 2012 decreased 24 basis points to 5.17% from 5.41% for the previous year. The decline in net interest margin was due to a combination of lower contractual note rates and the overall lessening impact of the discount accretion on the acquired loan portfolios. Our net interest spread for the year ended December 31, 2012 decreased to 5.03% from 5.23% for the prior year.

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Total interest income decreased $5.0 million, or 6.8%, to $69.1 million for the year ended December 31, 2012, from $74.1 million for the year ended December 31, 2011. The decrease in interest income was due primarily to lower yields on interest earning assets. The balance of average interest earning assets (including nonaccrual loans) increased $1.2 million, or 0.1%, from $1.248 billion for the year ended December 31, 2011 to $1.249 billion for the year ended December 31, 2012. The yield on interest earning assets decreased 41 basis points from 5.94% for the year ended December 31, 2011 to 5.53% for the year ended December 31, 2012. The decrease in the yield on earning assets for the year ended December 31, 2012 reflects the decreased loan yields due primarily to lower contractual note rates as well as the effects of the discount accretion on the acquired loan portfolios. The effect of discount accretion on net interest margin for the year ended December 31, 2012 and December 31, 2011 was approximately 50 basis points and 62 basis points, respectively. For the years ended December 31, 2012 and December 31, 2011, originated nonaccruing loans reduced the yield on interest earning assets by approximately seven basis points and 11 basis points, respectively. Originated nonaccrual loans totaled $12.5 million at December 31, 2012 compared to $23.3 million at December 31, 2011. Interest income on taxable and nontaxable investment securities decreased $441,000 to $3.3 million for the year ended December 31, 2012 from $3.7 million for the year ended December 31, 2011 due primarily to lower yields earned on the investment securities in 2012 as a result of declining interest rates.

Total interest expense decreased by $2.0 million, or 31.1%, to $4.5 million for the year ended December 31, 2012 from $6.6 million for the year ended December 31, 2011. The decrease in interest expense was due to a combination of lower balances of average interest bearing liabilities and lower rates paid on interest bearing liabilities. The average rate paid on interest bearing liabilities decreased to 0.50% for the year ended December 31, 2012 from 0.71% for the year ended December 31, 2011. Total average interest bearing liabilities decreased by $26.7 million, or 2.9%, to $904.5 million for the year ended December 31, 2012 from $931.1 million for the year ended December 31, 2011. The decrease in average interest bearing liabilities was due primarily to the $48.4 million decrease in certificates of deposits to $306.8 million for the year ended December 31, 2012 from $355.2 million for the year ended December 31, 2011. Deposit interest expense decreased $2.0 million, or 31.3%, to $4.5 million for the year ended December 31, 2012 compared to $6.5 million for the prior year. The decrease in deposit interest expense for the year ended December 31, 2012 is primarily a result of a 21 basis point decrease in the average cost of interest-bearing deposits, reflecting the relatively low interest rate environment.

Provision for Loan Losses. The provision for loan losses decreased $12.4 million, or 86.0%, to $2.0 million for the year ended December 31, 2012 from $14.4 million for the year ended December 31, 2011.

The provision for loan losses on originated loans decreased $4.5 million, or 86.6%, to $695,000 for the year ended December 31, 2012 from $5.2 million for the year ended December 31, 2011. The Banks had net charge-offs on originated loans of $3.9 million for the year ended December 31, 2012 compared to $4.9 million for the year ended December 31, 2011. The decrease in provision expense for originated loans was substantially due to an improvement in the environmental factors as well as lower net charge-offs on originated loans during the year ended December 31, 2012 compared the prior year. The ratio of net charge-offs to average total originated loans outstanding was 0.45% for the year ended December 31, 2012 and 0.59% for the year ended December 31, 2011.

The Banks have established comprehensive methodologies for determining the allowance for loan losses on originated loans. On a quarterly basis the Banks perform an analysis taking into consideration pertinent factors underlying the quality of the loan portfolio. These factors include changes in the amount and composition of the loan portfolio, historical loss experience for various loan classes, changes in economic conditions, delinquency rates, a detailed analysis of individual loans on nonaccrual status, and other factors to determine the level of the allowance for loan losses. The allowance for loan losses on originated loans decreased by $3.2 million, or 14.3%, to $19.1 million at December 31, 2012 from $22.3 million at December 31, 2011. As of December 31, 2012, the Banks identified $12.5 million of originated impaired loans and $15.0 million of originated performing restructured loans. Of those impaired and performing restructured loans, $12.6 million have no allowances for credit losses as their estimated collateral value is equal to or exceeds their carrying costs. The remaining $14.9 million have related allowances for credit losses totaling $4.4 million. Based on the comprehensive methodology, management deemed the allowance for loan losses on originated loans of $19.1 million at December 31, 2012 (2.19% of total originated loans and 170.44% of nonperforming originated loans, excluding government guarantees) appropriate to provide for probable incurred losses based on an evaluation of known and inherent risks in the loan portfolio at that date.

The provision for loan losses on purchased loans for the year ended December 31, 2012 totaled $1.3 million compared to $9.3 million for the year ended December 31, 2011. As of the acquisition date, purchased loans were recorded at their estimated fair value, incorporating our estimate of future expected cash flows until the ultimate resolution of these credits. To the extent actual or remaining projected cash flows are less than originally estimated, additional provisions for loan losses on the purchased loan portfolios will be recognized. However, provisions on the purchased covered loans would be primarily offset by a corresponding increase in the FDIC indemnification asset recognized within noninterest income. To the extent actual or remaining projected cash flows are more than originally estimated, the increase in cash flows is recognized prospectively in interest income. The decrease in the provision for the year ended December 31, 2012 as compared to the year ended December 31, 2011 is a result of less decreases in remaining projected cash flows on purchased loans, offset partially by specific loans that were charged-off during the year which caused decreases in projected cash flows.

The allowance for loan losses on purchased loans increased $871,000, or 10.1% to $9.5 million at December 31, 2012 from $8.6 million at December 31, 2011. The increase was the result of specific purchased loans that had remaining expected cash flows less than previously expected, which was usually the result of a charge-off.

While the Banks believe they have established their existing allowances for loan losses in accordance with GAAP, there can be no assurance that regulators, in reviewing the Banks loan portfolios, will not request the Banks to increase significantly their allowance for loan losses. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is appropriate or that increased provisions will not be necessary should the quality of the loans deteriorate. Any material increase in the allowance for loan losses would adversely affect the Company s financial condition and results of operations. For additional information, see Item 1. Business Analysis of Allowance for Loan Losses.

Noninterest Income. Total noninterest income increased $1.5 million, or 26.6%, to $7.3 million for the year ended December 31, 2012 compared to $5.7 million for the prior year. The increase was due primarily to the net FDIC loss sharing income, which was a reduction of income of $2.3 million for the year ended December 31, 2012 compared to a reduction of income of $1.0 million for the year ended December 31, 2011. The FDIC loss sharing income, net includes amortization of the FDIC indemnification asset and increases to the FDIC indemnification asset as a result of decreases in projected remaining cash flows of the purchased covered loans.

Noninterest Expense. Noninterest expense increased $689,000 or 1.4% to $50.4 million for the year ended December 31, 2012 compared to $49.7 million for the year ended December 31, 2011. The increase was due primarily to increased compensation and employee benefits expense in the amount of $1.9 million and a $481,000 increase in professional services partially offset by decreases of $605,000 in net other real estate owned expense and $556,000 in Federal deposit insurance premium expense. The increase in professional services was primarily due to the costs related to the Northwest Commercial Acquisition which closed in January 2013. Total expenses related to this acquisition were $285,000 for the year ended December 31, 2012.

The efficiency ratio for the year ended December 31, 2012 was 70.1% compared to 67.8% for the same period in the prior year. The increase in the ratio for the year ended December 31, 2012 was primarily related to the increase in noninterest expense and the decrease in net interest income. The net interest income was reduced because of the low interest rate environment. Additionally, while growth strategies are being executed, the Company expects to incur higher noninterest expenses as evidenced by the current increasing efficiency ratio. Noninterest expenses are expected to be more in line with revenue when these growth strategies begin producing long term results. The efficiency ratio consists of noninterest expense divided by the sum of net interest income before provision for loan losses plus noninterest income.

Income Tax Expense. The provision for income taxes increased by $3.5 million to an expense of $6.2 million for the year ended December 31, 2012 from an expense of $2.6 million for the year ended December 31, 2011. The Company s effective tax rate was 31.8% for the year ended December 31, 2012 compared to 28.8% for the same period in 2011. The increase in the Company s income tax expense from the prior year was primarily due to increases in pre-tax income. The increase in the Company s effective tax rate for the year ended December 31, 2012 is due substantially to increases in the level of net income before income taxes relative to the more modest amount of increase in the amount of tax-exempt income.

Results of Operations for the Years Ended December 31, 2011 and 2010

Earnings Summary. Net income applicable to common shareholders of $0.42 per diluted common share was recorded for the year ended December 31, 2011 compared to $1.04 per diluted common share for the year ended December 31, 2010. Net income for the year ended December 31, 2011 was $6.5 million compared to net income of $13.4 million for the same period in 2010. The decrease was primarily the result of an $11.8 million gain on bank acquisitions in 2010, a $2.4 million increase in the provision for loan losses and an $11.7 million increase in noninterest expense partially offset by a $16.5 million increase in net interest income. The Company s efficiency ratio increased to 67.8% for the year ended December 31, 2011 from 54.5% for the year ended December 31, 2010.

Net Interest Income. Net interest income increased $16.5 million, or 32.4%, to $67.5 million for the year ended December 31, 2011 compared with the previous year of $51.0 million. The increase in net interest income was due primarily to increased earning assets acquired from the Cowlitz and Pierce Commercial Acquisitions and an increased net interest margin. Net interest income as a percentage of average interest earning assets (net interest margin) for the year ended December 31, 2011 increased 63 basis points to 5.41% from 4.78% for the previous year. The increase in net interest margin was due primarily to increased loan yields as a result of discount accretion on the acquired loan portfolios balances and offset by low interest yields on interest earning overnight cash deposits in the Cowlitz and Pierce Commercial Acquisitions. Our net interest spread for the year ended December 31, 2011 increased to 5.23% from 4.56% for the prior year.

Total interest income increased $14.6 million, or 24.5%, to $74.1 million for the year ended December 31, 2011, from $59.5 million for the year ended December 31, 2010. The increase in interest income was due to a combination of higher balances of average interest earning assets and higher yields on interest earning assets. The balance of average interest earning assets (including nonaccrual loans) increased $180.7 million, or 16.9%, from $1.07 billion for the year ended December 31, 2010 to $1.25 billion for the year ended December 31, 2011. The increase in average interest earning assets for the year ended December 31, 2011 was primarily due to the Cowlitz and Pierce Commercial Acquisitions as well as increases in investment securities available for sale. The yield on average interest earning assets increased 36 basis points from 5.58% for the year ended December 31, 2010 to 5.94% for the year ended December 31, 2011. The increase in the yield on average interest earning assets for the year ended December 31, 2011 reflects the increased loan yields due to discount accretion on the acquired loan portfolios. The effect of discount accretion on loan yields for the year ended December 31, 2011 and December 31, 2010 was approximately 80 basis points and 37 basis points, respectively. For the years ended December 31, 2011 and December 31, 2010, originated nonaccruing loans reduced the yield earned on loans by approximately 14 basis points and 20 basis points, respectively. Originated nonaccrual loans totaled $23.3 million at December 31, 2011 as compared to $26.5 million at December 31, 2010. Interest income on taxable and nontaxable investment securities increased $602,000 due to purchases of investment securities available for sale.

Total interest expense decreased by $1.9 million, or 22.7%, to $6.6 million for the year ended December 31, 2011 from $8.5 million for the year ended December 31, 2010. The decrease in interest expense was attributable to lower average rates paid on interest bearing liabilities partially offset by higher balances of interest bearing liabilities. The average rate paid on interest bearing liabilities decreased to 0.71% for the year ended December 31, 2011 from 1.02% for the year ended December 31, 2010. Total average interest bearing liabilities increased by $98.1 million, or 11.8%, to $931.1 million for the year ended December 31, 2011 from $833.1 million for the year ended December 31, 2010. The increase in average interest bearing liabilities was due primarily to the Cowlitz and Pierce Commercial Acquisitions. Deposit interest expense decreased $1.9 million, or 22.4%, to $6.5 million for the year ended December 31, 2011 compared to $8.4 million for the prior year. The decrease in deposit interest expense for the year ended December 31, 2011 is primarily a result of a 31 basis point decrease in the average cost of interest-bearing deposits, reflecting the relatively low interest rate environment.

Provision for Loan Losses. The provision for loan losses increased $2.4 million, or 20.4%, to $14.4 million for the year ended December 31, 2011 from $12.0 million for the year ended December 31, 2010.

The provision for loan losses on originated loans decreased $6.8 million, or 56.8%, to $5.2 million for the year ended December 31, 2011 from $12.0 million for the year ended December 31, 2010. The Banks had net charge-offs of $4.9 million for the year ended December 31, 2011 compared to $16.1 million for the year ended December 31, 2010. The decrease in provision expense was substantially due to lower net charge-offs on originated loans during the year ended December 31, 2011 as compared the prior year. The ratio of net charge-offs to average total originated loans outstanding was 0.59% for the year ended December 31, 2011 and 2.24% for the year ended December 31, 2010.

The Banks have established comprehensive methodologies for determining the allowance for loan losses. On a quarterly basis the Banks perform an analysis taking into consideration pertinent factors underlying the quality of the loan portfolio. These factors include changes in the amount and composition of the loan portfolio, historical loss experience for various loan classes, changes in economic conditions, delinquency rates, a detailed analysis of individual loans on nonaccrual status, and other factors to determine the level of the allowance for loan losses. The allowance for loan losses on originated loans increased slightly by $255,000 to $22.3 million at December 31, 2011 from $22.1 million at December 31, 2010. As of December 31, 2011, the Banks identified $23.3 million of originated impaired loans and $13.8 million of originated performing restructured loans. Of those impaired and performing restructured loans, $10.9 million have no allowances for credit losses as their estimated collateral value is equal to or exceeds their carrying costs. The remaining $26.3 million have related allowances for credit losses totaling $4.5 million.

Based on the comprehensive methodology, management deemed the allowance for loan losses on originated loans of $22.3 million at December 31, 2011 (2.66% of total originated loans and 103.5% of nonperforming originated loans, excluding governmental guarantees) appropriate to provide for probable incurred losses based on an evaluation of known and inherent risks in the loan portfolio at that date.

The provision for loan losses on purchased loans for the year ended December 31, 2011 totaled $9.3 million compared to no provision for loan losses on purchased loans for the year ended December 31, 2010.

Noninterest Income. Total noninterest income decreased $13.0 million, or 69.4%, to $5.7 million for the year ended December 31, 2011 compared to $18.8 million for the prior year. The decrease was due substantially to an $11.8 million pretax gain on bank acquisitions in 2010 and a $2.3 million decrease in net FDIC loss sharing income partially offset by a $206,000 increase in service charges on deposits due mostly to deposits acquired through the Cowlitz and Pierce Commercial Acquisitions.

Noninterest Expense. Noninterest expense increased $11.7 million or 30.8% to $49.7 million for the year ended December 31, 2011 compared to $38.0 million for the year ended December 31, 2010. The increase was due to increased compensation and employee benefits expense in the amount of $7.2 million, increased occupancy and equipment expense of $1.8 million and increased net other real estate owned expense (including valuation adjustments) of $652,000. These increases were substantially due to the Cowlitz and Pierce Commercial Acquisitions.

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The efficiency ratio for the year ended December 31, 2011 was 67.8% compared to 54.5% for the same period in the prior year. While growth strategies are being executed, the Company expects to incur higher noninterest expense as evidenced by the increasing efficiency ratio.

Income Tax Expense (Benefit). The provision for income taxes decreased by $3.8 million to an expense of $2.6 million for the year ended December 31, 2011 from an expense of $6.4 million for the year ended December 31, 2010. The Company s effective tax rate was 28.8% for the year ended December 31, 2011 compared to 32.5% for the same period in 2010. The decrease in the Company s effective tax rate for the year ended December 31, 2011 is due substantially to an increase in balances of tax exempt securities and the lower level of net income before income taxes relative to the amount of tax-exempt income.

Liquidity and Capital Resources

Our primary sources of funds are customer and local government deposits, loan principal and interest payments, loan sales, interest earned on and proceeds from sales and maturities of investment securities, and advances from the FHLB of Seattle. These funds, together with retained earnings, equity and other borrowed funds, are used to make loans, acquire investment securities and other assets, and fund continuing operations. While maturities and scheduled amortization of loans are a predictable source of funds, deposit flows and loan prepayments are greatly influenced by the level of interest rates, economic conditions, and competition.

We must maintain an adequate level of liquidity to ensure the availability of sufficient funds to fund loan originations and deposit withdrawals, satisfy other financial commitments, and fund operations. We generally maintain sufficient cash and short-term investments to meet short-term liquidity needs. At December 31, 2012, cash and cash equivalents totaled $107.1 million, or 8.0% of total assets. Available for sale investment securities totaled $144.3 million at December 31, 2012; however, management generally does not consider those with maturities beyond one year to be a viable source of liquidity given that many available for sale securities are pledged to secure borrowing arrangements. Investment securities classified as either available for sale or held to maturity with maturities of one year or less amounted to $12.1 million, or 0.9% of total assets. At December 31, 2012, the Banks maintained credit facilities with the FHLB of Seattle for $156.3 million and credit facilities with the Federal Reserve Bank of San Francisco for $61.1 million, of which there were no borrowings outstanding as of December 31, 2012. The Banks also maintain advance lines with Zions Bank, Wells Fargo Bank, US Bank and Pacific Coast Bankers Bank to purchase federal funds totaling $57.8 million as of December 31, 2012. As of December 31, 2012, there were no overnight federal funds purchased.

During 2012 total assets decreased $23.4 million with cash on hand and in banks increasing $7.0 million, interest earning deposits decreasing $23.7 million, investment securities decreasing $2.3 million and net loans decreasing by $6.1 million as compared to the prior year-end. Our strategy has been to acquire core deposits (which we define to include all deposits except public funds, brokered CDs and other wholesale deposits) from our retail accounts, acquire noninterest bearing demand deposits from our commercial customers, and use our available borrowing capacity to fund growth in assets. We anticipate that we will continue to rely on the same sources of funds in the future and use those funds primarily to make loans and purchase investment securities.

Stockholders equity was $198.9 million at December 31, 2012 and $202.5 million at December 31, 2011. During the year ended December 31, 2012, we paid common stock dividends of $12.2 million, repurchased $6.0 million in common stock, realized net income of $13.3 million, recorded $63,000 in net unrealized losses on securities available for sale, net of tax, recorded $34,000 of market loss related to other than temporary impairment on securities held to maturity, net of tax, recorded $105,000 of accretion of market loss related to other than temporary impairment on securities held to maturity, net of tax, and realized the effects of exercising stock options, stock option compensation and earned ESOP and restricted stock shares totaling $1.3 million.

The Company and the Banks are subject to various regulatory capital requirements. As of December 31, 2012, the Company and the Banks were classified as well capitalized institutions under the criteria established by the Federal Deposit Insurance Act. Our initial public offering in January of 1998 significantly increased our

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capital to levels well in excess of regulatory requirements and our internal needs. Furthermore, on September 22, 2009, the Company completed the sale of 4.3 million shares of common stock in a public offering. The purchase price was $11.50 per share and net proceeds from the sale totaled approximately $46.6 million. On December 15, 2010, the Company completed the sale of 4.4 million shares of common stock in a public offering. The purchase price was $13.00 per share and net proceeds from the sale totaled approximately $54.1 million.

Quarterly, the Company reviews the potential payment of cash dividends to common shareholders. The timing and amount of cash dividends paid on our common stock depends on the Company s earnings, capital requirements, financial condition and other relevant factors. Dividends on common stock from the Company depend substantially upon receipt of dividends from the Banks, which are the Company s predominant sources of income. On January 30, 2013, the Company s Board of Directors declared a dividend of $0.08 per share payable on February 22, 2013 to shareholders of record on February 8, 2013.

Our capital levels are also modestly impacted by our 401(k) Employee Stock Ownership Plan and Trust (KSOP). The Employee Stock Ownership Plan (ESOP) purchased 2% of the common stock issued in the January 1998 stock offering and borrowed from the Company to fund the purchase of the Company s common stock. The loan to the ESOP was repaid in full as of December 31, 2012. While outstanding, the loan was repaid principally from the Banks contributions to the ESOP. The Banks contributions were sufficient to service the debt over the 15 year loan term at the interest rate of 8.5%. As the debt was repaid, shares were released, and allocated to plan participants based on the proportion of debt service paid during the year. As shares were released, compensation expense was recorded equal to the then current market price of the shares, our capital was increased, and the shares became outstanding for earnings per common share calculations. For the year ended December 31, 2012, the Company allocated or committed to be released to the ESOP 10,029 earned shares and has no unearned, restricted shares remaining to be released.

Contractual Obligations

The following table provides the amounts due under specified contractual obligations for the periods indicated as of December 31, 2012:

	December 31, 2012					
	Less than 1 year	Over 1-3 years	Over 3-5 years	More than 5 years	Indeterminate maturity(1)	Total
	(In thousands)					
Contractual payments by period:						
Deposits	$ 160,610	$ 107,700	$ 20,407	$ 210	$ 829,044	$ 1,117,971
Operating leases	1,545	2,976	2,465	3,314		10,300
Total contractual obligations	$ 162,155	$ 110,676	$ 22,872	$ 3,524	$ 829,044	$ 1,128,271

(1) Represents interest bearing and noninterest bearing checking, money market and checking accounts which can generally be withdrawn on demand.

Asset/Liability Management

Our primary financial objective is to achieve long term profitability while controlling our exposure to fluctuations in market interest rates. To accomplish this objective, we have formulated an interest rate risk management policy that attempts to manage the mismatch between asset and liability maturities while maintaining an acceptable interest rate sensitivity position. The principal strategies which we employ to control our interest rate sensitivity are: selling most long term, fixed rate, single-family residential mortgage loan originations; originating commercial loans and residential construction loans at variable interest rates repricing for terms generally one year or less; and offering noninterest bearing demand deposit accounts to businesses and

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individuals. The longer-term objective is to increase the proportion of noninterest bearing demand deposits, low-rate interest bearing demand deposits, money market accounts, and savings deposits relative to certificates of deposit to reduce our overall cost of funds.

Our asset and liability management strategies have resulted in a positive 0-3 month gap of 18.6% and a positive 4-12 month gap of 14.2% as of December 31, 2012. These gaps measure the difference between the dollar amount of our interest earning assets and interest bearing liabilities that mature or reprice within the designated period (three months and 4-12 months) as a percentage of total interest earning assets, based on certain estimates and assumptions as discussed below. We believe that the implementation of our operating strategies has reduced the potential effects of changes in market interest rates on our results of operations. The positive gap for the 0-3 month period indicates that decreases in market interest rates may adversely affect our results over that period.

The following table provides the estimated maturity or repricing and the resulting interest rate sensitivity gap of our interest earning assets and interest bearing liabilities at December 31, 2012 based upon estimates of expected mortgage prepayment rates and deposit run off rates consistent with national trends. We adjusted mortgage loan maturities for loans held for sale by reflecting these loans in the three-month category, which is consistent with their sale in the secondary mortgage market. The amounts in the table are derived from our internal data. We used certain assumptions in presenting this data so the amounts may not be consistent with other financial information prepared in accordance with generally accepted accounting principles. The amounts in the tables also could be significantly affected by external factors, such as changes in prepayment assumptions, early withdrawal of deposits and competition.

	December 31, 2012 Estimated Maturity or Repricing Within					
	0-3 months	Over 3 months-12 months	1-5 years	Over 5 years -15 years	Over 15 years	Total
	(Dollars in thousands)					
Interest Earnings Assets:						
Loans(1)	$ 273,855	$ 46,371	$ 366,977	$ 141,678	$ 49,376	$ 878,257
Investment securities	13,046	9,624	47,948	51,536	32,238	154,392
FHLB stock	5,495					5,495
Interest earning deposits	69,906					69,906
Total interest earning assets	$ 362,302	$ 55,995	$ 414,925	$ 193,214	$ 81,614	$ 1,108,050
Interest Bearing Liabilities:						
Total interest bearing deposits(2)	$ 139,820	$ 104,950	$ 625,943	$ 210	$	$ 870,923
Total securities sold under agreement to repurchase	16,021					16,021
Total interest bearing liabilities	$ 155,841	$ 104,950	$ 625,943	$ 210	$	$ 886,944
Rate sensitivity gap	$ 206,461	$ (48,955)	$ (211,018)	$ 193,004	$ 81,614	$ 221,106
Cumulative rate sensitivity gap:						
Amount	$ 206,461	$ 157,506	$ (53,512)	$ 139,491	$ 221,106	
As a percentage of total interest earning assets	18.63%	14.21%	(4.83)%	12.59%	19.95%	

(1) Originated loans receivable, including the loans held for sale and excluding deferred loan fees.

(2) Adjustable-rate liabilities are included in the period in which interest rates are next scheduled to adjust rather than in the period they are due to mature. Although regular savings, demand, NOW, and money market deposit accounts are subject to immediate withdrawal, based on historical experience management considers a substantial amount of such accounts to be core deposits having significantly longer maturities.

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For the purpose of the gap analysis, these accounts have been assigned decay rates to reflect their longer effective maturities. If all of these accounts had been assumed to be short-term, the 0-3 month cumulative gap of interest-sensitive assets would have been $(291.4) million, or (26.3%) of total interest earning assets at December 31, 2012.

Certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on some types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market interest rates. Additionally, some assets, such as adjustable rate mortgages, have features, which restrict changes in the interest rates of those assets both on a short-term basis and over the lives of such assets. Further, if a change in market interest rates occurs, prepayment, and early withdrawal levels could deviate significantly from those assumed in calculating the tables. Finally, the ability of many borrowers to service their adjustable rate debt may decrease if market interest rates increase substantially.

Impact of Inflation and Changing Prices

Inflation affects our operations by increasing operating costs and indirectly by affecting the operations and cash flow of our customers. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, changes in interest rates generally have a more significant impact on a financial institution s performance than the effects of general levels of inflation. Although interest rates do not necessarily move in the same direction or the same extent as the prices of goods and services, increases in inflation generally have resulted in increased interest rates.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to interest rate risk through our lending and deposit gathering activities. For a discussion of how this exposure is managed and the nature of changes in our interest rate risk profile during the past year, see Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operation Asset/Liability Management.

Neither we, nor the Banks, maintain a trading account for any class of financial instrument, nor do we, or they, engage in hedging activities or purchase high risk derivative instruments. Moreover, neither we, nor the Banks, are subject to foreign currency exchange rate risk or commodity price risk.

The table below provides information about our originated financial instruments that are sensitive to changes in interest rates as of December 31, 2012. The table presents principal cash flows and related weighted average interest rates by expected maturity dates. The expected maturity is the contractual maturity or earlier call date of the instrument. The data in this table may not be consistent with the amounts in the preceding table, which represents amounts by the repricing date or maturity date (whichever occurs sooner) adjusted by estimates such as mortgage prepayments and deposit reduction or early withdrawal rates.

	By Expected Maturity Date Year Ended December 31, (Dollars in thousands)						
	2013	2014	2015	2016-2017	After 2017	Total	Fair Value
Investment Securities(1)							
Amounts maturing:							
Fixed rate	$ 12,170	$ 1,082	$ 1,084	$ 5,574	$ 123,083	$ 142,993	
Weighted average interest rate	1.57%	4.14%	3.81%	4.15%	4.44%		
Adjustable rate					11,399	11,399	
Weighted average interest rate					3.31%		
Total	$ 12,170	$ 1,082	$ 1,084	$ 5,574	$ 134,482	$ 154,392	$ 155,303
Loans(2)							
Amounts maturing:							
Fixed rate	$ 50,156	$ 24,725	$ 28,152	$ 64,071	$ 198,301	$ 365,405	
Weighted average interest rate	5.41%	5.45%	4.96%	5.34%	5.30%		
Adjustable rate	171,672	20,230	25,585	43,602	250,087	511,176	
Weighted average interest rate	5.27%	6.03%	5.15%	5.23%	5.24%		
Total	$ 221,828	$ 44,955	$ 53,737	$ 107,673	$ 448,388	$ 876,581	$ 889,441
Certificates of Deposit							
Amounts maturing:							
Fixed rate	$ 160,610	$ 89,271	$ 18,429	$ 20,407	$ 210	$ 288,927	$ 290,484
Weighted average interest rate	0.63%	0.87%	2.05%	1.63%	3.00%		

(1) Balances represent carrying value.
(2) Originated loans receivable, excluding loans held for sale and deferred loan fees.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

For financial statements, see the Index to Consolidated Financial Statements on page F-1.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

On February 27, 2012, the Audit Committee of Heritage Financial Corporation (the Company), on behalf of the Company and its subsidiaries, Heritage Bank and Central Valley Bank, notified KPMG LLP that they will

be dismissed as the Company s independent public accountants upon completion of the audit for the fiscal year ended December 31, 2011. The decision to change independent accountants was approved by the Audit Committee.

During the two fiscal years ended December 31, 2011, and the subsequent interim period through March 2, 2012, there have been no disagreements with KPMG LLP on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedures, which disagreements, if not resolved to the satisfaction of KPMG LLP, would have caused them to make reference to such disagreements in their report on the financial statements for such years. During the two fiscal years ended December 31, 2011 and the subsequent period through March 2, 2012, there have been no reportable events (as defined in Regulation S-K Item 304 (a)(1)(v)). The audit reports of KPMG LLP on the Company s Consolidated Financial Statements as of and for the years ended December 31, 2011 and 2010 did not contain an adverse opinion or a disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principles.

On February 27, 2012, the Audit Committee engaged the firm of Crowe Horwath LLP as independent certified public accountants of the Company and its subsidiaries for the fiscal year ending December 31, 2012. During the year ended December 31, 2012, there were no disagreements with Crowe Horwath LLP, and the audit report of Crowe Horwath LLP on the Company s Consolidated Financial Statements as of and for the year ended December 31, 2012 did not contain an adverse opinion or a disclaimer of opinion and was not qualified or modified as to uncertainty, audit scope or accounting principles. The audit report of Crowe Horwath LLP on the effectiveness of internal control over financial reporting as of December 31, 2012 did not contain any adverse opinion or disclaimer of opinion, nor was it qualified or modified as to uncertainty, audit scope or accounting principles.

ITEM 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures.

Our disclosure controls and procedures are designed to ensure that information the Company must disclose in its reports filed or submitted under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized, and reported on a timely basis. Our management has evaluated, with the participation and under the supervision of our chief executive officer (CEO) and chief financial officer (CFO), the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act) as of the end of the period covered by this report. Based on this evaluation, our CEO and CFO have concluded that, as of such date, the Company s disclosure controls and procedures are effective in ensuring that information relating to the Company, including its consolidated subsidiaries, required to be disclosed in reports that it files under the Exchange Act is (1) recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and (2) accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

Internal Control Over Financial Reporting.

(a) Management s report on internal control over financial reporting.

The Company s management is responsible for establishing and maintaining adequate internal control over financial reporting. The Company s internal control system is designed to provide reasonable assurance to our management and the board of directors regarding the preparation and fair presentation of published financial statements. Nonetheless, all internal control systems, no matter how well designed, have inherent limitations. Even systems determined to be effective as of a particular date can provide only reasonable assurance with respect to financial statement preparation and presentation and may not eliminate the need for restatements.

The Company s management assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2012. In making this assessment, management used the criteria set forth by the

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Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control Integrated Framework*. Based on our assessment, we believe that, as of December 31, 2012, the Company s internal control over financial reporting is effective based on these criteria.

Crowe Horwath LLP, an independent registered public accounting firm, has audited the effectiveness of our internal control over financial reporting as of December 31, 2012, and their report is included in Item 8. Financial Statements and Supplementary Data.

(b) Attestation report of the registered public accounting firm.

See Item 8. Financial Statements and Supplementary Data.

(c) Changes in internal control over financial reporting.

There were no significant changes in the Company s internal control over financial reporting during the Company s most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

ITEM 9B. OTHER INFORMATION.

None

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PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information concerning directors of the registrant is incorporated by reference to the section entitled Election of Directors of our definitive proxy statement for the annual meeting of shareholders to be held May 1, 2013 (Proxy Statement).

For information regarding the executive officers of the Company, see Item 1. Business Executive Officers.

The required information with respect to compliance with Section 16(a) of the Exchange Act is incorporated by reference to the section entitled Security Ownership of Certain Beneficial Owners and Management of the Proxy Statement.

The Company has adopted a written Code of Ethics that applies to our directors, officers and employees. The Code of Ethics can be accessed electronically by visiting the Company s website at www.hf-wa.com.

The Audit and Finance Committee of our Board of Directors retains our independent auditors, reviews and approves the scope and results of the audits with the auditors and management, monitors the adequacy of our system of internal controls and reviews the annual report, auditors fees and non-audit services to be provided by the independent auditors. The members of our audit committee are Daryl D. Jensen, chair of the committee, Philip S. Weigand, Brian S. Charneski, John A. Clees, Jeffrey S. Lyon, Donald V. Rhodes, Ann Watson and Gary B. Christensen, all of whom are considered independent as defined by the SEC. Our Board of Directors has determined that Mr. Jensen meets the definition of an audit committee financial expert, as determined by the requirements of the SEC.

ITEM 11. EXECUTIVE COMPENSATION

Information concerning executive and director compensation and certain matters regarding participation in the Company s compensation committee required by this item is incorporated by reference to the headings Executive Compensation , Directors Compensation, and Report of the Compensation Committee of the Proxy Statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The following table summarizes the consolidated activity within the Company s stock option plans as of December 31, 2012, all of which were approved by shareholders.

Plan Category	Number of securities to be issued upon exercise of outstanding options and awards	Weighted-average exercise price of outstanding options	Number of securities remaining available for future issuance under equity compensation plans
Equity compensation plans, all of which are approved by security holders	490,328	$ 17.48	207,526

Information concerning security ownership of certain beneficial owners and management is incorporated by reference to the section entitled Security Ownership of Certain Beneficial Owners and Management of the Proxy Statement.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

Information concerning certain relationships and related transactions is incorporated by reference to the section entitled Meetings and Committees of the Board of Directors and Corporate Governance of the Proxy Statement.

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Our common stock is listed on the NASDAQ Global Select Market. In accordance with NASDAQ requirements, at least a majority of our directors must be independent directors. The Board of Directors has determined that ten of our eleven directors are independent. Directors Charneski, Christensen, Clees, Ellwanger, Fluetsch, Jensen, Lyon. Rhodes, Watson and Weigand are all independent. Only Brian L. Vance, who serves as President and Chief Executive Officer of Heritage Financial Corporation, and Chief Executive Officer of Heritage Bank and Vice Chairman and Chief Executive Officer of Central Valley Bank, is not independent.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

Information concerning principal accounting fees and services is incorporated by reference to the section entitled Proposal 3 Ratification of the Appointment of Registered Public Accounting Firm Audit Fees in the Proxy Statement.

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1) The Consolidated Financial Statements are contained as listed on the Index to Consolidated Financial Statements on page F-1.

(2) All schedules are omitted because they are not required or applicable, or the required information is shown in the Consolidated Financial Statements or notes.

(3) *Exhibits*

Exhibit No.	
2.1 & 2.2	Purchase and Assumption Agreements for Cowlitz & Pierce reference Q3 2012 Form 10-Q Exhibits (1)
3.1	Articles of Incorporation (2)
3.2	Bylaws of the Company (3)
4.2	Warrant for purchase (4)
10.1	1998 Stock Option and Restricted Stock Award Plan (5)
10.2	1997 Stock Option and Restricted Stock Award Plan (6)
10.3	2002 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan (7)
10.4	2006 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan (8)
10.5	Employment Agreement between Central Valley Bank and D. Michael Broadhead, effective December 3, 2010 (9)
10.6	Letter of Understanding between Heritage Financial Corporation and Donald V. Rhodes dated August 18, 2009 (10)
10.7	Annual Incentive Compensation Plan (11)
10.8	2010 Omnibus Equity Plan (12)
10.9	Deferred Compensation Plan and Participation Agreements for Brian L. Vance, Jeffrey J. Deuel and Donald J. Hinson (13)
10.10	Employment Agreements for Brian L. Vance, Jeffrey J. Deuel and Donald J. Hinson (13)
10.11	Change in Control Agreement by and between Heritage Bank and Gregory D. Patjens (13)
10.12	Change in Control Agreement by and between Heritage Bank and David A. Spurling (14)
11	Statement regarding computation of earnings per share (15)
14.0	Code of Ethics and Conduct Policy (16)
21.0	Subsidiaries of the Company
23.1	Consent of Independent Registered Public Accounting Firm Crowe Horwath LLP
23.2	Consent of Independent Registered Public Accounting Firm KPMG LLP
24.0	Power of Attorney

Exhibit No.	
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	The following materials from Heritage Financial Corporation s Annual Report on Form 10-K for the year ended December 31, 2012, formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Statements of Financial Condition, (ii) Consolidated Statements of Income; (iii) Consolidated Statements of Comprehensive Income, (iv) Consolidated Statements of Stockholder s Equity; (v) Consolidated Statements of Cash Flows, and (vi) the Notes to Consolidated Financial Statements (17)

(1) Incorporated by reference to the Current Report on Form 10-Q dated November 7, 2012.
(2) Incorporated by reference to the Registration Statement on Form S-1 (Reg. No. 333-35573) declared effective on November 12, 1997; as amended, said Amendment being incorporated by reference to the Amendment to the Articles of Incorporation of Heritage Financial Corporation filed with the Current Report on Form 8-K dated November 25, 2008.
(3) Incorporated by reference to the Current Report on Form 8-K dated November 29, 2007.
(4) Incorporated by reference to the Current Report on Form 8-K dated November 25, 2008.
(5) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-71415).
(6) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-57513).
(7) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-88980; 333-88982; 333-88976).
(8) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-134473; 333-134474; 333-134475).
(9) Incorporated by reference to the Quarterly Report on Form 10-Q dated May 1, 2007.
(10) Incorporated by reference to the Current Report on Form 8-K dated August 20, 2009.
(11) Incorporated by reference to the Annual Report on Form 10-K dated March 2, 2010.
(12) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 33-167146).
(13) Incorporated by reference to the Current Report on Form 8-K dated September 7, 2012.
(14) Included as an exhibit to the Annual Report on Form 10-K dated March 6, 2013.
(15) Reference is made to Note 13 Stockholder s Equity in the Selected Notes to Consolidated Financial Statements under Item 8 herein.
(16) Registrant elects to satisfy Regulation S-K §229.406(c) by posting its Code of Ethics on its website at www.HF-WA.com in the section titled Investor Information: Corporate Governance.
(17) Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise not subject to liability under those sections.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 6th day of March 2013.

HERITAGE FINANCIAL CORPORATION
(Registrant)

By /s/ BRIAN L. VANCE
Brian L. Vance
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on the 6th day of March 2013.

Principal Executive Officer:

/s/ BRIAN L. VANCE

Brian L. Vance
President and Chief Executive Officer

Principal Financial Officer:

/s/ DONALD J. HINSON

Donald J. Hinson
Executive Vice President and Chief Financial Officer

Remaining Directors:

*Brian S. Charneski

*Gary B. Christensen

*John A. Clees

*Kimberly T. Ellwanger

*Peter N. Fluetsch

*Daryl D. Jensen

*Jeffrey S. Lyon

*Donald V. Rhodes

*Ann Watson

*Philip S. Weigand

*By	/s/ Brian L. Vance
	Brian L. Vance
	Attorney-in-Fact

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2012, 2011 and 2010

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Heritage Financial Corporation

Olympia, Washington

We have audited the accompanying consolidated statement of financial condition of Heritage Financial Corporation and subsidiaries (the Company) as of December 31, 2012, and the related consolidated statements of income, comprehensive income, stockholders equity, and cash flows for the year then ended. We also have audited the Company s internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these financial statements and an opinion on the Company s internal control over financial reporting 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 and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the financial statements included 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, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Heritage Financial Corporation and subsidiaries as of December 31, 2012, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, Heritage Financial Corporation and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

/s/ Crowe Horwath LLP

San Francisco, California

March 6, 2013

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Heritage Financial Corporation:

We have audited the accompanying consolidated statement of financial condition of Heritage Financial Corporation and subsidiaries as of December 31, 2011, and the related consolidated statements of income, comprehensive income, stockholders equity, and cash flows for each of the years in the two-year period ended December 31, 2011. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated 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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Heritage Financial Corporation and subsidiaries as of December 31, 2011, and the results of their operations and their cash flows for each of the years in the two-year period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles.

/s/ KPMG LLP

Seattle, Washington

March 2, 2012

HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

December 31, 2012 and 2011

(Dollars in thousands)

	2012	2011
ASSETS		
Cash on hand and in banks	$ 37,180	$ 30,193
Interest earning deposits	69,906	93,566
Cash and cash equivalents	107,086	123,759
Investment securities available for sale	144,293	144,602
Investment securities held to maturity (fair value of $11,010 and $12,881)	10,099	12,093
Loans held for sale	1,676	1,828
Originated loans receivable, net	874,485	837,924
Less: Allowance for loan losses	(19,125)	(22,317)
Originated loans receivable, net of allowance for loan losses	855,360	815,607
Purchased covered loans receivable, net of allowance for loan losses of ($4,352 and $3,963)	83,978	105,394
Purchased non-covered loans receivable, net of allowance for loan losses of ($5,117 and $4,635)	59,006	83,479
Total loans receivable, net	998,344	1,004,480
Federal Deposit Insurance Corporation (FDIC) indemnification asset	7,100	10,350
Other real estate owned ($260 and $774 covered by FDIC loss share, respectively)	5,666	4,484
Premises and equipment, net	24,755	22,975
Federal Home Loan Bank (FHLB) stock, at cost	5,495	5,594
Accrued interest receivable	4,821	5,117
Prepaid expenses and other assets	8,288	8,190
Deferred income taxes, net	13,819	10,988
Other intangible assets, net	1,086	1,513
Goodwill	13,012	13,012
Total assets	$ 1,345,540	$ 1,368,985
LIABILITIES AND STOCKHOLDERS EQUITY		
Deposits	$ 1,117,971	$ 1,136,044
Securities sold under agreement to repurchase	16,021	23,091
Accrued expenses and other liabilities	12,610	7,330
Total liabilities	1,146,602	1,166,465
Stockholders equity:		
Preferred stock, no par value, 2,500,000 shares authorized; no shares issued and outstanding at December 31, 2012 and December 31, 2011		
Common stock, no par value, 50,000,000 shares authorized; 15,117,980 and 15,456,297 shares outstanding at December 31, 2012 and 2011, respectively	121,832	126,622
Unearned compensation Employee Stock Ownership Plan (ESOP)		(94)
Retained earnings	75,362	74,256
Accumulated other comprehensive income, net	1,744	1,736

Total stockholders equity	198,938	202,520
Total liabilities and stockholders equity	$ 1,345,540	$ 1,368,985

See accompanying notes to consolidated financial statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

For the years ended December 31, 2012, 2011 and 2010

(Dollars in thousands, except per share amounts)

	2012	2011	2010
Interest income:			
Interest and fees on loans	$ 65,588	$ 70,114	$ 56,054
Taxable interest on investment securities	2,195	2,912	2,661
Nontaxable interest on investment securities	1,097	821	470
Interest on interest earning deposits	229	273	337
Total interest income	69,109	74,120	59,522
Interest expense:			
Deposits	4,469	6,503	8,378
Other borrowings	65	79	133
Total interest expense	4,534	6,582	8,511
Net interest income	64,575	67,538	51,011
Provision for loan losses on originated loans	695	5,180	11,990
Provision for loan losses on purchased loans	1,321	9,250	
Net interest income after provision for loan losses	62,559	53,108	39,021
Noninterest income:			
Gain on bank acquisitions, net			11,830
Service charges and other fees	5,516	5,419	4,811
Merchant Visa income, net	685	556	515
Change in FDIC indemnification asset	(1,033)	(2,250)	50
Other income	2,104	2,021	1,573
Total noninterest income	7,272	5,746	18,779
Noninterest expense:			
Impairment loss on investment securities	130	118	318
Less: Portion recorded as other comprehensive loss	(52)	(20)	(20)
Impairment loss on investment securities, net	78	98	298
Compensation and employee benefits	29,020	27,109	19,910
Occupancy and equipment	7,365	7,127	5,326
Data processing	2,555	2,628	2,233
Marketing	1,517	1,361	1,171
Professional services	2,543	2,062	2,139
State and local taxes	1,226	1,336	968
Federal deposit insurance premium	1,002	1,558	1,656
Other real estate owned, net	316	921	269
Other expense	4,770	5,503	4,041

Total noninterest expense	50,392	49,703	38,011
Income before income taxes	19,439	9,151	19,789
Income tax expense	6,178	2,633	6,435
Net income	$ 13,261	$ 6,518	$ 13,354
Dividends accrued and discount accreted on preferred shares			1,686
Net income applicable to common shareholders	$ 13,261	$ 6,518	$ 11,668
Basic earnings per common share	$ 0.87	$ 0.42	$ 1.05
Basic weighted average common shares outstanding	15,080,149	15,431,355	11,121,346
Diluted earnings per common share	$ 0.87	$ 0.42	$ 1.04
Diluted weighted average common shares outstanding	15,094,789	15,497,426	11,173,658

See accompanying notes to consolidated financial statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

For the years ended December 31, 2012, 2011 and 2010

(Dollars in thousands)

Comprehensive Income	**2012**	**2011**	**2010**
Net income	$ 13,261	$ 6,518	$ 13,354
Change in fair value of securities available for sale, net of tax of $(34), $663 and $225	(63)	1,233	418
Reclassification adjustment of net gain from sale of available for sale securities included in income, net of tax of $0, $8 and $0		14	
Other-than-temporary impairment on securities held to maturity, net of tax of $(18), $(7) and $(8)	(34)	(13)	(14)
Accretion of other-than-temporary impairment on securities held to maturity, net of tax of $57, $68 and $111	105	125	206
Other comprehensive income	$ 8	$ 1,359	$ 610
Comprehensive income	$ 13,269	$ 7,877	$ 13,964

See accompanying notes to consolidated financial statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

For the years ended December 31, 2012, 2011 and 2010

(Dollars and shares in thousands, except per share amounts)

	Number of preferred stock shares	Preferred stock	Number of common shares	Common stock	Unearned Compensation-ESOP	Retained earnings	Accumulated other comprehensive income, net	Total stock holders equity
Balance at December 31, 2009	24	$ 23,487	11,058	$ 73,534	$ (270)	$ 61,980	$ (233)	$ 158,498
Restricted stock awards issued, net of forfeitures			56					
Stock option compensation expense				204				204
Exercise of stock options (including tax benefits from nonqualified stock options)			17	202				202
Share based payment and earned ESOP			9	420	88			508
Tax associated with share based payment and unallocated ESOP				(10)				(10)
Accretion of preferred stock		513				(513)		
Net income						13,354		13,354
Other comprehensive income, net of tax							610	610
Redemption of preferred stock	(24)	(24,000)						(24,000)
Common stock issuance, net of expenses			4,428	54,086				54,086
Cash dividends accrued on preferred stock						(1,173)		(1,173)
Balance at December 31, 2010		$	15,568	$ 128,436	$ (182)	$ 73,648	$ 377	$ 202,279
Restricted stock awards issued, net of forfeitures			76					
Stock option compensation expense				165				165
Exercise of stock options (including tax benefits from nonqualified stock options)			5	50				50
Share based payment and earned ESOP			8	767	88			855
Tax associated with share based payment and unallocated ESOP				(4)				(4)
Common stock repurchase			(201)	(2,342)				(2,342)
Net income						6,518		6,518
Other comprehensive income, net of tax							1,359	1,359
Repurchase of warrant issued to U.S. Treasury				(450)				(450)
Cash dividends declared on common stock ($0.38 per share)						(5,910)		(5,910)
Balance at December 31, 2011		$	15,456	$ 126,622	$ (94)	$ 74,256	$ 1,736	$ 202,520
Restricted stock awards issued, net of forfeitures			86					
Stock option compensation expense				106				106
Exercise of stock options (including tax benefits from nonqualified stock options)			12	129				129
Share based payment and earned ESOP			10	1,091	94			1,185
Tax associated with share based payment and unallocated ESOP				(93)				(93)
Common stock repurchased and retired			(446)	(6,023)				(6,023)

Net income				13,261		13,261
Other comprehensive income, net of tax					8	8
Cash dividends declared on common stock ($0.80 per share)				(12,155)		(12,155)
Balance at December 31, 2012	$ 15,118	$ 121,832	$	$ 75,362	$ 1,744	$ 198,938

See accompanying notes to consolidated financial statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the years ended December 31, 2012, 2011 and 2010

(Dollars in thousands)

	2012	2011	2010
Cash flows from operating activities:			
Net income	$ 13,261	$ 6,518	$ 13,354
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	4,290	2,185	2,050
Deferred loan fees (costs), net of amortization	236	537	(274)
Provision for loan losses	2,016	14,430	11,990
Net change in accrued interest receivable, prepaid expenses and other assets, accrued expenses and other liabilities	8,633	3,241	5,762
Recognition of compensation related to ESOP shares and share based payment	1,185	855	508
Stock option compensation expense	106	165	204
Tax provision realized from stock options exercised, share based payment and dividends on unallocated ESOP shares	93	4	10
Amortization of intangible assets	427	440	225
Deferred income tax	(2,835)	(7,465)	4,549
Gain on FDIC assisted bank acquisitions, net			(11,830)
(Gain) loss on sale of investment securities, net		(23)	44
Impairment loss on investment of securities	78	98	298
Origination of loans held for sale	(21,035)	(18,016)	(18,665)
Gain on sale of loans	(295)	(316)	(401)
Proceeds from sale of loans	21,482	17,268	19,127
Valuation adjustment on other real estate owned	824	871	
(Gain) loss on other real estate owned, net	(587)	71	121
Loss (gain) on sale of premises and equipment, net	3	8	(2)
Net cash provided by operating activities	27,882	20,871	27,070
Cash flows from investing activities:			
Loans originated, net of principal payments	(3,522)	(45,379)	39,173
Maturities of investment securities available for sale	61,751	35,196	25,125
Maturities of investment securities held to maturity	2,177	2,221	2,301
Purchase of investment securities available for sale	(63,903)	(53,590)	(13,740)
Purchase of investment securities held to maturity		(271)	(2,296)
Purchase of premises and equipment	(3,859)	(3,127)	(6,914)
Proceeds from sales of other real estate owned cash	5,255	3,257	1,948
Proceeds from sales of other real estate owned financed	732		
Proceeds from sale of premises and equipment		2	446
Proceeds from sales of investment securities available for sale		412	1,105
Proceeds from repurchase of FHLB stock	99		
Net cash acquired in acquisitions			196,614
Net cash (used in) provided by investing activities	(1,270)	(61,279)	243,762
Cash flows from financing activities:			
Net (decrease) increase in deposits	(18,073)	(232)	(229,234)
Net (decrease) increase in borrowed funds			(17,530)

Preferred stock cash dividends paid			(1,173)
Common stock cash dividends paid	(12,155)	(5,910)	
Net (decrease) increase in securities sold under agreement to repurchase	(7,070)	4,064	8,587
Proceeds from common stock issuance, net of expenses			54,086
Proceeds from exercise of stock options	129	50	202
Tax provision realized from stock options exercised, share based payment and dividends on unallocated ESOP shares	(93)	(4)	(10)
Repurchase of common stock	(6,023)	(2,342)	
Repurchase of common stock warrant		(450)	
Repurchase of preferred stock			(24,000)
Net cash used in financing activities	(43,285)	(4,824)	(209,072)
Net (decrease) increase in cash and cash equivalents	(16,673)	(45,232)	61,760
Cash and cash equivalents at beginning of year	123,759	168,991	107,231
Cash and cash equivalents at end of year	$ 107,086	$ 123,759	$ 168,991

	2012	2011	2010
Supplemental disclosures of cash flow information:			
Cash paid for interest	$ 4,608	$ 6,724	$ 8,455
Cash paid for income taxes	10,713	9,998	1,494
Loans transferred to other real estate owned	(7,406)	(5,653)	(3,693)
Assets acquired (liabilities assumed) in acquisitions:			
Investment securities			47,397
Loans covered by loss sharing			142,974
Loans not covered by loss sharing			145,246
Federal Home Loan Bank stock			2,264
Accrued interest receivable			1,133
FDIC indemnification asset			16,084
Core deposit intangible			1,832
Other real estate owned			702
Other assets			1,219
Deposits			(525,382)
Borrowings			(17,530)
Deferred tax liability			(4,140)
Other liabilities			(724)

See accompanying notes to consolidated financial statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Summary of Significant Accounting Policies

(a) Description of Business

Heritage Financial Corporation (the Company) is a bank holding company incorporated in the State of Washington in August 1997. The Company is primarily engaged in the business of planning, directing and coordinating the business activities of its wholly owned subsidiaries: Heritage Bank and Central Valley Bank (the Banks). The Banks are Washington-chartered commercial banks and their deposits are insured by the FDIC under the Deposit Insurance Fund (DIF). Heritage Bank conducts business from its main office in Olympia, Washington and its twenty-seven branch offices (including one branch acquired subsequent to December 31, 2012 in the Northwest Commercial Bank acquisition discussed below) located in western Washington and the greater Portland, Oregon area. Central Valley Bank conducts business from its main office in Toppenish, Washington and its five branch offices located in Yakima and Kittitas counties of Washington State.

The Company s business consists primarily of lending and deposit relationships with small businesses and their owners in its market areas and attracting deposits from the general public. The Company also makes real estate construction and land development loans, one-to-four family residential loans, and consumer loans and originates for sale or investment purposes first mortgage loans on residential properties located in western and central Washington State and the greater Portland, Oregon area.

Effective July 30, 2010, Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of the Cowlitz Bank, a Washington state-chartered bank headquartered in Longview, Washington (the Cowlitz Acquisition). The Cowlitz Acquisition included nine branches of Cowlitz Bank, including its division Bay Bank, which opened as branches of Heritage Bank as of August 2, 2010. It also included the Trust Services Division of Cowlitz Bank. Effective November 5, 2010, Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Pierce Commercial Bank, a Washington state-chartered bank headquartered in Tacoma, Washington (the Pierce Commercial Acquisition). The Pierce Commercial Acquisition included one branch, which opened as a branch of Heritage Bank as of November 8, 2010. The Cowlitz Acquisition and the Pierce Commercial Acquisition are collectively referred to as the Cowlitz and Pierce Acquisitions .

On September 14, 2012, the Company announced that it had entered into a definitive agreement along with its financial institution subsidiary, Heritage Bank, to acquire Northwest Commercial Bank (NCB). NCB was headquartered in Lakewood, Washington and was a full service commercial bank that operated two branch locations in Washington State. The transaction closed on January 9, 2013, and NCB was merged with and into Heritage Bank. See Note 19, Subsequent Events .

(b) Basis of Presentation

The accounting and reporting policies of the Company and its subsidiaries conform to U.S. Generally Accepted Accounting Principles (GAAP). In preparing the Consolidated Financial Statements, management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of financial statements and the reported amounts of income and expense during the reporting periods. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, other than temporary impairments in the fair value of investment securities, expected cash flows of purchased loans and related indemnification asset, fair value measurements, stock-based compensation, impairment of goodwill and other intangible assets and income taxes. Actual results could differ from these estimates.

The accompanying Consolidated Financial Statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions among the Company and its subsidiaries have been eliminated in consolidation.

Certain prior year amounts have been reclassified to conform to the current period s presentation. Reclassifications had no effect on prior year net income or stockholders equity.

(c) Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents includes cash on hand and in banks, interest earning deposits with original maturities of 90 days or less, and federal funds sold.

The Banks are required to maintain an average reserve balance with the Federal Reserve Bank in the form of cash. For the years ended December 31, 2012 and 2011, the Banks maintained adequate levels of cash to meet the Federal Reserve Bank requirement.

(d) Investment Securities

The Company identifies investments as held to maturity or available for sale at the time of acquisition. Securities are classified as held to maturity when the Company has the ability and positive intent to hold them to maturity. Securities classified as available for sale are available for future liquidity requirements and may be sold prior to maturity.

Investment securities held to maturity are recorded at cost, adjusted for amortization of premiums or accretion of discounts using the interest method. Securities available for sale are carried at fair value. Unrealized gains and losses on securities available for sale are excluded from earnings and are reported in other comprehensive income, net of related income taxes. Realized gains and losses on sale of investment securities are computed on the specific identification method.

Management evaluates securities for other-than-temporary impairment (OTTI) on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. Although these evaluations involve significant judgment, an unrealized loss in the fair value of a debt security is generally deemed to be temporary when the fair value of the security is below the carrying value primarily due to changes in interest rates, there has not been significant deterioration in the financial condition of the issuer, and it is not more likely than not that the Company will be required to sell the security before the anticipated recovery of its remaining carrying value. If any of these criteria is not met, the impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. An unrealized loss in the value of an equity security is generally considered temporary when the fair value of the security is below the carrying value primarily due to current market conditions and not deterioration in the financial condition of the issuer, and it is not more likely than not that the Company will be required to sell the security before the anticipated recovery of its remaining carrying value. Other factors that may be considered in determining whether a decline in the value of either a debt or an equity security is other than temporary include ratings by recognized rating agencies; actions of commercial banks or other lenders relative to the continued extension of credit facilities to the issuer of the security; the financial condition, capital strength and near-term prospects of the issuer and recommendations of investment advisors or market analysts. If any of these criteria is not met, the entire difference between amortized cost and fair value is recognized as impairment through earnings, and a new cost basis is established for the security. Continued deterioration of market conditions could result in additional impairment losses recognized within the investment portfolio.

(e) Loans Receivable and Loans Held for Sale

Loans Held for Sale:

Mortgage loans held for sale are carried at the lower of amortized cost or market value determined on an aggregate basis. Any loan that management determines will not be held to maturity is classified as held for sale at the time of origination, purchase or securitization, or when such decision is made. Unrealized losses on such loans are included in income.

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Originated Loans:

Originated loans are generally recorded at their outstanding principal balance adjusted for charge-offs, the allowance for loan losses and deferred fees and costs. Interest on loans is calculated using the simple interest method based on the daily balance of the principal amount outstanding and is credited to income as earned. Loans are considered past due or delinquent when principal or interest payments are past due 30 days or more. Loans on which the accrual of interest has been discontinued are designated as nonaccrual loans. Delinquent loans may remain on accrual status between 30 days and 89 days past due. The accrual of interest is discontinued at the time the loan is 90 days delinquent unless the credit is well secured and in the process of collection. Loans are placed on nonaccrual at an earlier date if collection of the contractual principal or interest is doubtful. All interest accrued but not collected on loans deemed nonaccrual during the period is reversed against interest income in that period. The interest payments received on nonaccrual loans is accounted for on the cost-recovery method whereby the interest payment is applied to the principal balances. Loans may be returned to accrual status when improvements in credit quality eliminate the doubt as to the full collectability of both interest and principal and a period of sustained performance has occurred. Substantially all loans that are nonaccrual are also impaired. Income recognition on impaired loans conforms to that used on nonaccrual loans

Loans are charged-off if collection of the contractual principal or interest as scheduled in the loan agreement is doubtful. Credit card loans and other consumer loans are typically charged-off no later than 180 days past due.

Purchased Covered and Purchased Non-Covered Loans:

Loans acquired in a business acquisition are designated as purchased loans. These loans are recorded at their fair value at acquisition date, factoring in credit losses expected to be incurred over the life of the loan. Accordingly, an allowance for loan losses is not carried over or recorded as of the acquisition date. Purchased loans subject to FDIC shared-loss agreements are identified as covered on the Consolidated Statements of Financial Condition, while purchased loans not subject to FDIC shared-loss agreements are referred to as non-covered . The covered loans have an additional evaluation separate from originated and purchased non-covered loans as they have shared-loss attributes which may reduce the Bank s risk of loss. For further information see Note 4, FDIC Indemnification Asset .

Loans purchased with evidence of credit deterioration since origination for which it is probable that all contractually required payments will not be collected are accounted for under Financial Accounting Standards Board (FASB) Accounting Standards Codification (FASB ASC) 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*, formerly AICPA SOP 03-3 *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*. These loans are identified as purchased impaired loans. In situations where such loans have similar risk characteristics, loans may be aggregated into pools to estimate cash flows. A pool is accounted for as a single asset with a single interest rate, cumulative loss rate and cash flow expectation. Expected cash flows at the acquisition date in excess of the fair value of loans are considered to be accretable yield, which is recognized as interest income over the life of the loan or pool using a level yield method if the timing and amount of the future cash flows of the pool is reasonably estimable.

The cash flows expected over the life of the purchased impaired loan or pool are estimated quarterly using an internal cash flow model that projects cash flows and calculates the carrying values of the pools, book yields, effective interest income and impairment, if any, based on pool level events. Assumptions as to default rates, loss severity and prepayment speeds are utilized to calculate the expected cash flows. To the extent actual or projected cash flows are less than previously estimated, additional provisions for loan losses on the purchased loan portfolios will be recognized immediately into earnings. To the extent actual or projected cash flows are more than previously estimated, the increase in cash flows is recognized immediately as a recapture of provision for loan losses up to the amount of any provision previously recognized for that pool of loans, if any, then prospectively recognized in interest income as a yield adjustment. Any disposals of loans, including sales of loans, payments in full or foreclosures result in the removal of the loan from the loan pool at the carrying amount.

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Loans accounted for under FASB ASC 310-30 are generally considered accruing and performing loans as the loans accrete interest income over the estimated life of the loan when cash flows are reasonably estimable. Accordingly, purchased impaired loans that are contractually past due are still considered to be accruing and performing loans. If the timing and amount of cash flows is not reasonably estimable, the loans may be classified as nonaccrual loans and interest income may be recognized on a cash basis or as a reduction of the principal amount outstanding.

Loans purchased that are not accounted for under FASB ASC 310-30 are accounted for under FASB ASC 310-20, *Receivables Nonrefundable fees and Other Costs,* formerly SFAS91 *Nonrefundable fees and Other Costs,* which considers the contractual cash flows. These loans are identified as purchased other loans, and are initially recorded at their fair value, which is estimated using an internal cash flow model and assumptions similar to the FASB ASC 310-30 loans. The difference between the estimated fair value and the unpaid principal balance at acquisition date is recognized as interest income over the life of the loan using an effective interest method for non-revolving credits or a straight-line method, which approximates the effective interest method, for revolving credits. Any unrecognized discount for a loan that is subsequently repaid or fully charged-off will be recognized immediately into income.

(f) Impaired Loans and Troubled Debt Restructures

Impaired Loans:

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

Troubled Debt Restructures:

A troubled debt restructured loan (TDR) is a restructuring in which the Banks, for economic or legal reasons related to a borrower s financial difficulties, grant a concession to a borrower that it would not otherwise consider. These concessions may include changes of the interest rate, forbearance of the outstanding principal or accrued interest, extension of the maturity date, delay in the timing of the regular payment, or any other actions intended to minimize potential losses. The Banks do not forgive principal for a majority of their TDRs, but in those situations where principal is forgiven, the entire amount of such principal forgiveness is immediately charged off to the extent not done so prior to the modification. The Banks also consider insignificant delays in payments when determining if a loan should be classified as a TDR.

A loan that has been placed on nonaccrual status that is subsequently restructured will usually remain on nonaccrual status until the borrower is able to demonstrate repayment performance in compliance with the restructured terms for a sustained period, typically for six months. A restructured loan may return to accrual status sooner based on other significant events or mitigating circumstances. A loan that has not been placed on nonaccrual status may be restructured and such loan may remain on the accrual status after such restructuring. In these circumstances, the borrower has made payments before and after the restructuring. Generally, this restructuring involves a reduction in the loan interest rate and/or a change to interest-only payments for a period of time. The restructured loan is considered impaired despite the accrual status and a specific valuation allowance is calculated similar to the impaired loans.

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A TDR is considered defaulted if, during the 12-month period after the restructure, the loan has not performed in accordance to the restructured terms. Defaults include loans whose payments are 90 days past due and loans whose revised maturity date passed and no further modifications will be granted for that borrower.

A loan may subsequently be excluded from the impaired loan disclosures if (i) the restructured interest rate was greater than or equal to the interest rate of a new loan with comparable risk at the time of the restructure, and (ii) the loan is no longer impaired based on the terms of the restructured agreement. The Banks policy is that the borrower must demonstrate a sustained period, typically six consecutive months, of payments in accordance with the modified loan before it can be reviewed for removal from the impaired loan disclosure under the second criteria. However, the loan must be reported as an impaired loan in at least one annual report on Form 10-K.

(g) Loan Fees

Loan origination fees and certain direct origination costs are deferred and amortized as an adjustment of the yields of the loans over their contractual lives, adjusted for prepayment of the loans, using the effective interest method or the straight-line method, which approximates the effective interest method. In the event loans are sold, the net deferred loan origination fees or costs are recognized as a component of the gains or losses on the sales of loans.

(h) Allowance for Loan Losses

Allowance for Loan Losses on Originated Loans:

The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management s best estimate of probable losses that have been incurred within the existing portfolio of originated loans. For further information on the policy on purchased loans, see Allowance for Loan Losses on Purchased Loans below. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The Company s allowance for loan losses methodology includes allowance allocations calculated in accordance with FASB ASC 310, *Receivables* and allowance allocations calculated in accordance with FASB ASC 450, *Contingencies*. Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools and specific loss allocations, with adjustments for current events and conditions. The Company s process for determining the appropriate level of the allowance for loan losses is designed to account for credit deterioration as it occurs. The provision for loan losses reflects loan quality trends, including the levels of and trends related to nonaccrual loans, past due loans, potential problem loans, criticized loans and net charge-offs or recoveries, among other factors. The provision for loan losses also reflects the totality of actions taken on all loans for a particular period. In other words, the amount of the provision reflects not only the necessary increases in the allowance for loan losses related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools. Losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The level of the allowance reflects management s continuing evaluation of known and inherent risks in the loan portfolio. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management s judgment, should be charged off.

The Company s allowance for loan losses consists of three elements: (i) specific valuation allowances determined in accordance with FASB ASC 310 based on probable losses on specific loans; (ii) historical loss factor determined in accordance with FASB ASC 450 based on historical loan loss experience for similar loans with similar characteristics and trends; and (iii) an environmental loss factor to reflect the impact of current conditions, as determined in accordance with FASB ASC 450 based on general economic conditions and other qualitative risk factors both internal and external to the Company. The historical loss factor and environmental loss factor are combined and multiplied against the outstanding principal balance of loans in the pool of similar loans with similar characteristics. The Company s pools of similar loans are grouped by class of loan.

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The allowances established for probable losses on specific loans are based on a regular analysis and evaluation of problem loans. Loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the obligor s ability to repay; (ii) the underlying collateral, if any; and (iii) the economic environment and industry in which the borrower operates. This analysis is performed at the loan officer level for all loans. When a loan is performing but has an assigned risk grade greater than pass, the loan officer analyzes the loan to determine an appropriate monitoring and collection strategy. When a loan is nonperforming or has been classified as a nonaccrual loan, a member from the special assets department will analyze the loan to determine if it is impaired. If the loan is considered impaired, the special asset department will evaluate the need for a specific valuation allowance on the loan. Specific valuation allowances are determined by analyzing the borrower s ability to repay amounts owed, collateral deficiencies and economic conditions affecting the borrower s industry, among other things.

Historical loss factors are calculated based on the historical loss experience and recovery experience of specific classes of loans. The Company calculates historical loss ratios for the classes of loans based on the proportion of actual charge-offs and recoveries experienced to the total population of loans in the pool for a rolling twelve quarter average.

Environmental loss factors are based on general economic conditions and other qualitative risk factors both internal and external to the Company. In general, such valuation allowances are determined by evaluating, among other things: (i) levels of and trend in delinquencies and impaired loans; (ii) levels and trends in charge-offs and recoveries; (iii) effects of changes in risk selection and underwriting standards, and other changes in lending policies, procedures, and practices; (iv) experience, ability, and depth of lending management and other relevant staff; (v) national and local economic trends and conditions; (vi) external factors such as competition, legal, and regulatory and; (vii) effects of changes in credit concentrations. Management evaluates the degree of risk that each one of these components has on the quality of the loan portfolio on a quarterly basis. Each component is determined to be on a scale of risk. The results are then utilized in a matrix to determine an appropriate environmental loss factor for each class of loan. An additional environmental factor is added after the calculated matrix factor if the specific loan is risk graded greater than watch.

The allowance for loan loss evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available. While management utilizes its best judgment and information available to recognize losses on loans, future additions to the allowance may be necessary based on declines in local and national economic conditions. In addition, 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 adjustments to the allowance based on their judgments about information available to them at the time of their examinations. The Company believes the allowance for loan losses is appropriate given all the above considerations.

The Banks are also party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of their customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheet. The Company has a policy in which it evaluates the risk on a quarterly basis, and provides for an allowance for credit losses, as necessary. The methodology is similar to the allowance for loan losses, and includes an estimate of the probability of drawdown of the loan commitment. Based on its analysis, the Company has recorded an allowance for off-balance sheet financial instruments of $75,000 as of December 31, 2012.

Allowance for Loan Losses on Purchased Loans:

The purchased loans acquired in the Cowlitz Acquisition and the Pierce Commercial Acquisition are subject to the Company s internal and external credit review. Under the accounting guidance of FASB ASC 310-30, the allowance for loan losses on purchased impaired loans is measured at each financial reporting period, or measurement date, based on expected cash flows. If and when credit deterioration, or decreases in expected cash flows initially estimated, occurs subsequent to the acquisition date, a provision for loan losses for purchased loans will be charged to earnings as of the measurement date. For the purchased covered loans, a provision for loan losses will be charged to earnings for the full amount without regard to the FDIC shared-loss agreement, and the portion of the loss reimbursable from the FDIC is recorded in noninterest income and increases the FDIC indemnification asset.

The purchased other loans not accounted for under FASB ASC 310-30 and the balances funded on purchased loans after the acquisition date, called subsequent advances , are also subject to the Company s credit reviews. An allowance for loan loss is estimated in a similar manner as the originated loan portfolio, and a provision for loan loss is charged to earnings as necessary. Management also reviews historical and environmental factors specific to the purchased portfolios which may be slightly different than the originated loan portfolio.

(i) FDIC Indemnification Asset

The FDIC indemnification asset was measured at estimated fair value at acquisition date on the same basis as the purchased covered loans, and represents the present value of the estimated losses on covered loans to be reimbursed by the FDIC. The present value was calculated using the shorter of the shared-loss agreement terms or the life of the loan. Under the terms of the FDIC shared-loss agreements, the FDIC will absorb 80% of losses and receive 80% of loss recoveries for the covered loans. The FDIC indemnification asset will be reduced as losses are recognized on covered loans and shared-loss payments are received from the FDIC. Since the FDIC indemnification asset was initially recorded at estimated fair value using a discount rate, a portion of the discount is taken into noninterest income at each reporting date.

The FDIC indemnification asset is evaluated quarterly. Realized losses in excess of prior estimates will immediately increase the FDIC indemnification asset by a credit to noninterest income. Conversely, if realized losses are less than prior estimates, the FDIC indemnification asset will be reduced by a charge to noninterest income on a prospective basis, and any change in value would be limited to the contractual terms of the shared-loss agreement.

(j) Mortgage Banking Operations

The Company sells one-to-four family residential mortgage loans on a servicing released basis and recognizes a cash gain or loss. A cash gain or loss is recognized to the extent that the sales proceeds of the mortgage loans sold exceed or are less than the net book value at the time of sale. Income from mortgage loans brokered to other lenders is recognized into income on date of loan closing.

Commitments to sell one-to-four family residential mortgage loans are made primarily during the period between the taking of the loan application and the closing of the mortgage loan. The timing of making these sale commitments is dependent upon the timing of the borrower s election to lock-in the mortgage interest rate and fees prior to loan closing. Most of these sale commitments are made on a best-efforts basis whereby the Banks are only obligated to sell the mortgage if the mortgage loan is approved and closed by the Banks. Commitments to fund mortgage loans (interest rate locks) to be sold into the secondary market and forward commitments for the future delivery of these mortgage loans are accounted for as free standing derivatives. Fair values of these mortgage derivatives are estimated based on changes in mortgage interest rates from the date the interest on the loan is locked. The Company enters into forward commitments for the future delivery of mortgage loans when interest rate locks are entered into, in order to hedge the change in interest rates resulting from its commitments to fund the loans. Changes in the fair values of these derivatives are included in gains on sales of loans. The fair value of these derivative instruments was not significant at December 31, 2012 and 2011.

(k) Other Real Estate and Other Assets Owned

Other real estate acquired by the Company in satisfaction of debt are held for sale and recorded at fair value at time of foreclosure. When property is acquired, it is recorded at the estimated fair value (less the costs to sell) at the date of acquisition, not to exceed net realizable value, and any resulting write-down is charged to the allowance for loan losses. Upon acquisition, all costs incurred in maintaining the property are expensed. Costs relating to the development and improvement of the property, however, are capitalized to the extent of the property s net realizable value.

(l) Premises and Equipment

Premises and equipment, including leasehold improvements, are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets or the lease period, whichever is shorter. The estimated useful lives used to compute depreciation and amortization for buildings and building improvements is 15 to 39 years; and for furniture, fixtures and equipment is three to seven years. The Company reviews buildings, leasehold improvements and equipment for impairment whenever events or changes in the circumstances indicate that the undiscounted cash flows for the property are less than its carrying value. If identified, an impairment loss is recognized through a charge to earnings based on the fair value of the property.

(m) Other Intangible Assets

The other intangible assets represents the Core Deposit Intangible (CDI) acquired in business combinations. The fair value of the CDI stemming from any given business combination is based on the present value of the expected cost savings attributable to the core deposit funding, relative to an alternative source of funding. The CDI is amortized over an estimated useful life which approximates the existing deposit relationships acquired on an accelerated method. The useful life of the CDI related to Pierce Commercial Bank, Cowlitz Bank, and Western Washington Bancorp acquisitions is four, nine, and eight years, respectively. The Company evaluates such identifiable intangibles for impairment when an indication of impairment exists. Amortization expense relate to the core deposit intangibles was $427,000, $440,000 and $225,000 for the years ended December 31, 2012, 2011 and 2010.

The estimated aggregated amortization expense related to these intangible assets for future years is as follows:

	Year Ending December 31, (In thousands)
2013	$ 334
2014	273
2015	171
2016	134
2017	96
Thereafter	78
	$ 1,086

(n) Goodwill

The Company s goodwill represents the excess of the purchase price over the fair value of net assets acquired in the purchases of North Pacific Bank in 1998 and Western Washington Bancorp in 2006. The Company s goodwill is assigned to Heritage Bank and is evaluated for impairment at the Heritage Bank level (reporting unit).

In accordance with ASU 2011-08 *Intangibles Goodwill and Other* (Topic 350), an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. In other words, before the first step of the existing guidance, the entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that the fair value of goodwill is less than carrying value. The qualitative assessment includes adverse events or circumstances identified that could negatively affect the reporting units fair value as well as positive and mitigating events. Such indicators may include, among others: a significant change in legal factors or in the general business climate; significant change in the Company s stock price and market capitalization; unanticipated competition; and an action or assessment by a regulator. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step process is unnecessary. The entity has the option to bypass the qualitative assessment step for any reporting unit in any period and proceed directly to the first step of the exiting two-step process. The entity can resume performing the qualitative assessment in any subsequent period.

The first step of the goodwill impairment test is performed, when considered necessary, by comparing the reporting unit s aggregate fair value to its carrying value. Absent other indicators of impairment, if the aggregate fair value exceeds the carrying value, goodwill is not considered impaired and no additional analysis is necessary. If the carrying value of the reporting unit were to exceed the aggregate fair value, a second step would be performed to measure the amount of impairment loss, if any. To measure any impairment loss the implied fair value would be determined in the same manner as if the reporting unit were being acquired in a business combination. If the implied fair value of goodwill is less than the recorded goodwill an impairment charge would be recorded for the difference.

No goodwill impairment charges were required for the years ended December 31, 2012, 2011 or 2010. For the year ended December 31, 2012, the Company s step-one analysis concluded that the reporting unit s fair value was greater than its carrying value. Even though there was no goodwill impairment at December 31, 2012, adverse events may impact the recoverability of goodwill and could result in a future impairment charge which could have a material impact on the Company s Consolidated Financial Statements.

(o) Income Taxes

The Company and its subsidiaries file a United States consolidated federal income tax return and an Oregon State income tax return. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the consolidated financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates applicable to taxable income in the periods in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rate is recognized in income in the period that includes the enactment date.

As of December 31, 2012 and December 31, 2011, the Company had an insignificant amount of unrecognized tax benefits, none of which would affect its effective tax rate if recognized. The Company does not anticipate that the amount of unrecognized tax benefits will significantly increase or decrease in the next 12 months. The Company s policy is to recognize interest and penalties on unrecognized tax benefits in income taxes in the Consolidated Statements of Income. The amount of interest and penalties accrued as of December 31, 2012 and 2011 and for the years ended December 31, 2012, 2011 and 2010 were immaterial. The Company and its subsidiaries file a United States consolidated tax return and the tax years subject to examination by the Internal Revenue Service are the years ended December 31, 2012, 2011, 2010 and 2009.

(p) Employee Stock Ownership Plan

The Company sponsors an Employee Stock Ownership Plan (ESOP). The ESOP purchased 2% of the common stock issued in a January 1998 stock offering and borrowed $1.3 million from the Company in order to fund the purchase of the Company s common stock. The loan to the ESOP was repaid in full as of December 31, 2012. When outstanding, the loan was repaid principally from the Banks contributions to the ESOP. The Banks contributions were sufficient to service the debt over the 15-year loan term at the interest rate of 8.5%. As the debt was repaid, shares were released and allocated to plan participants based on the proportion of debt service paid during the year. As shares were released, compensation expense was recorded equal to the then current market price of the shares and the shares become outstanding for earnings per common share calculations. Cash dividends on allocated shares were recorded as a reduction of retained earnings and paid or distributed directly to participants accounts. Cash dividends on unallocated shares were recorded as a reduction of debt and accrued interest.

(q) Stock Based Compensation

The Company maintains a number of stock-based incentive programs, which are discussed in more detail in Note 14. Compensation cost is recognized for stock options and restricted stock awards issued to employees and directors, based on the fair value of these awards at the date of grant. The Company did not grant stock option awards for the years ended December 31, 2012 or 2011. The fair value of stock options granted during the year ended December 31, 2010 is estimated on the date of grant using the Black-Scholes-Merton option pricing model. The market price of the Company s common stock at the date of grant is used for the restricted stock awards. Compensation cost is recognized over the required service period, generally defined as the vesting period, on a straight-line basis.

(r) Deferred Compensation Plans

The Company has adopted a Deferred Compensation Plan and has entered into arrangements with certain executive officers. Under the Plan, participants are permitted to elect to defer compensation and the Company has the discretion to make additional contributions to the Plan on behalf of any participant based on a number of factors. Such discretionary contributions are generally approved by the Compensation Committee of the Board of Directors. The notional account balances of participants under the Plan earn interest on an annual basis. The applicable interest rate is the Moody s Seasoned Aaa Corporate Bond Yield as of January 1 of each year. Generally, a participant s account is payable upon the earliest of the participant s separation from service with the Company, the participant s death or disability, or a specified date that is elected by the participant in accordance with applicable rules of the Internal Revenue Code. The Company s obligation to make payments under the Plan is a general obligation of the Company and is to be paid from the Company s general assets. As such, participants are general unsecured creditors of the Company with respect to their participation under the Plan. The Company records a liability within accrued expenses and other liabilities on the consolidated statement of financial condition in a systematic and rationale manner. Since the amounts earned are generally based on the Company s annual performance, the Company records deferred compensation expense each year for an amount calculated based on that year s financial performance.

(s) Earnings per Share

Basic earnings per common share is net income available to common shareholders divided by the weighted average number of common shares outstanding during the period. ESOP shares are considered outstanding for this calculation unless unearned. All outstanding unvested share-based payment awards that contain rights to nonforfeitable dividends are considered participating securities for this calculation. Diluted earnings per common share includes the dilutive effect of additional potential common shares issuable under stock options. Earnings and dividends per share are restated for all stock splits and stock dividends through the date of issuance of the financial statements.

(t) Operating Segments

While the Company s chief decision-makers monitor the revenue streams of the various products and services, operations are managed and financial performance is evaluated on a Company-wide basis. Operating segments are aggregated into one as operating results for all segments are similar. Accordingly, all of the financial service operations are considered by management to be aggregated in one reportable operating segment.

(u) Recently Issued Accounting Pronouncements

FASB ASU 2011-03, *Reconsideration of Effective Control for Repurchase Agreements*, was issued in April 2011 addressing the accounting for repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. The amendments remove from the assessment of effective control (i) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (ii) the collateral maintenance implementation guidance related to that criterion. The provisions of this Update were effective for the first interim or annual period beginning on or after December 15, 2011, and were applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. The adoption of the Update did not have a material effect on the Company s Consolidated Financial Statements at the date of adoption.

FASB ASU 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, was issued in May 2011 as a result of the FASB and International Accounting Standards Board s (IASB) goal to develop common requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. GAAP and International Financial Reporting Standards. The provisions of this Update were effective during the interim or annual periods beginning after December 15, 2011, and were to be applied prospectively. The adoption of the Update did not have a material effect on the Company s Consolidated Financial Statements at the date of adoption, however, the additional disclosures are included in Note 17, Fair Value Measurements.

FASB ASU 2011-05, *Presentation of Comprehensive Income*, was issued in June 2011 requiring that all nonowner changes in stockholders equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This Update also requires that reclassification adjustments for items that are reclassified from other comprehensive income to net income be presented on the face of the financial statements. The provisions of this Update were effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, and were to be applied retrospectively. Early adoption was permitted. In October 2011, the FASB announced they were considering deferring certain provisions in ASU 2011-05 related to presentation of reclassification adjustments from other comprehensive income to net income. The adoption of the Update changed the presentation of other comprehensive income. The Company has presented Consolidated Statements of Comprehensive Income for the years ended December 31, 2012, 2011 and 2010 as a separate statement immediately following the Consolidated Statements of Income for the years ended December 31, 2012, 2011 and 2010.

FASB ASU 2011-11, *Disclosures about Offsetting Assets and Liabilities*, was issued in December 2011 to require an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. Management does not expect the adoption of the Update to have a material effect on the Company s Consolidated Financial Statements at the date of adoption.

FASB ASU 2012-06, *Business Combinations (Topic 805): Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution*, was issued in October 2012. The objective of the Update is to address the diversity in practice about how to interpret the terms on the same basis and contractual limitations when subsequently measuring an indemnification asset. This Update is effective for fiscal years and interim periods beginning on or after December 15, 2012. Early adoption is permitted, and adoption should be applied prospectively to indemnification assets existing as of the date of adoption. This Update will not have a material effect on the Company s Consolidated Financial Statements at the date of adoption as the Company currently accounts for its indemnification asset in a manner consistent with the Update.

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FASB ASU 2013-02, *Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*, was issued in February 2013. The Update requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component and to present either on the face of the statement where net income is presented, or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount reclassified is required to be reclassified to net income in its entirety in the same reporting period. The amendments are effective for annual and interim reporting periods beginning on or after December 15, 2012. The Company is currently in the process of evaluating the ASU but does not expect it will have a material impact on the Company s Consolidated Financial Statements at the date of adoption.

(2) Loans Receivable

The Company originates loans in the ordinary course of business. These loans are identified as originated loans. Disclosures related to the Company s recorded investment in originated loans receivable generally exclude accrued interest receivable and net deferred loan origination fees and costs due to their insignificance. The Company has also acquired loans through FDIC-assisted and open bank transactions. Loans acquired in a business acquisition are designated as purchased loans. The Company refers to the purchased loans subject to the FDIC shared-loss agreements as covered loans, and those loans without a shared-loss agreement are referred to as non-covered loans. Loans purchased with evidence of credit deterioration since origination for which it is probable that all contractually required payments will not be collected are accounted for under FASB ASC 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*. These loans are identified as purchased impaired loans. Loans purchased that are not accounted for under FASB ASC 310-30 are accounted for under FASB ASC 310-20, *Receivables Nonrefundable fees and Other Costs*. These loans are identified as purchased other loans.

(a) Loan Origination/Risk Management

The Company originates loans in one of the four segments of the total loan portfolio: commercial business, real estate construction and land development, one-to-four family residential, and consumer. Within these segments are classes of loans to which management monitors and assesses credit risk in the loan portfolios. The Company has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies, and nonperforming and potential problem loans. The Company also conducts external loan reviews and validates the credit risk assessment on a periodic basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company s policies and procedures.

A discussion of the risk characteristics of each portfolio segment is as follows:

Commercial Business:

There are three significant classes of loans in the commercial portfolio segment, including commercial and industrial loans, owner-occupied commercial real estate, and non-owner occupied commercial real estate. The owner and non-owner occupied commercial real estate are both considered commercial real estate loans. As the commercial and industrial loans carry different risk characteristics than the commercial real estate loans, they are discussed separately below.

Commercial and industrial. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may include a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate. The Company originates commercial real estate loans within its primary market areas. These loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate involves more risk than other classes in that the lending typically involves higher loan principal amounts, and payments on loans secured by real estate properties are dependent on successful operation and management of the properties. Repayment of these loans may be more adversely affected by conditions in the real estate market or the economy.

One-to-Four Family Residential:

The majority of the Company s one-to four-family residential loans are secured by single-family residences located in its primary market areas. The Company s underwriting standards require that single-family portfolio loans generally are owner-occupied and do not exceed 80% of the lower of appraised value at origination or cost of the underlying collateral. Terms of maturity typically range from 15 to 30 years. The Company generally sells most single-family loans in the secondary market. Management determines to what extent the Company will retain or sell these loans and other fixed rate mortgages in order to control the Banks interest rate sensitivity position, growth and liquidity.

Real Estate Construction and Land Development:

The Company originates construction loans for one-to-four family residential and for five or more residential properties and commercial properties. The one-to-four family residential construction loans generally include construction of custom homes whereby the home buyer is the borrower. The Company also provides financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. Substantially all construction loans are short-term in nature and priced with a variable rate of interest. Construction lending can involve a higher level of risk than other types of lending because funds are advanced partially based upon the value of the project, which is uncertain prior to the project s completion. Because of the uncertainties inherent in estimating construction costs as well as the market value of a completed project and the effects of governmental regulation of real property, the Company s estimates with regards to the total funds required to complete a project and the related loan-to-value ratio may vary from actual results. As a result, construction loans often involve the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project and the ability of the borrower to sell or lease the property or refinance the indebtedness. If the Company s estimate of the value of a project at completion proves to be overstated, it may have inadequate security for repayment of the loan and may incur a loss if the borrower does not repay the loan. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

Consumer:

The Company originates consumer loans and lines of credit that are both secured and unsecured. The underwriting process is developed to ensure a qualifying primary and secondary source of repayment. Underwriting standards for home equity loans are heavily influenced by statutory requirements, which include, but are not limited to, a maximum loan-to-value percentage of 80%, collection remedies, the number of such

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loans a borrower can have at one time and documentation requirements. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed. The majority of the consumer loans are relatively small amounts spread across many individual borrowers which minimizes the credit risk. Additionally, trend reports are reviewed by management on a regular basis.

Originated loans receivable at December 31 2012 and December 31, 2011 consisted of the following portfolio segments and classes:

	December 31, 2012	December 31, 2011
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 277,240	$ 273,590
Owner-occupied commercial real estate	188,494	166,881
Non-owner occupied commercial real estate	265,835	251,049
Total commercial business	731,569	691,520
One-to-four family residential	38,848	37,960
Real estate construction and land development:		
One-to-four family residential	25,175	22,369
Five or more family residential and commercial properties	52,075	54,954
Total real estate construction and land development	77,250	77,323
Consumer	28,914	32,981
Gross originated loans receivable	876,581	839,784
Net deferred loan fees	(2,096)	(1,860)
Total originated loans receivable	$ 874,485	$ 837,924

The recorded investment in purchased covered loans receivable at December 31, 2012 and December 31, 2011 consisted of the following portfolio segments and classes:

	December 31, 2012	December 31, 2011
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 25,781	$ 38,607
Owner-occupied commercial real estate	34,796	38,067
Non-owner occupied commercial real estate	13,028	15,753
Total commercial business	73,605	92,427
One-to-four family residential	5,027	5,197
Real estate construction and land development:		
One-to-four family residential	4,433	5,786
Five or more family residential and commercial properties		
Total real estate construction and land development	4,433	5,786
Consumer	5,265	5,947
Total purchased covered loans receivable	88,330	109,357
Allowance for loan losses	(4,352)	(3,963)

Purchased covered loans receivable, net	$ 83,978	$ 105,394

The December 31, 2012 and December 31, 2011 gross recorded investment balance of purchased impaired covered loans accounted for under FASB ASC 310-30 was $59.0 million and $78.7 million, respectively. The gross recorded investment balance of purchased other covered loans was $29.3 million and $30.7 million at December 31, 2012 and December 31, 2011, respectively. As of December 31, 2012 and December 31, 2011, the recorded investment balance of purchased covered loans which are no longer covered under the FDIC shared-loss agreements was $3.5 million and $3.8 million, respectively.

Funds advanced on the purchased covered loans subsequent to acquisition are referred to as subsequent advances and are included in the purchased covered loan balances as these subsequent advances are covered under the FDIC shared-loss agreements. These subsequent advances are not accounted for under FASB ASC 310-30. The total balance of subsequent advances on the purchased covered loans was $6.9 million and $13.5 million as of December 31, 2012 and December 31, 2011, respectively.

The recorded investment in purchased non-covered loans receivable at December 31, 2012 and December 31, 2011 consisted of the following portfolio segments and classes:

	December 31, 2012	December 31, 2011
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 24,763	$ 35,607
Owner-occupied commercial real estate	13,211	17,052
Non-owner occupied commercial real estate	11,019	12,833
Total commercial business	48,993	65,492
One-to-four family residential	3,040	2,743
Real estate construction and land development:		
One-to-four family residential	513	1,381
Five or more family residential and commercial properties	864	1,078
Total real estate construction and land development	1,377	2,459
Consumer	10,713	17,420
Total purchased non-covered loans receivable	64,123	88,114
Allowance for loan losses	(5,117)	(4,635)
Purchased non-covered loans receivable, net	$ 59,006	$ 83,479

The December 31, 2012 and December 31, 2011 gross recorded investment balance of purchased impaired non-covered loans accounted for under FASB ASC 310-30 was $42.0 million and $56.1 million, respectively. The recorded investment balance of purchased other non-covered loans was $22.1 million and $32.0 million at December 31, 2012 and December 31, 2011, respectively.

(b) Concentrations of Credit

Most of the Company s lending activity occurs within the State of Washington, and to a lesser extent the State of Oregon. The primary market areas include Thurston, Pierce, King, Mason, Cowlitz and Clark counties in Washington and Multnomah County in Oregon, as well as other markets. The majority of the Company s loan portfolio consists of commercial and industrial, non-owner occupied commercial real estate, and owner occupied commercial real estate. As of December 31, 2012 and December 31, 2011, there were no concentrations of loans related to any single industry in excess of 10% of total loans.

(c) Credit Quality Indicators

As part of the on-going monitoring of the credit quality of the Company s loan portfolio, management tracks certain credit quality indicators including trends related to (i) the risk grade of the loans, (ii) the level of classified loans, (iii) net charge-offs, (iv) nonperforming loans, and (v) the general economic conditions of the United States of America, and specifically the states of Washington and Oregon. The Company utilizes a risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 0 to 9, and a W . A description of the general characteristics of the risk grades is as follows:

Grades 0 to 5: These grades are considered pass grade with negligible to above average but acceptable risk. These borrowers generally have strong to acceptable capital levels and consistent

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earnings and debt service capacity. Loans with the higher grades within the pass category may include borrowers who are experiencing unusual operating difficulties, but have acceptable payment performance to date. Increased monitoring of financials and/or collateral may be appropriate. Loans with this grade show no immediate loss exposure.

Grade W : This grade is considered pass grade and includes loans on management s watch list and is intended to be utilized on a temporary basis for pass grade borrowers where a potentially significant risk-modifying action is anticipated in the near term.

Grade 6: This grade includes Other Assets Especially Mentioned (OAEM) loans in accordance with regulatory guidelines, and is intended to highlight loans with elevated risks. Loans with this grade show signs of deteriorating profits and capital, and the borrower might not be strong enough to sustain a major setback. The borrower is typically higher than normally leveraged, and outside support might be modest and likely illiquid. The loan is at risk of further decline unless active measures are taken to correct the situation.

Grade 7: This grade includes Substandard loans, in accordance with regulatory guidelines, for which the loan has a high credit risk. The loan also has well-defined weaknesses which make payment default or principal exposure likely, but not yet certain. The borrower may have shown serious negative trends in financial ratios and performance. Such loans are apt to be dependent upon collateral liquidation, a secondary source of repayment or an event outside of the normal course of business. Loans with this grade can be accrual or nonaccrual status based on the Company s accrual policy.

Grade 8: This grade includes Doubtful loans in accordance with regulatory guidelines, and the Company has determined these loans to have excessive risk. Such loans are placed on nonaccrual status and may be dependent upon collateral having a value that is difficult to determine or upon some near-term event which lacks certainty. Additionally, these loans generally have a specific valuation allowance.

Grade 9: This grade includes Loss loans in accordance with regulatory guidelines. These loans are determined to have the highest risk of loss. Such loans are charged-off or charged-down when payment is acknowledged to be uncertain or when the timing or value of payments cannot be determined. Loss is not intended to imply that the loan or some portion of it will never be paid, nor does it in any way imply that there has been a forgiveness of debt.

Loan grades for all commercial business loans and real estate construction and land development loans are established at the origination of the loan. One-to-four family residential loans and consumer loans (non-commercial loans) are not graded as a 0 to 9 at origination date as these loans are determined to be pass graded loans. These non-commercial loans may subsequently require a 0-9 risk grade if the credit department has evaluated the credit and determined it necessary to classify the loan. Loan grades are reviewed on a quarterly basis, or more frequently if necessary, by the credit department. Typically, an individual loan grade will not be changed from the prior period unless there is a specific indication of credit deterioration or improvement. Credit deterioration is evidenced by delinquency, direct communications with the borrower, or other borrower information that becomes known to management. Credit improvements are evidenced by known facts regarding the borrower or the collateral property.

The loan grades relate to the likelihood of losses in that the higher the grade, the greater the loss potential. Loans with a pass grade may have some inherent losses in the portfolios, but to a lesser extent than the other loan grades. These pass graded loans may also have a zero percent loss based on historical experience and current market trends. The OAEM loan grade is transitory in that the Company is waiting on additional information to determine the likelihood and extent of the potential loss. However, the likelihood of loss is greater than Watch grade because there has been measurable credit deterioration. Loans with a Substandard grade are generally loans for which the Company has individually analyzed for potential impairment. For Doubtful and Loss graded loans, the Company is almost certain of the losses, and the unpaid principal balances are generally charged-off to the realizable value.

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The following tables present the balance of the originated loans receivable by credit quality indicator as of December 31, 2012 and December 31, 2011.

	Pass	OAEM	December 31, 2012 Substandard (In thousands)	Doubtful	Total
Commercial business:					
Commercial and industrial	$ 254,593	$ 3,908	$ 18,157	$ 582	$ 277,240
Owner-occupied commercial real estate	181,630	2,658	4,206		188,494
Non-owner occupied commercial real estate	256,077	4,132	5,257	369	265,835
Total commercial business	692,300	10,698	27,620	951	731,569
One-to-four family residential	37,239	920	689		38,848
Real estate construction and land development:					
One-to-four family residential	16,446	1,795	6,934		25,175
Five or more family residential and commercial properties	48,718		3,357		52,075
Total real estate construction and land development	65,164	1,795	10,291		77,250
Consumer	28,748		156	10	28,914
Gross originated loans	$ 823,451	$ 13,413	$ 38,756	$ 961	$ 876,581

	Pass	OAEM	December 31, 2011 Substandard (In thousands)	Doubtful	Total
Commercial business:					
Commercial and industrial	$ 247,503	$ 2,770	$ 22,887	$ 430	$ 273,590
Owner-occupied commercial real estate	162,536	1,225	3,120		166,881
Non-owner occupied commercial real estate	240,096	2,063	8,890		251,049
Total commercial business	650,135	6,058	34,897	430	691,520
One-to-four family residential	36,997	431	532		37,960
Real estate construction and land development:					
One-to-four family residential	10,725	2,828	8,816		22,369
Five or more family residential and commercial properties	42,541		12,413		54,954
Total real estate construction and land development	53,266	2,828	21,229		77,323
Consumer	32,629		346	6	32,981
Gross originated loans	$ 773,027	$ 9,317	$ 57,004	$ 436	$ 839,784

The tables above include $27.5 million and $37.1 million of originated impaired loans as of December 31, 2012 and December 31, 2011, respectively, as detailed in the impaired loans section below. These impaired loans have been individually reviewed for potential losses and have specific valuation allowance, as necessary. The tables above also include potential problem loans. Potential problem loans are those loans that are currently accruing interest and are not considered impaired, but which management is monitoring because the financial information of the borrower causes concern as to their ability to meet their loan repayment terms. Potential problem originated loans as of December 31, 2012 and December 31, 2011 were $28.3 million and $29.7 million, respectively. The balance of potential problem originated loans guaranteed by a governmental agency was $3.2 million and $2.8 million as of December 31, 2012 and December 31, 2011, respectively. This guarantee reduces the Company s credit exposure.

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The following tables present the recorded investment balance of the purchased other loans receivable by credit quality indicator as of December 31, 2012 and December 31, 2011.

	December 31, 2012				
	Pass	OAEM	Substandard (In thousands)	Doubtful	Total
Commercial business:					
Commercial and industrial	$ 11,393	$ 496	$ 92	$	$ 11,981
Owner-occupied commercial real estate	23,685	2,390	335		26,410
Non-owner occupied commercial real estate	3,108	732	973		4,813
Total commercial business	38,186	3,618	1,400		43,204
One-to-four family residential	770	553	61		1,384
Real estate construction and land development:					
One-to-four family residential					
Five or more family residential and commercial properties					
Total real estate construction and land development					
Consumer	6,385	2	346	32	6,765
Gross purchased other loans	$ 45,341	$ 4,173	$ 1,807	$ 32	$ 51,353

	December 31, 2011				
	Pass	OAEM	Substandard (In thousands)	Doubtful	Total
Commercial business:					
Commercial and industrial	$ 11,781	$ 125	$ 780	$	$ 12,686
Owner-occupied commercial real estate	29,791		587		30,378
Non-owner occupied commercial real estate	4,427	1,046	441		5,914
Total commercial business	45,999	1,171	1,808		48,978
One-to-four family residential	1,529		42		1,571
Real estate construction and land development:					
One-to-four family residential	50				50
Five or more family residential and commercial properties					
Total real estate construction and land development	50				50
Consumer	11,435		674		12,109
Gross purchased other loans	$ 59,013	$ 1,171	$ 2,524	$	$ 62,708

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(d) Nonaccrual loans

Originated nonaccrual loans, segregated by segments and classes of loans, were as follows as of December 31, 2012 and December 31, 2011:

	December 31, 2012(1)	December 31, 2011(1)
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 4,560	$ 6,946
Owner-occupied commercial real estate	563	399
Non-owner occupied commercial real estate	369	921
Total commercial business	5,492	8,266
One-to-four family residential	389	
Real estate construction and land development:		
One-to-four family residential	3,063	5,150
Five or more family residential and commercial properties	3,357	9,797
Total real estate construction and land development	6,420	14,947
Consumer	157	125
Gross originated nonaccrual loans	$ 12,458	$ 23,338

(1) $1.2 million and $1.8 million of originated nonaccrual loans were guaranteed by governmental agencies at December 31, 2012 and December 31, 2011, respectively.

The recorded investment balance of purchased other nonaccrual loans, segregated by segments and classes of loans, were as follows as of December 31, 2012 and December 31, 2011:

	December 31, 2012(1)	December 31, 2011(1)
	(In thousands)	
Commercial business:		
Commercial and industrial	$	$
Owner-occupied commercial real estate	139	
Non-owner occupied commercial real estate	437	
Total commercial business	576	
One-to-four family residential	61	
Consumer	163	490
Gross purchased other nonaccrual loans	$ 800	$ 490

(1) $39,000 of purchased other nonaccrual loans were considered covered at December 31, 2012. There were no purchased other nonaccrual loans considered covered at December 31, 2011.

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(e) Past due loans

The Company performs aging analysis of past due loans using the categories of 30-89 days past due and 90 or more days past due. This policy is consistent with regulatory reporting requirements. The balances of originated past due loans, segregated by segments and classes of loans, as of December 31, 2012 and December 31, 2011 were as follows:

	December 31, 2012					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing
	(In thousands)					
Commercial business:						
Commercial and industrial	$ 2,768	$ 2,014	$ 4,782	$ 272,458	$ 277,240	$ 25
Owner-occupied commercial real estate	920	112	1,032	187,462	188,494	
Non-owner occupied commercial real estate	92	369	461	265,374	265,835	
Total commercial business	3,780	2,495	6,275			