HERITAGE FINANCIAL CORP /WA/
Form 10-K
March 02, 2012
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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, 2011

¨ **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 $187,483,668 and was based upon the last sales price as quoted on the NASDAQ Stock Market for June 30, 2011.

The registrant had 15,456,297 shares of common stock outstanding as of February 9, 2012.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive Proxy Statement for the 2012 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, 2011

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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.

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 Heritage Bank and Central Valley Bank are insured by the FDIC. Heritage Bank conducts business from its main office in Olympia, Washington and its twenty-six branch offices 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.

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.

On November 2008, the Company entered into a Letter Agreement and Securities Purchase Agreement (collectively, the Purchase Agreement) with the U.S. Department of the Treasury (Treasury) under the 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. 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. Under the terms of the Warrant, because the Company s September 22, 2009 offering of common stock was a qualified equity offering resulting in aggregate gross proceeds of at least $24.0 million, the number of shares of our common stock underlying the Warrant was reduced by 50% to 138,037 shares.

In December 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 $57.6 million.

In December 2010 the Company redeemed the 24,000 shares of its Series A Preferred Stock held by the Treasury. The Company paid the Treasury a total of $24.1 million, consisting of $24.0 million of principal and $123,000 of accrued and unpaid dividends.

On August 17, 2011, the Company repurchased the Warrant from the Treasury for $450,000. The Warrant repurchase, together with the Company s earlier redemption of the entire amount of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, held by the Treasury, represents full repayment of all TARP obligations and cancellation of all equity interests in the Company held by the Treasury.

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-six branch offices 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. Commercial and industrial loans, including owner occupied commercial real estate loans, totaling $440.5 million, or 52.5% of total originated loans, as of December 31, 2011 and $392.3 million, or 52.8% of total originated loans, as of December 31, 2010 and non-owner occupied commercial real estate totaling $251.0 million, or 30.0% of total originated loans, as of December 31, 2011 and $221.7 million, or 29.9% of total originated loans, as of December 31, 2010. One-to-four family residential loans totaled $38.0 million, or 4.5% of total originated loans, at December 31, 2011, and $47.5 million, or 6.5% of total originated loans, at December 31, 2010. Real estate construction and land development loans totaled $77.3 million, or 9.3% of total originated loans, at December 31, 2011, and $58.0 million, or 7.8% of total originated loans, at December 31, 2010.

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, 2011 Balance	2011 % of Total Originated Loans	2010 Balance	2010 % of Total Originated Loans	2009 Balance	2009 % of Total Originated Loans	2008 Balance	2008 % of Total Originated Loans	2007 Balance	2007 % of Total Originated Loans
	(Dollars in thousands)									
Originated Loans:										
Commercial business:										
Commercial and industrial(1)(2)	$ 440,471	52.5%	$ 392,301	52.8%	$ 408,622	52.8%	$ 410,657	50.9%	$ 388,483	49.8%
Non-owner occupied commercial real estate(1)	251,049	30.0	221,739	29.9	194,613	25.2	190,706	23.5	196,637	25.2
Total commercial business	691,520	82.5	614,040	82.7	603,235	78.0	601,363	74.4	585,120	75.0
One-to-four family residential(3)	37,960	4.5	47,505	6.5	53,623	7.0	57,231	7.1	57,132	7.4
Real estate construction and land development:										
One-to-four family residential	22,369	2.7	29,377	4.0	46,060	6.0	71,159	8.8	82,165	10.6
Multifamily residential and commercial properties	54,954	6.6	28,588	3.8	49,665	6.4	59,572	7.3	40,342	5.2
Total real estate construction and land development(4)	77,323	9.3	57,965	7.8	95,725	12.4	130,731	16.1	122,507	15.8
Consumer	32,981	3.9	23,832	3.2	21,261	2.8	21,255	2.6	16,641	2.1
Gross originated loans	839,784	100.2	743,342	100.2	773,844	100.2	810,580	100.2	781,400	100.3
Less: deferred loan fees	(1,860)	(0.2)	(1,323)	(0.2)	(1,597)	(0.2)	(1,854)	(0.2)	(2,081)	(0.3)
Total originated loans	$ 837,924	100.0%	$ 742,019	100.0%	$ 772,247	100.0%	$ 808,726	100.0%	$ 779,319	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 multifamily residential and commercial properties. The amounts reclassified were $33.2 million and $32.9 million as of December 31, 2008 and 2007, respectively.
(3) Excludes loans held for sale of $1.8 million, $764,000, $825,000, $304,000, and $447,000 as of December 31, 2011, 2010, 2009, 2008, and 2007, 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 December 31, 2011 and December 31, 2010. There were no purchased covered loans for the years ended December 31, 2009, 2008 and 2007. These balances are prior to deduction for the allowance for loan losses.

	December 31, 2011 Balance	2011 % of Total Purchased Covered Loans	2010 Balance	2010 % of Total Purchased Covered Loans
Purchased Covered Loans:				
Commercial business:				
Commercial and industrial(1)	$ 76,674	70.1%	$ 92,265	71.7%
Non-owner occupied commercial real estate(1)	15,753	14.4	17,576	13.6
Total commercial business	92,427	84.5	109,841	85.3
One-to-four family residential	5,197	4.8	6,224	4.8

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

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

The following table provides information about our purchased non-covered loan portfolio by type of loan for the December 31, 2011 and December 31, 2010. There were no purchased non-covered loans for the years ended December 31, 2009, 2008 and 2007. These balances are prior to deduction for the allowance for loan losses.

	December 31,			
	2011		2010	
	Balance	% of Total Purchased Non-Covered Loans	Balance	% of Total Purchased Non-Covered Loans
Purchased Non-Covered Loans:				
Commercial business:				
Commercial and industrial(1)	$ 52,659	59.8%	$ 77,815	59.4%
Non-owner occupied commercial real estate(1)	12,833	14.5	18,435	14.0
Total commercial business	65,492	74.3	96,250	73.4
One-to-four family residential	2,743	3.1	4,986	3.8
Real estate construction and land development:				
One-to-four family residential	1,381	1.6	3,816	2.8
Multifamily residential and commercial properties	1,078	1.2	1,244	0.9
Total real estate construction and land development(2)	2,459	2.8	5,060	3.9
Consumer	17,420	19.8	24,753	18.9
Gross purchased non-covered loans	$ 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, 2011 (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	$ 139,666	$ 175,699	$ 376,155	$ 691,520
Real estate construction and land development	54,978	21,538	807	77,323
Total	$ 194,644	$ 197,237	$ 376,962	$ 768,843
Fixed rate loans		$ 94,963	$ 121,604	$ 216,567
Variable or adjustable rate loans		102,274	255,358	357,632
Total		$ 197,237	$ 376,962	$ 574,199

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) and Heritage Bank is a

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preferred lender of the SBA. Before extending credit to a business we look closely at 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, 2011 we had $691.5 million, or 82.5%, of our total originated loans receivable in commercial business loans with an average loan size of approximately $270,000.

We originate commercial real estate loans within our primary market areas. Owner-occupied commercial real estate loans are preferred. 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 multifamily 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 single-family residential mortgage 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 Risk Factors Our loan portfolio is concentrated in loans with a higher risk of loss Repayment of our commercial business loans as well as 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 Risk Factors Our loan portfolio is concentrated in loans with a higher risk of loss Our commercial real estate loans, which includes multifamily 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 Mortgages

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 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 typically range from 15 to 30 years. We generally sell most single-family 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 Management s Discussion and Analysis of Financial Condition and Results of Operations Asset/Liability Management.

Real Estate Construction and Land Development

We originate single-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. 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, have prompt and thorough documentation of all draw requests and we inspect the project prior to paying any draw requests.

See 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 complete project. These estimates may be inaccurate.

Origination and Sales of Residential Mortgage Loans

Consistent with our asset/liability management strategy, we sell a significant portion of our residential mortgage loans to the secondary market. Commitments to sell 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 $84,000, $115,000, and $131,000 in mortgage loans for others as of December 31, 2011, 2010, and 2009, respectively.

The following table presents summary information concerning our origination and sale of residential mortgage loans and the gains from the sale of loans.

	Year Ended December 31,				
	2011	**2010**	**2009**	**2008**	**2007**
			(In thousands)		
Residential mortgage loans:					
Originated	$ 24,929	$ 18,605	$ 16,981	$ 16,177	$ 4,963
Sold	16,952	16,125	16,460	16,320	4,516
Gains on sales of loans, net	$ 285	$ 226	$ 288	$ 265	$ 64

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.

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

	December 31	
	2011	2010
	(In thousands)	
Commercial business:		
Commercial and industrial	$ 138,118	$ 147,022
Owner-occupied commercial real estate	2,328	2,977
Non-owner occupied commercial real estate	6,225	6,712
Total commercial business	146,671	156,711
One-to-four family residential		44
Real estate construction and land development:		
One-to-four family residential	4,247	3,542
Five or more family residential and commercial properties	15,305	11,595
Total real estate construction and land development	19,552	15,137
Consumer	37,251	40,640
Total outstanding commitments	203,474	212,532

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.

	December 31,				
	2011	2010	2009	2008	2007
	(Dollars in thousands)				
Nonaccrual originated loans:					
Commercial business	$ 8,266	$ 10,667	$ 9,728	$ 1,176	$ 33
One-to-four family residential					
Real estate construction and land development	14,947	15,816	25,108	2,221	949
Consumer	125				39
Total nonaccrual originated loans(1)(2)	23,338	26,483	34,836	3,397	1,021
Noncovered other real estate owned	3,710	3,030	704	2,031	169
Total nonperforming originated assets	$ 27,048	$ 29,513	$ 35,540	$ 5,428	$ 1,190
Restructured originated performing loans:					
Commercial business	$ 12,606	$ 394	$ 425	$	$
One-to-four family residential	835				
Real estate construction and land development	364				
Total restructured originated loans(3)	$ 13,805	$ 394	$ 425	$	$
Accruing originated loans past due 90 days or more(4)	$ 1,328	$ 1,313	$ 277	$ 664	$ 2,084
Potential problem originated loans(5)	$ 29,742	$ 56,088	$ 53,086	$ 43,061	$ 22,023
Allowance for loan losses on originated loans	$ 22,317	$ 22,062	$ 26,164	$ 15,423	$ 10,374
Nonperforming originated loans to total originated loans(6)	2.57%	3.14%	4.27%	0.42%	0.13%
Allowance for loan losses to total originated loans	2.66%	2.97%	3.38%	1.91%	1.33%
Allowance for loan losses to nonperforming originated loans(5)	103.52%	94.73%	79.34%	454.02%	1,016.06%
Nonperforming originated assets to total originated assets(6)	2.14%	2.38%	3.32%	0.57%	0.13%

(1) $11.7 million, $8.7 million and $17.0 million of nonaccrual loans were considered troubled debt restructures at December 31, 2011, 2010 and 2009, respectively. There were no troubled debt restructures at December 31, 2008 and 2007.
(2) $1.8 million, $3.2 million and $2.3 million of nonaccrual loans were guaranteed by government agencies at December 31, 2011, 2010 and 2009, respectively. There were no nonaccrual loans guaranteed by government agencies at December 31, 2008 and 2007.
(3) $592,000 of restructured loans were guaranteed by government agencies at December 31, 2011. There were no restructured loans guaranteed by government agencies at December 31, 2010, 2009, 2008 and 2007.
(4) $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. There were no accruing originated loans past due 90 days or more guaranteed by government agencies at December 31, 2009, 2008 and 2007.
(5) $2.8 million, $5.4 million and $7.2 million of potential problem originated loans were guaranteed by government agencies at December 31, 2011, 2010 and 2009, respectively. There were no potential problem originated loans guaranteed by government agencies at December 31, 2008 and 2007.
(6) Excludes portions guaranteed by government agencies.

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

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past due for 90 days or more, is less than fully collateralized, and is not in the process of collection. Amounts received on nonaccrual loans generally are applied first to principal and then to interest only after all principal has been collected.

Nonperforming originated assets decreased to $27.0 million, or 2.14% of total originated assets, at December 31, 2011 from $29.5 million, or 2.38% of total originated assets, at December 31, 2010 due to a decrease in nonperforming originated loans, offset by an increase in other real estate owned. During the year ended December 31, 2011, there were $4.9 million in net charge-offs of which $1.9 million related to nonperforming commercial loans and $2.7 million related to nonperforming construction loans. In addition, nonperforming loan balances totaling $5.7 million were transferred to other real estate owned during the year ended December 31, 2011. This decrease in total nonperforming originated loans was offset by the $4.0 million addition to nonperforming originated loans of a restructured commercial real estate construction and land development loan.

Restructured originated performing loans as of December 31, 2011 and December 31, 2010 were $13.8 million and $394,000, respectively. During the year ended December 31, 2011, certain performing originated loans were classified as troubled debt restructurings as of September 30, 2011 as a result of the Banks broadening definitions of concessions and borrowers having financial difficulty, which would warrant classification as troubled debt restructurings in accordance with Accounting Standards Update (ASU) No. 2011-02. The December 31, 2011 balance of these loans identified during the 2011 review was $6.7 million. The increase in restructured originated performing loans was also due to the additions of a $4.3 million commercial business loan and a $2.6 million commercial business loan which were not previously classified as potential problem loans or troubled debt restructures at December 31 2010.

Potential problem originated loans as of December 31, 2011 and December 31, 2010 were $29.7 million and $56.1 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, 2011 and December 31, 2010, the balance of accruing TDRs was $13.8 million and $394,000, respectively. The related allowance for loan losses on the accruing TDRs was $1.4 million as of December 31, 2011 and no related allowance for loan losses as of December 31, 2010. At December 31, 2011, non-accruing TDRs were $11.7 million and had a related allowance for loan losses of $1.8 million. At December 31, 2010, non-accruing TDRs of $8.7 million had a related allowance for loan losses of $1.6 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. Potential problem originated loans decreased $26.4 million to $29.7 million at December 31, 2011 from $56.1 million at December 31, 2010.

Analysis of Allowance for Loan and Lease Losses

Management maintains an allowance for loan and lease losses (ALLL) to provide for estimated credit losses inherent in the loan portfolio. The adequacy of the ALLL 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 ALLL 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 ALLL 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 result in a material increase in the allowance for loan losses and may adversely affect the Company s financial conditions 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 the routine examination process, which may result in the establishment of additional reserves 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 loan losses for originated loans for the indicated periods:

	Year Ended December 31,				
	2011	2010	2009	2008	2007
	(Dollars in thousands)				
Total originated loans outstanding at end of period(1)	$ 837,924	$ 742,019	$ 772,247	$ 808,726	$ 779,319
Average total originated loans outstanding during period(1)	$ 833,441	$ 717,159	$ 787,527	$ 795,752	$ 778,058
Allowance balance at beginning of period	$ 22,062	$ 26,164	$ 15,423	$ 10,374	$ 10,105
Provision for loan losses	5,180	11,990	19,390	7,420	810
Charge-offs:					
Commercial business	(2,690)	(8,106)	(2,668)	(144)	(412)
One-to-four family residential	(15)	(169)	(189)	(280)	(67)
Real estate construction and land development	(2,948)	(8,344)	(5,774)	(1,818)	
Consumer	(316)	(73)	(192)	(165)	(94)
Total charge-offs	(5,969)	(16,692)	(8,823)	(2,407)	(573)
Recoveries:					
Commercial business	821	243	1	1	2
One-to-four family residential		15	1		5
Real estate construction and land development	201	285	50		
Consumer	22	57	122	35	25
Total recoveries	1,044	600	174	36	32
Net (charge-offs) recoveries	(4,925)	(16,092)	(8,649)	(2,371)	(541)
Allowance balance at end of period	$ 22,317	$ 22,062	$ 26,164	$ 15,423	$ 10,374
Ratio of net (charge-offs) recoveries during period to average total originated loans outstanding	(0.59)%	(2.24)%	(1.10)%	(0.30)%	(0.06)%

(1) Excludes loans held for sale.

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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,									
	2011		2010		2009		2008		2007	
	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	$ 12,888	82.3%	$ 14,350	82.5%	$ 12,137	77.8%	$ 2,785	74.2%	$ 1,999	74.7%
One-to-four family residential	416	4.5	500	6.5	550	7.0	5,797	7.1	4,231	7.4
Real estate construction	7,556	9.3	5,435	7.8	12,892	12.4	6,587	16.1	3,839	15.8
Consumer	547	3.9	846	3.2	361	2.8	254	2.6	305	2.1
Unallocated	910		931		224					
Total allowance for loan losses	$ 22,317	100.0%	$ 22,062	100.0%	$ 26,164	100.0%	$ 15,423	100.0%	$ 10,374	100.0%

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

Investment Activities

At December 31, 2011, our investment securities portfolio totaled $156.7 million, which consisted of $144.6 million of securities available for sale and $12.1 million of securities held to maturity. This compares with a total portfolio of $138.9 million at December 31, 2010, which was comprised of $125.1 million of securities available for sale and $13.8 million of securities held to maturity. The increase in the investment securities portfolio was accomplished through the use of funds previously held in interest earning deposits. Interest earning deposits decreased to $93.6 million at December 31, 2011 from $129.8 million at December 31, 2010. 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.

In the second quarter of 2009, the Company adopted FASB ASC 320-10-65, *Recognition and Presentation of Other-Than-Temporary Impairments,* which provides for the bifurcation of other-than-temporary impairments into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. As a result of adopting FASB ASC 320-10-65, the Company recorded $830,000 in impairments on private collateralized mortgage obligations not related to credit losses through other comprehensive income rather than through earnings and $500,000 in impairments related to credit losses through earnings during the year ended December 31, 2009. The Company also reclassified $229,000 from retained earnings to other comprehensive income related to impairment charges on private residential collateralized mortgage obligations at December 31, 2008 and March 31, 2009 that were not due to credit losses. The activity related to the amount of other-than-temporary impairments related to credit losses on held to maturity securities during the year ended December 31, 2011, 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, some corporate notes, municipal bonds, and federal funds. Investment in non-investment grade bonds and stripped mortgage backed securities are not permitted under the policy.

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

	December 31, 2011		2010		2009	
	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 agencies	$ 31,307	21.7%	$ 41,429	33.1%	$ 22,958	25.3%
Municipal securities	33,423	23.1	20,213	16.1	7,460	8.2
Corporate securities	8,097	5.6	10,276	8.2	10,176	11.2
Mortgage backed securities and collateralized mortgage obligations:						
U.S. Government agencies	71,775	49.6	53,257	42.6	50,142	55.3
Total	$ 144,602	100.0%	$ 125,175	100.0%	$ 90,736	100.0%

The following table provides information regarding our investment securities available for sale, by contractual maturity, at December 31, 2011.

	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 agencies	$ 19,659	1.25%	$ 10,644	0.87%	$	%	$ 1,004	%
Municipal securities	1,891	3.45	4,843	2.98	19,337	4.22	7,353	4.73
Corporate securities	8,097	2.00						
Mortgage backed securities and collateralized mortgage obligations:								
U.S. Government agencies			49	7.65	14,279	2.48	57,446	2.64
Total	$ 29,647	1.59%	$ 15,536	1.52%	$ 33,616	3.45%	$ 65,803	2.84%

(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,					
	2011		2010		2009	
	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 agencies	$ 1,799	14.9%	$ 1,858	13.5%	$ 1,443	10.6%
Municipal securities	3,566	29.5	3,410	24.8	1,618	11.9
Mortgage backed securities and collateralized mortgage obligations:						
U.S. Government agencies	5,412	44.7	6,592	47.9	8,236	60.4
Private residential collateralized mortgage obligations	1,316	10.9	1,908	13.8	2,339	17.1
Total	$ 12,093	100.0%	$ 13,768	100.0%	$ 13,636	100.0%

The following table provides information regarding our investment securities held to maturity, by contractual maturity, at December 31, 2011.

	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 agencies	$	%	$ 160	5.06%	$ 1,919	3.71%	$	%
Municipal securities	413	5.26	1,733	5.44	1,125	4.67	532	5.33
Mortgage backed securities and collateralized mortgage obligations:								
U.S. Government agencies					77	7.54	5,666	3.49
Private residential collateralized mortgage obligations							1,256	5.15
Total	$ 413	5.26%	$ 1,893	5.72%	$ 3,121	6.48%	$ 7,454	4.39%

(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, 2011 the Banks were required to maintain an investment in the stock of FHLB of Seattle of at least $1.2 million. At December 31, 2011 the Banks had an investment in FHLB stock carried at a cost basis (par value) of $5.6 million.

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The Company evaluated its investment in FHLB of Seattle stock for other-than-temporary impairment, consistent with its accounting policy. 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. Even though the Company did not recognize an other-than-temporary impairment loss on its FHLB of Seattle stock during the year ended December 31, 2011, continued 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 2011, non-maturity deposits (total deposits less certificate of deposit accounts) increased $73.1 million, or 10.0%. As a result, the percentage of certificate of deposit accounts to total deposits decreased to 29.0% at December 31, 2011 from 35.5% at December 31, 2010.

Deposit Activities. We offer a variety of deposit accounts designed to attract both short-term and long-term deposits. These accounts include non-interest demand accounts, negotiable order of withdrawal (NOW) accounts, money market accounts, savings accounts and certificates of deposit (CDs). These accounts, with the exception of non-interest 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.

Non-Interest Demand Accounts. Non-interest demand accounts 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 12 months.

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

	December 31,					
	2011		2010		2009	
	Amount	Percent	Amount	Percent	Amount	Percent
	(Dollars in thousands)					
Non-interest demand deposits	$ 230,993	20.4%	$ 194,583	17.1%	$ 133,169	15.8%
NOW Accounts	304,818	26.8	287,247	25.3	211,509	25.2
Money market accounts	166,913	14.7	150,983	13.3	113,332	13.5
Savings accounts	103,716	9.1	100,552	8.8	78,205	9.3
Total non-maturity deposits	806,440	71.0	733,335	64.5	536,215	63.8
CDs	329,604	29.0	402,941	35.5	303,913	36.2
Total deposits	$ 1,136,044	100.0%	$ 1,136,276	100.0%	$ 840,128	100.0%

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

	Year ended December 31,					
	2011		2010		2009	
	Average Balance	Average Yield/Rate	Average Balance	Average Yield/Rate	Average Balance	Average Yield/Rate
	(Dollars in thousands)					
NOW accounts and money market accounts	$ 453,509	0.41%	$ 376,245	0.58%	$ 310,860	0.89%
Savings accounts	103,170	0.35	89,978	0.56	85,541	0.98
CDs	355,167	1.20	351,191	1.62	323,696	2.47
Total interest bearing deposits	911,846	0.71	817,414	1.02	720,097	1.61
Non-interest demand deposits	205,862		150,906		120,107	
Total deposits	$ 1,117,708	0.58%	$ 968,320	0.87%	$ 840,204	1.38%

The following table shows the amount and maturity of certificates of deposit of $100,000 or more as of December 31, 2011 (In thousands):

Remaining maturity:	
Three months or less	$ 50,352
Over three months through six months	33,301
Over six months through twelve months	52,209
Over twelve months	47,949
Total	$ 183,811

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, multifamily mortgage loans, commercial real estate loans and stock issued by the FHLB, which is owned by us. At December 31, 2011, the Banks maintained an uncommitted credit facility with the FHLB of Seattle in a collective amount of $169.7 million and an uncommitted credit facility with the Federal Reserve Bank of San Francisco in a collective amount of $70.5 million, of which there were no advances or borrowings outstanding.

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The Banks also maintain advance lines with Zions Bank, US Bank and Pacific Coast Bankers Bank to purchase federal funds in a collective amount of up to $42.8 million as of December 31, 2011. At December 31, 2011 we had securities sold under agreement to repurchase of $23.1 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,		
	2011	2010	2009
	(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, 2011, 2010 and 2009.

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 over recent years, and it is reasonable to expect that similar changes will continue in the future. Most recently, The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) was enacted on July 21, 2010, which will significantly change the current bank regulatory structure. See Other Regulatory Developments The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 herein for a discussion of this new 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 information is qualified in its entirety by reference to the particular statutory and regulatory provisions described.

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.

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 in final form 18 months after the date of enactment of the Dodd-Frank Act (July 21, 2010). Many of the Dodd-Frank Act s implementing rules and regulations have been delayed and proposed capital regulations were issued by the Federal Reserve in December 2011, which are subject to a comment period ending in March 2012.

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, Item 5 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, 2011 were 4% and 8%, respectively. At December 31, 2011, we had Tier 1 risk-based capital and total risk-based capital of 19.0% and 20.3%, 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, 2011, we had a leverage ratio of 13.8%.

The Dodd-Frank Act contains a number of provisions that will affect the capital requirements applicable to the Company and the Banks. In addition, on September 12, 2010, the Basel Committee on Banking Supervision adopted the Basel III capital rules. These rules, which will be phased in over a period of years, set new standards for common equity, tier 1 and total capital, determined on a risk-weighted basis. Although Basel III is intended to be implemented by participating countries for large, internationally active banks, its provisions are likely to be considered by United States banking regulators in developing new regulations applicable to other banks in the United States, including the Bank.

For banks in the United States, among the most significant provisions of Basel III concerning capital are the following:

- A minimum ratio of common equity to risk-weighted assets reaching 4.5%, plus an additional 2.5% as a capital conservation buffer, by 2019 after a phase-in period.
- A minimum ratio of Tier 1 capital to risk-weighted assets reaching 6.0% by 2019 after a phase-in period.
- A minimum ratio of total capital to risk-weighted assets, plus the additional 2.5% capital conservation buffer, reaching 10.5% by 2019 after a phase-in period.
- An additional countercyclical capital buffer to be imposed by applicable national banking regulators periodically at their discretion, with advance notice.
- Restrictions on capital distributions and discretionary bonuses applicable when capital ratios fall within the buffer zone.
- Deduction from common equity of deferred tax assets that depend on future profitability to be realized.
- Increased capital requirements for counterparty credit risk relating to OTC derivatives, repos and securities financing activities.

For capital instruments issued on or after January 13, 2013 (other than common equity), a loss-absorbency requirement such that the instrument must be written off or converted to common equity if a trigger event occurs, either pursuant to applicable law or at the direction of the banking regulator. A trigger event is an event under which the banking entity would become nonviable without the write-off or conversion, or without an injection of capital from the public sector. The issuer must maintain authorization to issue the requisite shares of common equity if conversion were required.

The Basel III provisions on liquidity include complex criteria establishing a liquidity coverage ratio (LCR) and net stable funding ratio (NSFR). The purpose of the LCR is to ensure that a bank maintains adequate unencumbered, high quality liquid assets to meet its liquidity needs for 30 days under a severe liquidity stress scenario. The purpose of the NSFR is to promote more medium and long-term funding of assets and activities, using a one-year horizon. Although Basel III is described as a final text, it is subject to the resolution of certain issues and to further guidance and modification, as well as to adoption by United States banking regulators, including decisions as to whether and to what extent it will apply to United States banks that are not large, internationally active banks.

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, 2011, 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 required by the Dodd-Frank Act, the FDIC has adopted rules effective April 1, 2011, under which insurance premium assessments are based on an institution s total assets minus its tangible equity (defined as Tier 1 capital) instead of its deposits. Under these rules, an institution with total assets of less than $10 billion will be assigned to one of four risk categories based on its capital, supervisory ratings and other factors. Well capitalized institutions that are financially sound with only a few minor weaknesses are assigned to Risk Category I. Risk Categories II, III and IV present progressively greater risks to the DIF. A range of initial base assessment rates apply to each category, subject to adjustment downward based on unsecured debt issued by the institution and, except for an institution in Risk Category I, adjustment upward if the institution s brokered deposits exceed 10% of its domestic deposits, to produce total base assessment rates. Total base assessment rates range from 2.5 to 9 basis points for Risk Category I, 9 to 24 basis points for Risk Category II, 18 to 33 basis points for Risk Category III, and 30 to 45 basis points for Risk Category IV, all subject to further adjustment upward if the institution holds more than a *de minimis* amount of unsecured debt issued by another FDIC-insured institution. The FDIC may increase or decrease its rates by 2.0 basis points without further rulemaking.

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 establishes 1.35% as the minimum reserve ratio. The FDIC has adopted a plan under which it will meet this ratio by September 30, 2020, the deadline imposed by the Dodd-Frank Act. The Dodd-Frank Act requires the FDIC to offset the effect on institutions with assets less than $10 billion of the increase in the statutory minimum reserve ratio to 1.35% from the former statutory minimum of 1.15%. The FDIC has not yet announced how it will implement this offset. In addition to the statutory minimum ratio, the FDIC must designate a reserve ratio, known as the designated reserve ratio, or DRR, which may exceed the statutory minimum. The FDIC has established 2.0% as the DRR. In addition, all institutions with deposits insured by the FDIC are required to pay assessments to fund interest payments on bonds issued by the Financing Corporation, an agency of the Federal government established to fund the costs of failed thrifts in the 1980 s. For the quarterly period ended December 31, 2011, the Financing Corporation assessment equaled 0.680 basis points for each $100 in domestic deposits. These assessments, which may be revised based upon the level of DIF deposits, will continue until the bonds mature in the years 2017 through 2019.

Under the Dodd-Frank Act, beginning on January 1, 2011, all non-interest bearing transaction accounts and interest on lawyers trust accounts (IOLTA) qualify for unlimited deposit insurance by the FDIC through December 31, 2012. NOW accounts, which were previously fully insured under the Transaction Account Guarantee Program, are no longer eligible for an unlimited guarantee due to the expiration of this program on December 31, 2010. NOW accounts, along with all other deposits maintained at the Banks, are now insured by the FDIC up to $250,000 per account owner.

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.

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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 Wall Street Reform and Consumer Protection Act of 2010. 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:

- Centralize 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 would apply to all banks and thrifts. Smaller financial institutions, including the Banks, will be subject to the supervision and enforcement of their primary federal banking regulator with respect to the federal consumer financial protection laws.

- Require 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.

- Provide 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 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.

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 354 full-time equivalent employees at December 31, 2011. We experienced an increase of 33 full-time equivalent employees during 2011, due to the addition of the Kent and Gig Harbor branches as well as increases in loan productions and loan support. 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.

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Executive Officers

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

Name	Age(1)	Position	Has Served the Company, Heritage Bank or Central Valley Bank Since
Brian L. Vance	57	President and Chief Executive Officer of Heritage; President and Chief Executive Officer of Heritage Bank; Vice Chairman and Chief Executive Officer of Central Valley Bank	1996
Jeffrey J. Deuel	53	Executive Vice President, Heritage; Executive Vice President and Chief Operating Officer of Heritage Bank	2010
Gregory D. Patjens	62	Executive Vice President and Chief Lending Officer of Heritage Bank	1999
Donald J. Hinson	50	Senior Vice President and Chief Financial Officer of Heritage, Heritage Bank and Central Valley Bank	2005
D. Michael Broadhead	66	President of Central Valley Bank	1986
David A. Spurling	58	Senior Vice President and Chief Credit Officer of Heritage Bank	2001

(1) Age is as of December 31, 2011

Biographical Information

Brian L. Vance became President and Chief Executive Officer of the Company 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 the Company 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 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.

Gregory D. Patjens is Executive Vice President and Chief Lending Officer of Heritage Bank. Mr. Patjens joined Heritage Bank in 1999 as Executive Vice President Administration and was promoted in 2001 to Executive Vice President and Retail Banking Manager. Mr. Patjens was employed for over 25 years with Key Bank and its predecessor, Puget Sound National Bank, in positions with responsibilities for a variety of administrative and bank operations functions. Prior to leaving Key Bank, Mr. Patjens was Senior Vice President for Key Services, National Client Services.

Donald J. Hinson became the Senior Vice President and Chief Financial Officer of the Company, Heritage Bank and Central Valley Bank in 2007. Mr. Hinson joined the Company in 2005 as Vice President and Controller of Heritage Bank. 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.

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ITEM 1A. RISK FACTORS

The following are certain risks that management believes are specific to our business. This 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 will 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 particular acquisitions 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 recently completed FDIC-assisted transactions involving our assumption of deposits and the acquisition of assets of Cowlitz Bank and Pierce 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 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 rates 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 loss sharing agreements we have entered into with the FDIC 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 loss share 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.

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. Accordingly, the failure to identify and retain such personnel would place significant limitations on our ability to successfully execute our growth strategy. In addition, to the extent we expand our lending beyond our current market areas, we 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 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 loss share agreement with the FDIC may result in significant losses.

In connection with the Cowlitz Bank Acquisition, Heritage Bank entered in to loss sharing agreements with the FDIC that significantly reduces the Bank s credit loss exposure. The purchase and assumption agreement and the loss sharing agreement for the Cowlitz Bank Acquisition has 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 REO under the requirements of the loss sharing 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.

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 face 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 strain on management resources, management of problem loans, problems related to integration of personnel and operating systems and impact to our capital resources requiring us to raise additional capital. We cannot give assurance that we will 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.

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The Dodd-Frank Wall Street Reform and Consumer Protection Act will, among other things, tighten capital standards, create a new Consumer Financial Protection Bureau and result in new laws and regulations that are expected to increase our costs of operations.

The Dodd-Frank Act has had a significant impact on the bank regulatory structure for financial institutions, as well as 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. Much of the impact of the Dodd-Frank Act still remains to be seen in the coming months or years, as the effective dates of the many implementing regulations of the Dodd-Frank Act are gradually phased in.

Among the many requirements in the Dodd-Frank Act for new banking regulations is a requirement for new capital regulations to be adopted within 18 months after the date of enactment of the Dodd-Frank Act. These regulations must be at least as stringent as, and may call for higher levels of capital than, current regulations. Generally, trust preferred securities will no longer be eligible as Tier 1 capital and outstanding TARP preferred securities will continue to qualify as Tier 1 capital. In addition, the banking regulators are required to seek to make capital requirements for banks and bank holding companies, countercyclical so that capital requirements increase in times of economic expansion and decrease in times of economic contraction.

Certain provisions of the Dodd-Frank Act are expected to have a near term impact on us. For example, effective July 21, 2011 a federal prohibition on the payment of interest on demand deposits was eliminated, thus allowing businesses to have interest bearing checking accounts. Depending on competitive responses, this significant change to existing law could have an adverse impact our interest expense.

In addition, the Dodd-Frank Act created a new Consumer Financial Protection Bureau, or CFPB, with broad powers to supervise and enforce consumer protection laws. The CFPB 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 CFPB has examination and enforcement authority over all banks and savings institutions with more than $10 billion in assets. Financial institutions with $10 billion or less in assets, such as the Banks, will continue to be examined for compliance with the consumer laws by their primary bank regulators.

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.

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 based 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 credit worthiness 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, 2011, 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 $691.5 million, or approximately 82.5% of our total originated loan portfolio.

Our non-owner occupied commercial real estate loans, which includes multifamily 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 multifamily 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. Commercial and multifamily 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 multifamily 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 multifamily 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 multifamily 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 multifamily 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, 2011, our non-owner occupied commercial real estate loans totaled $251.0 million, or 30.0% 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.

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As of December 31, 2011, our originated real estate construction and land development loans totaled $77.3 million, or 9.3% of our total originated loan portfolio. Of these loans, $22.4 million, or 2.7%, were one-to-four family residential construction related and $54.9 million, or 6.6%, were multifamily residential and commercial construction related. Approximately $8.3 million, or 10.7%, of our total originated construction loans were nonperforming at December 31, 2011.

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 credit history 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 non-covered 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.

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. 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, 2011 we recorded a provision for loan losses of $14.4 million compared to $12.0 million for the year ended December 31, 2010. The provision related to the originated portfolio was $5.2 million and $12.0 for the years ended December 31, 2011 and 2010, respectively. Our provision for loan losses on purchased loans was $9.3 million for the year ended December 31, 2011. There was no provision for loan losses on purchased loans for the year ended December 31, 2010. We also recorded net loan charge-offs of $5.6 million for the year ended December 31, 2011 compared to $16.1 million for the year ended December 31, 2010. The net charge-offs related to the originated portfolio was $4.9 million and $16.1 million for the years ended

December 31, 2011 and 2010, 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. 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 64.1% of our nonperforming originated loans at December 31, 2011. At December 31, 2011 our total nonperforming originated loans were $23.3 million, or 2.57% of total originated loans, compared to $26.5 million or 3.14% of total loans at December 31, 2010. 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 state 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, the Puget Sound and Portland, Oregon areas have experienced substantial home price declines and increased foreclosures. A series of large Pacific Northwest businesses have implemented substantial employee layoffs and scaled back plans for future growth. Additionally, acquisitions and consolidations have resulted in substantial employee layoffs, along with a significant increase in office space vacancies in downtown Seattle. The Yakima Valley has likewise seen increased unemployment and a continued decline in housing prices.

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;
- collateral for loans made may decline further in value, in turn reducing customers borrowing power, reducing the value of assets and collateral associated with existing loans; and
- low cost or non-interest bearing deposits may decrease.

We cannot accurately predict the effect of the national economic recession on our future results of operations or the market price of our stock.

The national economy and the financial services sector in particular are currently facing challenges of a scope unprecedented in recent history. We cannot accurately predict the severity or duration of the current economic recession, which has adversely impacted the markets we serve. Any further deterioration in the economies of the nation as a whole or in its local markets would have an adverse effect, which could be material, on our business, financial condition, results of operations and prospects, and could also cause the market price of our common stock to decline. While it is impossible to predict how long these recessionary conditions may exist, the economic downturn could continue to present risks for some time for the banking industry and us.

Further economic downturns may adversely affect our investment securities portfolio.

Further deterioration in the credit markets created market volatility and illiquidity, which may result in further significant declines in the market values of a broad range of investment products. We continue to monitor our investment portfolio for deteriorating collateral values and other-than-temporary impairments. Additionally, other than temporary impairments could adversely affect our operating results.

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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, 2011, 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.

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 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.

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, 2011, we owned $5.6 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. 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. The FHLB has 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. However, continued deterioration in the FHLB s financial position may result in impairment in the value of those securities. In addition, on October 25, 2010, the FHLB received a consent order from the FHFA. The potential impact of the consent order is unknown at this time. 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. These regulations may sometimes impose significant limitations on operations. The significant federal and state banking regulations that affect us are described in this report under the heading Item 1. Business Supervision and Regulation. 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.

Such changes could subject us to additional costs, limit the types of financial services and products we may offer, restrict mergers and acquisitions, investments, access to capital, the location of banking offices, and/or increase the ability of non-banks to offer competing financial services and products, among other things. Further, recent regulatory changes to the rules for overdraft fees for debit transactions and interchange fees could reduce our fee income which would result in a reduction of our noninterest income. Our failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputational damage, could have a material adverse effect on our business, financial condition and results of operations. While we have policies and procedures designed to prevent any such violations, there can be no assurance that such violations will not occur.

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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. In this regard we are currently working with a nationally recognized community bank compensation consultant to prepare severance agreements to replace the severance agreements we previously had in place with certain of our key employees.

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, 2011, Heritage Bank had ten offices located in Tacoma and surrounding areas of Pierce County (all but four of which are owned), five offices located in Thurston County (all of which are owned with one office located on leased land), three 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, 2011, we had approximately 1,159 shareholders of record (not including the number of persons or entities holding stock in nominee or street name through various brokerage firms) and 15,456,297 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 9, 2012 was $14.20 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.

	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

	2010 Quarter ended:			
	March 31	June 30	September 30	December 31
High	$ 15.36	$ 16.46	$ 15.70	$ 15.49
Low	$ 13.40	$ 13.61	$ 12.32	$ 13.23

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 most recent fiscal year quarterly cash dividends per common share are listed below:

Declared	Cash Dividend per Share	Record Date	Paid
May 2, 2011	$0.03	May 13, 2011	May 27, 2011
July 27, 2011	$0.05	August 12, 2011	August 26, 2011
October 27, 2011	$0.05	November 10, 2011	November 23, 2011
November 16, 2011	$0.25	November 28, 2011	December 9, 2011

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

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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 a new 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 12 months. This marked the Company s ninth stock repurchase plan. During the quarter ended December 31, 2011, the Company repurchased 131,905 shares at an average price of $11.77. Since the establishment of this repurchase plan, the Company has repurchased a total of 201,205 shares at an average price of $11.64 per share.

The following table sets forth information about the Company s purchases of its outstanding common stock during the quarter ended December 31, 2011.

Period	**Total Number of Shares Purchased**	**Average Price Paid Per Share**	**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, 2011 October 31, 2011			6,086,916	712,700
November 1, 2011 November 30, 2011	131,905	$ 11.77	6,218,821	580,795
December 1, 2011 December 31, 2011			6,218,821	580,795
Total	131,905	$ 11.77	6,218,821	580,795

The information regarding the Company s equity compensation plan is contained under Part III, Item 12 of this Form 10-K and is incorporated by reference herein.

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Stock Performance Graph

The chart shown below depicts total return to stockholders during the period beginning December 31, 2006 and ending December 31, 2011. Total return includes appreciation or depreciation in market value of Heritage 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 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, 2006, and that all dividends were reinvested in Heritage common stock.

	Period Ended					
Index	**12/31/06**	**12/31/07**	**12/31/08**	**12/31/09**	**12/31/10**	**12/31/11**
Heritage Financial Corporation	$ 100.00	$ 83.11	$ 53.81	$ 61.05	$ 61.67	$ 57.46
NASDAQ Composite	100.00	110.66	66.42	96.54	114.06	113.16
NASDAQ Bank	100.00	80.09	62.84	52.60	60.04	53.74

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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,				
	2011	2010	2009	2008	2007
	(Dollars in thousands, except per share amounts)				
Operations Data:					
Interest income	$ 74,120	$ 59,522	$ 53,341	$ 56,948	$ 62,391
Interest expense	6,582	8,511	11,645	18,606	25,770
Net interest income	67,538	51,011	41,696	38,342	36,621
Provision for loan losses	14,430	11,990	19,390	7,420	810
Noninterest income	8,096	21,356	8,488	8,824	8,572
Noninterest expense	52,053	40,588	30,716	30,419	28,288
Income tax expense (benefit)	2,633	6,435	(503)	2,976	5,387
Net income	6,518	13,354	581	6,351	10,708
Net income (loss) applicable to common shareholders	6,518	11,668	(739)	6,208	10,708
Earnings (loss) per common share(1)					
Basic	0.42	1.05	(0.10)	0.93	1.62
Diluted	0.42	1.04	(0.10)	0.93	1.60
Dividend payout ratio to common shareholders(2)	90.5%		(100.0)%	59.5%	51.5%
Performance Ratios:					
Net interest spread(3)	5.23%	4.56%	4.25%	4.11%	3.86%
Net interest margin(4)	5.41%	4.78%	4.57%	4.59%	4.50%
Efficiency ratio(5)	68.82%	56.09%	60.67%	64.50%	62.59%
Return on average assets	0.48%	1.16%	0.06%	0.71%	1.23%
Return on average common equity	3.17%	8.15%	(0.72)%	6.98%	12.87%

	December 31,				
	2011	2010	2009	2008	2007
Balance Sheet Data:					
Total assets	$ 1,368,985	$ 1,367,684	$ 1,014,859	$ 946,145	$ 886,055
Originated loans receivable, net	815,607	719,957	746,083	793,303	768,945
Purchased covered loans receivable	105,394	128,715			
Purchased noncovered loans receivable	83,479	131,049			
Loans receivable, net	1,004,480	979,721	746,083	793,303	768,945
Loans held for sale	1,828	764	825	304	447
Deposits	1,136,044	1,136,276	840,128	824,480	776,280
FDIC indemnification asset	10,350	16,071			
FHLB advances					14,990
Securities sold under agreement to repurchase	23,091	19,027	10,440		
Stockholders equity	202,520	202,279	158,498	113,147	84,967
Book value per common share	13.10	12.99	12.21	13.40	12.79
Equity to assets ratio	14.8%	14.8%	15.6%	12.0%	9.6%
Capital Ratios:					
Total risk-based capital ratio	19.0%	21.5%	20.7%	13.7%	10.7%
Tier 1 risk-based capital ratio	20.3%	20.2%	19.4%	12.5%	9.5%
Leverage ratio	13.8%	13.9%	14.6%	11.0%	8.2%
Asset Quality Ratios:					
Nonperforming originated loans to total originated loans	2.57%	3.14%	4.27%	0.42%	0.13%
Allowance for loan losses to total originated loans	2.66%	2.97%	3.38%	1.91%	1.33%

Allowance for loan losses to nonperforming originated loans	103.52%	94.73%	79.34%	454.02%	1,016.06%
Nonperforming originated assets to total originated assets	2.14%	2.38%	3.32%	0.57%	0.13%
Other Data:					
Number of banking offices	33	31	20	20	20
Number of full-time equivalent employees	354	321	222	217	224

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(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.

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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, 2011 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 and Pierce 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;

- 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 reserve 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, including the recently adopted Dodd-Frank Act and regulations that have been or will be promulgated thereunder and interpretation of regulatory capital or other rules;

- our ability to control operating costs and expenses;

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 balance sheet;

staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges;

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- computer systems on which we depend could fail or experience a security breach;
- 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 branch expansion strategy;
- 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;
- 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 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, the forward-looking statements discussed in this Form 10-K, and you should not put undue reliance on any forward-looking statements.

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 cash flows related to impaired purchased loans, other than temporary impairments in the market value of investments and 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 conditions 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 the routine examination process, which may result in the establishment of additional reserves 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 loans losses, risk related to asset quality and lending activity, see Part I, Item 1, Business Analysis of Allowance for Loan and Lease Losses as well as Results of Operations for the Years Ended December 31, 2011 and 2010 Provision for Loan Losses.

Estimated Cash Flows related to Impaired Purchased 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 amount of the future cash flows of the pool is 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 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 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 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 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. Heritage has adopted the ASU for the quarter ended December 31, 2011.

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 as 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. We believe that consolidation across the community bank landscape will continue to take place and further believe that, with our capital and liquidity positions, 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, including additional FDIC-assisted transactions. In markets where we wish to enter or expand our business, we will also consider opening *de novo* offices. 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 maintaining our lending objectives. We will continue to focus on loan types and markets that we know well and 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 our 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, 2011, the ratio of our allowance for loan losses to total originated loans was 2.66% and the ratio of the allowance to nonperforming originated loans was 103.52%. Our liquidity position is also strong, with $123.8 million in cash and cash equivalents as of December 31, 2011. As of December 31, 2011, 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 ratios were 20.3%, 19.0% and 13.8%, 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 our communities 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, 2011, as a percentage of our total deposits, non-maturity deposits were 71.0%. We maintain state of the art technology-based products, such as 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. We provide our business customers with an array of competitive deposit and cash management products through a variety of delivery channels with state of the art technologies. Our lending staff is well seasoned with extensive knowledge of our markets and adds value through a focused advisory role that we believe strengthens our customer relationships and 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 well-balanced and 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 to 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 in our commercial banking relationships, market expansion and asset quality.

During the period from December 31, 2007 through December 31, 2011 our total assets have grown $482.9 million, or 54.5%, with net loans receivable growing $235.5 million, or 30.6%, million during the period. Our emphasis in growing our commercial business loan portfolio resulted in an increase in commercial business loans of $106.4 million, or 18.2%, since 2007. Overall loan increases have benefited from our emphasis in increasing our lending in the Pierce County market and the acquisitions of Cowlitz Bank and Pierce Commercial Bank.

Deposits increased $359.8 million to $1.14 billion at December 31, 2011 from $776.3 million at December 31, 2007. From December 31, 2007 to December 31, 2011, non-maturity deposits (total deposits less certificate of deposit accounts) increased $390.0 million, or 93.6%. As a result, the percentage of certificate of deposit accounts to total deposits decreased to 29.0% at December 31, 2011 from 47.0% at December 31, 2007.

Stockholders equity has increased by $117.6 million to $202.5 million at December 31, 2011 from December 31, 2007 due to a combination of earnings and issuances of common stock. During the period from December 31, 2007 through December 31, 2011, our annual net income decreased by 39.1% or $4.2 million, mostly due to increases in the allowance for loan losses.

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,								
	2011			2010			2009		
	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	$ 981,848	$ 70,114	7.14%	$ 810,177	$ 56,054	6.92%	$ 766,346	$ 50,567	6.60%
Taxable securities	129,217	2,912	2.25	105,815	2,661	2.52	59,365	2,295	3.87
Nontaxable securities	25,122	821	3.27	13,411	470	3.50	5,721	244	4.26
Interest earning deposits and Federal funds sold	105,836	273	0.26	133,277	337	0.25	76,922	235	0.31
FHLB stock	5,594			4,204			3,566		
Total interest earning assets	$ 1,247,617	$ 74,120	5.94%	$ 1,066,884	$ 59,522	5.58%	$ 911,920	$ 53,341	5.85%
Noninterest earning assets	102,691			86,039			66,279		
Total assets	$ 1,350,308			$ 1,152,923			$ 978,199		
Interest Bearing Liabilities:									
Certificates of deposit	$ 355,167	$ 4,274	1.20%	$ 351,191	$ 5,677	1.62%	$ 323,696	$ 7,988	2.47%
Savings accounts	103,170	361	0.35	89,978	501	0.56	85,541	842	0.98
Interest bearing demand and money market accounts	453,509	1,868	0.41	376,245	2,200	0.58	310,860	2,769	0.89
Total interest bearing deposits	911,846	6,503	0.71	817,414	8,378	1.02	720,097	11,599	1.61
FHLB advances and other borrowings	1		0.30	1,896	48	2.53	1		1.73
Securities sold under agreement to repurchase	19,301	79	0.41	13,750	85	0.62	6,206	46	0.75
Total interest bearing liabilities	$ 931,148	$ 6,582	0.71%	$ 833,060	$ 8,511	1.02%	$ 726,304	$ 11,645	1.60%
Demand and other noninterest bearing deposits	205,862			150,906			120,107		
Other noninterest bearing liabilities	7,795			2,993			5,321		
Preferred stock				22,889			23,413		
Stockholders equity	205,503			165,964			126,467		
Total liabilities and stockholders equity	$ 1,350,308			$ 1,152,923			$ 978,199		
Net interest income		$ 67,538			$ 51,011			$ 41,697	
Net interest spread			5.23%			4.56%			4.25%
Net interest margin			5.41%			4.78%			4.57%

Average interest earning assets to average interest bearing liabilities	133.99%	128.07%	125.56%

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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,					
	2011 Compared to 2010 Increase (Decrease) Due to			2010 Compared to 2009 Increase (Decrease) Due to		
	Volume	Rate	Total	Volume	Rate	Total
	(In thousands)					
Interest Earning Assets:						
Loans	$ 12,273	$ 1,786	$ 14,059	$ 3,033	$ 2,454	$ 5,487
Taxable securities	527	(277)	250	1,168	(802)	366
Nontaxable securities	383	(31)	352	269	(43)	226
Interest earning deposits and Federal funds sold	(71)	6	(65)	143	(41)	102
FHLB stock						
Interest income	$ 13,112	$ 1,484	$ 14,596	$ 4,613	$ 1,568	$ 6,181
Interest bearing liabilities:						
Certificates of deposit	$ 48	$ (1,450)	$ (1,402)	$ 444	$ (2,756)	$ (2,312)
Savings accounts	46	(187)	(141)	25	(365)	(340)
Interest bearing demand and money market accounts	318	(649)	(331)	382	(951)	(569)
Total interest bearing deposits	412	(2,286)	(1,874)	851	(4,072)	(3,221)
FHLB advances and other borrowings	(6)	(44)	(50)	48		48
Securities sold under agreement to repurchase	23	(29)	(6)	47	(8)	39
Interest expense	$ 429	$ (2,359)	$ (1,930)	$ 946	$ (4,080)	$ (3,134)

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 a $11.5 million increase in noninterest expense partially offset by a $16.5 million increase in net interest income. The Company s efficiency ratio increased to 68.8% for the year ended December 31, 2011 from 56.2% 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 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 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 increases 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%,

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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 Acquisitions as well as increases in investment securities available for sale. The yield on 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 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 decreases 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 increases in average interest bearing liabilities were due primarily to the Cowlitz and Pierce 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 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. 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 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 projected cash flows are more than originally estimated, the increase in cash flows is recognized prospectively in interest income.

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 $26.2 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 103.2% of nonperforming originated loans) appropriate to provide for probable losses based on an evaluation of known and inherent risks in the loan portfolio at that date. 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 the Allowance for Loan and Lease Losses.

Noninterest Income. Total noninterest income decreased $13.3 million, or 62.1%, to $8.1 million for the year ended December 31, 2011 compared to $21.4 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 $573,000 increase in service charges on deposits due mostly to deposits acquired through the Cowlitz and Pierce Commercial Acquisitions.

Noninterest Expense. Noninterest expense increased $11.5 million or 28.2% to $52.1 million during the year ended December 31, 2011 compared to $40.6 million for the year ended December 31, 2010. The increase was due to increased salaries and benefits expense in the amount of $7.2 million, increased occupancy and equipment expense of $1.8 million and increased other real estate owned expense (including valuation adjustments) of $652,000. These increases were substantially due to the Cowlitz and Pierce Commercial Acquisitions.

The efficiency ratio for the year ended December 31, 2011 was 68.8% compared to 56.2% for the same period in the prior year. While growth strategies are being executed the Company expects to incur higher expenses as evidenced by the current efficiency ratio. Expenses are expected to be more in line with revenue when these growth strategies begin producing long term results. The increase was primarily related to the increase in noninterest expense resulting from the Cowlitz and Pierce Acquisitions. 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 (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 income before taxes relative to the amount of tax-exempt income.

Results of Operations for the Years Ended December 31, 2010 and 2009

On July 30, 2010, Heritage Bank acquired certain assets and assumed certain liabilities of Cowlitz Bank from the FDIC, which had been appointed receiver of the institution, including nine branches located in Washington State and Oregon State. As a results of the Cowlitz Acquisition, Heritage Bank acquired assets with a fair value of approximately $344.8 million, including $145.3 million of loans, $74.1 million of cash and cash equivalents, $70.8 million of a FDIC receivable, $33.7 million of investment securities, $16.1 million of a FDIC indemnification asset, $1.2 million of FHLB stock, $1.7 million of core deposit intangible and $1.2 million of other assets. Heritage Bank assumed liabilities with a fair value of approximately $344.5 million, including $343.9 million of deposits and $422,000 of other liabilities. In connection with this acquisition, Heritage Bank entered into loss-sharing agreements with the FDIC which cover approximately $167.2 million in unpaid principal balance of acquired loans at July 30, 2010.

On November 5, 2010, Heritage Bank acquired certain assets and assumed certain liabilities of Pierce Commercial Bank from the FDIC, which had been appointed receiver of the institution. Pierce Commercial Bank was a full service commercial bank headquartered in Tacoma, Washington. As a results of the Pierce Commercial Acquisition, Heritage Bank acquired assets with a fair value of approximately $210.7 million, including $142.9 million of loans, $30.3 million of cash and cash equivalents, $21.5 million of a FDIC receivable, $13.7 million of investment securities, $1.1 million of FHLB and Federal Reserve stock, and $1.2 million of other assets. Heritage Bank assumed liabilities with a fair value of approximately $203.3 million, including $181.5 million of deposits, $17.5 million in FHLB borrowings and $300,000 of other liabilities. In connection with the Pierce Commercial Acquisition, Heritage Bank did not enter into loss-sharing agreements with the FDIC to cover expected losses on acquired loans or other real estate owned.

Earnings Summary. Including preferred stock dividends, net income applicable to common shareholders of $1.04 per diluted common share was recorded for the year ended December 31, 2010 compared to a net loss of $0.10 per diluted common share for the year ended December 31, 2009. Net income for the year ended December 31, 2010 was $13.4 million compared to net income of $581,000 for the same period in 2009. The increase was primarily the result of a $11.8 million gain on bank acquisitions, a $7.4 million decrease in the provision for loan losses and a $9.3 million increase in net interest income partially offset by a $9.8 million increase in noninterest expense. The Company s efficiency ratio improved to 56.2% for the year ended December 31, 2010 from 61.3% for the year ended December 31, 2009.

Net Interest Income. Net interest income increased $9.3 million, or 22.3%, to $51.0 million for the year ended December 31, 2010 compared with the previous year of $41.7 million. The increase in net interest income was due primarily to increased earning assets acquired from the Cowlitz and Pierce Commercial Acquisitions. Net interest income as a percentage of average earning assets (net interest margin) for the year ended December 31, 2010 increased 21 basis points to 4.78% from 4.57% 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 earning overnight cash deposits in the Cowlitz and Pierce Commercial Acquisitions. Our net interest spread for the year ended December 31, 2010 increased to 4.56% from 4.25% for the prior year.

Total interest income increased $6.2 million, or 11.6%, to $59.5 million for the year ended December 31, 2010 from $53.3 million for the year ended December 31, 2009 as the yield on interest earning assets decreased to 5.58% for the year ended December 31, 2010 from 5.85% for the year ended December 31, 2009. Total average interest earning assets (including nonaccrual loans) increased by $155.0 million to $1.07 billion for the year ended December 31, 2010 from $911.9 million for the year ended December 31, 2009, mostly due to the Cowlitz and Pierce Commercial Acquisitions. Nonaccrual originated loans decreased by $8.3 million to $26.5 million at December 31, 2010 from $34.8 million at December 31, 2009.

Total interest expense decreased by $3.1 million, or 26.9%, to $8.5 million for the year ended December 31, 2010 from $11.6 million for the year ended December 31, 2009 as the average rate paid on interest bearing liabilities decreased to 1.02% for the year ended December 31, 2010 from 1.60% for the year ended December 31, 2009. Total average interest bearing liabilities increased by $106.8 million to $833.1 million at December 31, 2010 from $726.3 at December 31, 2009, mostly due to the Cowlitz and Pierce Commercial Acquisitions.

Provision for Loan Losses. The provision for loan losses decreased $7.4 million, or 38.2%, to $12.0 million for the year ended December 31, 2010 from $19.4 million for the year ended December 31, 2009. The decreased provision for loan losses was primarily the result of a decrease in nonaccrual originated loans. The Banks had net charge-offs of $16.1 million for the year ended December 31, 2010 compared to net charge-offs of $8.6 million for the year ended December 31, 2009. The ratio of net charge-offs to average total loans outstanding was 2.24% for the year ended December 31, 2010 and 1.10% for the year ended December 31, 2009. The increased amount of charge-offs were due mostly to the resolution of several construction and commercial loans that were nonperforming as of December 31, 2009.

The allowance for loan losses decreased by $4.1 million to $22.1 million at December 31, 2010 from $26.2 million at December 31, 2009. The decreased level of the allowance for loan losses was primarily attributable to decreases in the expected loss allocated to nonperforming originated loans and total originated loans offset by an increase in performing originated loans classified as potential problem loans. As of December 31, 2010, we had identified $26.9 million of impaired originated loans, including $9.1 million of restructured loans. Of those impaired loans, $6.7 million have no allowances for credit losses as their estimated collateral value is equal to or exceeds their carrying costs. The remaining $20.2 million have related allowances for credit losses totaling $4.6 million.

Based on the comprehensive methodology, management deemed the allowance for loan losses of $22.1 million at December 31, 2010 (2.97% of total originated loans and 93.16% of nonperforming originated loans) adequate to provide for probable losses based on an evaluation of known and inherent risks in the loan portfolio at that date. *Noninterest Income.* Total noninterest income increased $12.8 million, or 148.0%, to $21.5 million for the year ended December 31, 2010 compared to $8.7 million for the prior year. The increase was due substantially to an $11.8 million pretax gain on bank acquisitions and a $462,000 increase in service charges on deposits due to deposits acquired through the Cowlitz and Pierce Commercial Acquisitions.

Noninterest Expense. Noninterest expense increased $9.8 million or 31.8% to $40.7 million during the year ended December 31, 2010 compared to $30.9 million for the year ended December 31, 2009. The increase was due to increased salaries and benefits expense in the amount of $5.7 million, increased occupancy and equipment expense of $1.4 million, increased professional services of $1.3 million, and increased data processing of $552,000. These increases were substantially due to the Cowlitz and Pierce Commercial Acquisitions.

The efficiency ratio for the year ended December 31, 2010 was 56.2% compared to 61.3% for the prior year.

Income Tax Expense (Benefit). The provision for income taxes increased by $6.9 million to a net expense of $6.4 million for the year ended December 31, 2010 from a benefit of $503,000 for the year ended December 31, 2009 primarily as a result of an increase in income before taxes. The Company s effective tax rate was 32.5% for the year ended December 31, 2010.

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, 2011, cash and cash equivalents totaled $123.8 million, or 9.0% of total assets and investment securities classified as either available for sale or held to maturity with maturities of one year or less amounted to $30.1 million, or 2.2% of total assets. At December 31, 2011, the Banks maintained an uncommitted credit facility with the FHLB of

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Seattle for $169.7 million and an uncommitted credit facility with the Federal Reserve Bank of San Francisco for $70.5 million, of which there were no borrowings outstanding as of December 31, 2011. The Banks also maintain advance lines with Zions Bank, US Bank and Pacific Coast Bankers Bank to purchase federal funds totaling $42.8 million as of December 31, 2011. As of December 31, 2011, there were no overnight federal funds purchased.

During 2011 total assets grew $1.3 million with cash on hand and in banks decreasing $7.0 million, interest earning deposits and federal funds sold decreasing $38.2 million, investment securities increasing $17.8 million and net loans increasing by $24.8 million over 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 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 $202.5 million at December 31, 2011 and $202.3 million at December 31, 2010. During the year ended December 31, 2011, we paid common stock dividends of $5.9 million, repurchased $2.3 million in common stock, repurchased $450,00 in a warrant issued to the U.S Treasury, realized net income of $6.5 million, recorded $1.2 million in unrealized gains on securities available for sale, net of tax, recorded $13,000 of market loss related to other than temporary impairment on securities held to maturity, net of tax, recorded $125,000 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 $1.1 million.

On November 21, 2008, the Company completed a sale to the Treasury of 24,000 shares of the Company s Series A Fixed Rate Cumulative Perpetual Preferred Stock for an aggregate purchase price of $24.0 million in cash, with a related Warrant to purchase 276,074 shares of the Company s common stock. On December 22, 2010, the Company redeemed the 24,000 shares of its Series A preferred stock. The Company paid the Treasury a total of $24.1 million, consisting of $24.0 million of principal and $123,000 of accrued and unpaid dividends. Under the terms of the Warrant, because our September 22, 2009 offering of common stock was a qualified equity offering resulting in aggregate gross proceeds of at least $24.0 million, the number of shares of the Company s common stock underlying the Warrant was reduced by 50% to 138,037 shares. On August 17, 2011, the Company repurchased the Warrant from the Treasury for $450,000. The Warrant repurchase, together with the Company s earlier redemption of the entire amount of Fixed Rate Cumulative Perpetual Preferred Stock, Series A, held by the Treasury, represents full repayment of all TARP obligations and cancellation of all equity interests in the Company held by the Treasury.

The Company and the Banks are subject to various regulatory capital requirements. As of December 31, 2011, 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 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 $57.6 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 February 1, 2012, the Company s Board of Directors declared a dividend of $0.06 per share payable on February 24, 2012 to shareholders of record on February 10, 2012.

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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 will be repaid principally from the Banks contributions to the ESOP. The Banks contributions will be sufficient to service the debt over the 15 year loan term at the interest rate of 8.5%. As the debt is repaid, shares are released, and allocated to plan participants based on the proportion of debt service paid during the year. As shares are released, compensation expense is recorded equal to the then current market price of the shares, our capital is increased, and the shares become outstanding for earnings per common share calculations. For the year ended December 31, 2011, the Company has allocated or committed to be released to the ESOP 9,258 earned shares and has 10,029 unearned, restricted shares remaining to be released. The fair value of unearned, restricted shares held by the ESOP trust was $126,000 at December 31, 2011.

Contractual Obligations

The following table provides the amounts due under specified contractual obligations for the periods indicated as of December 31, 2011:

	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	$ 252,677	$ 51,580	$ 25,147	$ 200	$ 806,440	$ 1,136,044
Operating leases	1,471	2,593	2,553	5,334		11,951
Purchase obligations(2)	157					157
Total contractual obligations	$ 254,305	$ 54,173	$ 27,700	$ 5,534	$ 806,440	$ 1,148,152

(1) Represents interest bearing and noninterest bearing checking, money market and checking accounts.
(2) Represents agreements to purchase goods or services.

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 individuals. The longer-term objective is to increase the proportion of noninterest bearing demand deposits, low 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 16.86% and a positive 4-12 month gap of 10.56% as of December 31, 2011. 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.

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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, 2011 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.

	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)	$ 247,840	$ 67,018	$ 370,845	$ 109,312	$ 46,597	$ 841,612
Investment securities	7,572	27,073	26,778	46,372	48,900	156,695
FHLB stock	5,594					5,594
Interest earning deposits	123,759					123,759
Total interest earning assets	$ 384,765	$ 94,091	$ 397,623	$ 155,684	$ 95,497	$ 1,127,660
Interest Bearing Liabilities:						
Total interest bearing deposits	$ 171,572	$ 165,103	$ 568,376	$	$	$ 905,051
Total securities sold under agreement to repurchase	23,091					23,091
Total interest bearing liabilities	$ 194,663	$ 165,103	$ 568,376	$	$	$ 928,142
Rate sensitivity gap	$ 190,102	$ (71,012)	$ (170,753)	$ 155,684	$ 95,497	$ 199,518
Cumulative rate sensitivity gap:						
Amount	$ 190,102	$ 119,090	$ (51,663)	$ 104,021	$ 199,518	
As a percentage of total interest earning assets	16.86%	10.56%	(4.58)%	9.22%	17.69%	

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

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, 2011. 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)						
	2012	2013	2014	2015-2016	After 2016	Total	Fair Value
Investment Securities							
Amounts maturing:							
Fixed rate	$ 30,051	$ 12,212	$ 1,244	$ 3,857	$ 107,156	$ 154,520	
Weighted average interest rate	1.64%	1.15%	4.17%	3.59%	3.09%		
Adjustable rate					2,175	2,175	
Weighted average interest rate					5.32%		
Total	$ 30,051	$ 12,212	$ 1,244	$ 3,857	$ 109,331	$ 156,695	$ 157,483
Loans(1)							
Amounts maturing:							
Fixed rate	$ 55,344	$ 28,418	$ 24,283	$ 47,733	$ 161,689	$ 317,467	
Weighted average interest rate	5.82%	6.55%	5.80%	5.66%	5.95%		
Adjustable rate	144,104	34,350	21,715	52,953	269,195	522,317	
Weighted average interest rate	5.53%	5.31%	5.94%	5.36%	5.91%		
Total	$ 199,448	$ 62,768	$ 45,998	$ 100,686	$ 430,884	$ 839,784	$ 863,176
Certificates of Deposit							
Amounts maturing:							
Fixed rate	$ 252,677	$ 40,044	$ 11,536	$ 13,158	$ 12,189	$ 329,604	$ 331,618
Weighted average interest rate	0.97%	1.38%	2.16%	2.76%	1.97%		

(1) 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

None

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ITEM 9A. CONTROLS AND PROCEDURES

(i) 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.

(ii) 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, 2011. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control Integrated Framework*. Based on our assessment, we believe that, as of December 31, 2011, the Company s internal control over financial reporting is effective based on these criteria.

KPMG, an independent registered public accounting firm, has audited the effectiveness of our internal control over financial reporting as of December 31, 2011, which is included in this Item 9A.

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

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Heritage Financial Corporation:

We have audited Heritage Financial Corporation and subsidiaries (the Company) internal control over financial reporting as of December 31, 2011, 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 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 the Company s internal control over financial reporting based on our audit.

We conducted our audit 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 effective internal control over financial reporting was maintained in all material respects. Our audit 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 audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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 Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of financial condition of Heritage Financial Corporation and subsidiaries as of December 31, 2011 and 2010, and the related consolidated statements of operations, stockholders equity and comprehensive income (loss), and cash flows for each of the years in the three-year period ended December 31, 2011, and our report dated March 2, 2012 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Seattle, Washington

March 2, 2012

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(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 2, 2012 (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-See page 22] 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 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, 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 set incorporated by reference to the headings Executive Compensation , Director Compensation, and Compensation Committee Report 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, 2011, 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	582,003	$ 18.33	687,999

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.

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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 Matters of the Proxy Statement.

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 eight of our ten directors are independent. Directors Charneski, Christensen, Clees, Ellwanger, Fluetsch, Jensen, Lyon and Weigand are all independent. Only Brian L. Vance, who serves as President and Chief Executive Officer of Heritage Financial Corporation and Heritage Bank, and Donald V. Rhodes, the Chairman of Heritage Financial Corporation and its financial institution subsidiaries and the former President and Chief Executive Officer of Heritage Financial Corporation and Heritage Bank, are not independent.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

Information concerning principal accounting fees and services is incorporated by reference to the section entitled Audit Fees in the Proxy Statement.

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.	
3.1	Articles of Incorporation(1)
3.2	Bylaws of the Company(2)
4.2	Warrant for purchase(3)
10.1	1998 Stock Option and Restricted Stock Award Plan(4)
10.6	1997 Stock Option and Restricted Stock Award Plan(5)
10.10	2002 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan(6)
10.12	2006 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan(7)
10.13	Employment Agreement between the Company and Brian L. Vance, effective December 3, 2010 as amended and restated in February 2007(8)
10.14	Employment Agreement between Central Valley Bank and D. Michael Broadhead, effective December 3, 2010(8)
10.19	Letter of Understanding between Heritage Financial Corporation and Donald V. Rhodes dated August 18, 2009(9)
10.20	Annual Incentive Compensation Plan(10)
10.22	2010 Omnibus Equity Plan(11)
14.0	Code of Ethics and Conduct Policy(12)
21.0	Subsidiaries of the Company
23.0	Consent of Independent Registered Public Accounting Firm
24.0	Power of Attorney
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, 2011, formatted in Extensible Business Reporting Language (XBRL): (i) Consolidated Statements of Financial Condition, (ii) Consolidated Statements of Operations; (iii) Consolidated Statements of Changes in Shareholder s Equity and Comprehensive Income (Loss), (iv) Consolidated Statements of Cash Flows, and (v) the Notes to Consolidated Financial Statements(13)

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(1) 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.
(2) Incorporated by reference to the Current Report on Form 8-K dated November 29, 2007.
(3) Incorporated by reference to the Current Report on Form 8-K dated November 25, 2008.
(4) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-71415).
(5) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-57513).
(6) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-88980; 333-88982; 333-88976).
(7) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-134473; 333-134474; 333-134475).
(8) Incorporated by reference to the Quarterly Report on Form 10-Q dated May 1, 2007.
(9) Incorporated by reference to the Current Report on Form 8-K dated August 20, 2009.
(10) Incorporated by reference to the Annual Report on Form 10-K dated March 2, 2010.
(11) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 33-167146).
(12) 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.
(13) 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 2nd day of March 2012.

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 2nd day of March 2012.

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
Senior 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

*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, 2011, 2010, and 2009

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:

We have audited the accompanying consolidated balance sheets of Heritage Financial Corporation and subsidiaries as of December 31, 2011 and 2010, and the related consolidated statements of operations, stockholders equity and comprehensive income (loss), and cash flows for each of the years in the three-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 2010, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Heritage Financial Corporation s internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 2, 2012 expressed an unqualified opinion on the effectiveness of the Company s internal control over financial reporting.

/s/ KPMG LLP

Seattle, Washington

March 2, 2012

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

December 31, 2011 and 2010

(Dollars in thousands, except per share amounts)

	2011	2010
ASSETS		
Cash on hand and in banks	$ 30,193	$ 37,179
Interest earning deposits	93,566	129,822
Federal funds sold		1,990
Investment securities available for sale	144,602	125,175
Investment securities held to maturity (market value of $12,881 and $14,290)	12,093	13,768
Loans held for sale	1,828	764
Originated loans receivable	837,924	742,019
Less: Allowance for loan losses	(22,317)	(22,062)
Originated loans receivable, net	815,607	719,957
Purchased covered loans receivable, net of allowance for loan losses of ($3,963 and $0)	105,394	128,715
Purchased non-covered loans receivable, net of allowance for loan losses of ($4,635 and $0)	83,479	131,049
Total loans receivable, net	1,004,480	979,721
FDIC indemnification asset	10,350	16,071
Other real estate owned ($774 and $0 covered by FDIC loss share, respectively)	4,484	3,030
Premises and equipment, at cost, net	22,975	21,750
Federal Home Loan Bank stock, at cost	5,594	5,594
Accrued interest receivable	5,117	4,626
Prepaid expenses and other assets	8,190	8,974
Deferred income taxes, net	10,988	4,255
Intangible assets, net	1,513	1,953
Goodwill	13,012	13,012
Total assets	$ 1,368,985	$ 1,367,684
LIABILITIES AND STOCKHOLDERS EQUITY		
Deposits	$ 1,136,044	$ 1,136,276
Securities sold under agreement to repurchase	23,091	19,027
Accrued expenses and other liabilities	7,330	10,102
Total liabilities	1,166,465	1,165,405
Stockholders equity:		
Preferred stock, no par value, 2,500,000 shares authorized; Series A (liquidation preference $1,000 per share); no shares issued and outstanding at December 31, 2011 and December 31, 2010		
Common stock, no par, 50,000,000 shares authorized; 15,456,297 and 15,568,471 shares outstanding at December 31, 2011 and 2010, respectively	126,622	128,436
Unearned compensation ESOP and other	(94)	(182)
Retained earnings	74,256	73,648
Accumulated other comprehensive income, net	1,736	377
Total stockholders equity	202,520	202,279

Total liabilities and stockholders equity	$ 1,368,985	$ 1,367,684

See accompanying notes to consolidated financial statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

For the years ended December 31, 2011, 2010 and 2009

(Dollars in thousands, except per share amounts)

	2011	2010	2009
Interest income:			
Interest and fees on loans	$ 70,114	$ 56,054	$ 50,567
Taxable interest on investment securities	2,912	2,661	2,295
Nontaxable interest on investment securities	821	470	244
Interest on federal funds sold and interest earning deposits	273	337	235
Total interest income	74,120	59,522	53,341
Interest expense:			
Deposits	6,503	8,378	11,598
Other borrowings	79	133	47
Total interest expense	6,582	8,511	11,645
Net interest income	67,538	51,011	41,696
Provision for loan losses	5,180	11,990	19,390
Provision for loan losses on purchased loans	9,250		
Net interest income after provision for loan losses	53,108	39,021	22,306
Noninterest income:			
Gain on bank acquisitions		11,830	
Gains on sales of loans, net	316	401	422
Service charges on deposits	5,226	4,653	4,191
Merchant Visa income	2,906	3,092	3,008
Change in FDIC indemnification asset	(2,250)	50	
Other income	1,898	1,330	867
Total noninterest income	8,096	21,356	8,488
Noninterest expense:			
Impairment loss on investment securities	118	318	1,330
Less: Portion recorded as other comprehensive income	(20)	(20)	(830)
Impairment loss on investment securities, net	98	298	500
Salaries and employee benefits	27,109	19,910	14,259
Occupancy and equipment	7,127	5,326	3,928
Data processing	2,628	2,233	1,681
Marketing	1,361	1,171	990
Merchant Visa	2,350	2,577	2,500
Professional services	2,062	2,139	823
State and local taxes	1,336	968	967
Federal deposit insurance premium	1,558	1,656	1,616
Other real estate owned	921	269	162

Other expense	5,503	4,041	3,290
Total noninterest expense	52,053	40,588	30,716
Income before income taxes	9,151	19,789	78
Income tax expense (benefit)	2,633	6,435	(503)
Net income	$ 6,518	$ 13,354	$ 581
Dividends accrued and discount accreted on preferred shares		1,686	1,320
Net income (loss) applicable to common shareholders	$ 6,518	$ 11,668	$ (739)
Basic earnings (loss) per common share	$ 0.42	$ 1.05	$ (0.10)
Basic weighted average common shares outstanding	15,431,355	11,121,346	7,831,614
Diluted earnings (loss) per common share	$ 0.42	$ 1.04	$ (0.10)
Diluted weighted average common shares outstanding	15,497,426	11,173,658	7,831,614

See accompanying notes to consolidated financial statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME (LOSS)

For the years ended December 31, 2011, 2010 and 2009

(Dollars and shares in thousands)

	Number of preferred stock shares	Preferred stock	Number of common shares	Common stock	Unearned Compensation-ESOP and restricted stock awards	Retained earnings	Accumulated other comprehensive income (loss), net	Total stock holders equity
Balance at December 31, 2008	24	$ 23,367	6,700	$ 26,546	$ (358)	$ 63,240	$ 352	$ 113,147
Restricted stock awards canceled			(1)					
Restricted stock awards issued			5					
Stock option compensation expense				143				143
Exercise of stock options (including tax benefits from nonqualified stock options)			4	39				39
Share based payment and earned ESOP			9	318	88			406
Tax benefit (provision) associated with share based payment and unallocated ESOP				(84)				(84)
Accretion of preferred stock		120				(120)		
Net income						581		581
Change in fair value of securities available for sale, net of reclassification adjustments							90	90
Cumulative effect of adoption of FASB ASC 320-10-65 relating to impairment of debt securities, net of tax						149	(149)	
Other-than-temporary impairment on securities held to maturity, net of tax							(540)	(540)
Accretion of other-than-temporary impairment on securities held to maturity, net of tax							14	14
Common stock issuance, net of expenses			4,341	46,572				46,572
Cash dividends accrued on preferred stock						(1,200)		(1,200)
Cash dividends declared and paid on common stock						(670)		(670)
Balance at December 31, 2009	24	$ 23,487	11,058	$ 73,534	$ (270)	$ 61,980	$ (233)	$ 158,498
Restricted stock awards canceled			(1)					
Restricted stock awards issued			57					
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 benefit (provision) associated with share based payment and unallocated ESOP				(10)				(10)
Accretion of preferred stock		513				(513)		
Net income						13,354		13,354
Change in fair value of securities available for sale, net of reclassification adjustments							418	418
Other-than-temporary impairment on securities held to maturity, net of tax							(14)	(14)
Accretion of other-than-temporary impairment on securities held to maturity, net of tax							206	206
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 canceled	(5)					
Restricted stock awards issued	81					
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 benefit (provision) associated with share based payment and unallocated ESOP		(4)				(4)
Common stock repurchase	(201)	(2,342)				(2,342)
Net income				6,518		6,518
Change in fair value of securities available for sale, net of reclassification adjustments					1,247	1,247
Other-than-temporary impairment on securities held to maturity, net of tax					(13)	(13)
Accretion of other-than-temporary impairment on securities held to maturity, net of tax					125	125
Repurchase of warrant issued to U.S. Treasury		(450)				(450)
Cash dividends declared and paid on common stock				(5,910)		(5,910)
Balance at December 31, 2011	$ 15,456	$ 126,622	$ (94)	$ 74,256	$ 1,736	$ 202,520

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Comprehensive Income	2011	2010	2009
Net income	$ 6,518	$ 13,354	$ 581
Change in fair value of securities available for sale, net of tax of $663, $225, and $45	1,233	418	84
Reclassification adjustment of net gain from sale of available for sale securities included in income, net of tax of $8, $0, $3	14		5
Cumulative effect of adoption of FASB ASC 320-10-65 relating to impairment of debt securities, net of tax of $0, $0, $(80)			(149)
Other-than-temporary impairment on securities held to maturity, net of tax of $(7), $(8), $(290)	(13)	(14)	(540)
Accretion of other-than-temporary impairment on securities held to maturity, net of tax of $68, $111, $8	125	206	14
Comprehensive income (loss)	$ 7,877	$ 13,964	$ (5)

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, 2011, 2010 and 2009

(Dollars in thousands)

	2011	2010	2009
Cash flows from operating activities:			
Net income	$ 6,518	$ 13,354	$ 581
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	2,185	2,050	1,140
Deferred loan fees, net of amortization	537	(274)	(257)
Provision for loan losses	14,430	11,990	19,390
Net change in accrued interest receivable, prepaid expenses and other assets, accrued expenses and other liabilities			