HERITAGE FINANCIAL CORP /WA/
Form 10-K
March 11, 2014
Table of Contents

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, 2013
OR
.. TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File Number 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 (I.R.S. Employer Identification No.)
201 Fifth Avenue SW, Olympia, WA (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 ý
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 ý
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 ý 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 ý 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 ý 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 ý

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant was $208,300,000 and was based upon the last sales price as quoted on the NASDAQ Stock Market for June 30, 2013.

The registrant had 16,216,367 shares of common stock outstanding as of February 25, 2014.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive Proxy Statement for the 2014 Annual Meeting of Shareholders will be incorporated by reference into Part III of this Form 10-K.

Table of Contents

HERITAGE FINANCIAL CORPORATION
FORM 10-K
December 31, 2013
TABLE OF CONTENTS

Table of Contents

PART 1

ITEM 1. BUSINESS

General

Heritage Financial Corporation (the “Company” or "Heritage") 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 (the "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., at which time Washington State Bank, N.A. was merged into Heritage Bank.

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. In 2013, the Company consolidated three of these branches into existing Heritage Bank branches. Effective November 5, 2010, Heritage Bank entered into a definitive agreement with the FDIC, pursuant to which Heritage Bank acquired certain assets and assumed certain liabilities of Pierce Commercial Bank, a Washington state-chartered commercial bank headquartered in Tacoma, Washington (the “Pierce Commercial Acquisition”). The Pierce Commercial Acquisition included one branch, which opened as a branch of Heritage Bank on November 8, 2010. On September 14, 2012, the Company announced that it had entered into a definitive agreement along with Heritage Bank, to acquire Northwest Commercial Bank (“NCB”), a full service commercial bank headquartered in Lakewood, Washington that operated two branch locations in Washington State (the “NCB Acquisition”). The acquisition of NCB was completed on January 9, 2013, at which time NCB was merged with and into Heritage Bank. The Lakewood branch was subsequently consolidated with an existing Heritage Bank branch in 2013. On March 11, 2013, the Company entered into a definitive agreement to acquire Valley Community Bancshares, Inc. ("Valley" or "Valley Community Bancshares") and its wholly-owned subsidiary, Valley Bank, both headquartered in Puyallup, Washington (the “Valley Acquisition”) and its eight branches. The Valley Acquisition was completed on July 15, 2013. Subsequently, four of these branches were consolidated into existing branches and closed as of December 31, 2013.

On April 8, 2013, the Company announced the proposed merger of its two wholly-owned bank subsidiaries Central Valley Bank and Heritage Bank, with Central Valley Bank merging into Heritage Bank. The common control merger was completed on June 19, 2013. Central Valley Bank now operates as a division of Heritage Bank.

On October 23, 2013, the Company, along with the Bank, and Washington Banking Company (“Washington Banking”) and its wholly owned subsidiary bank, Whidbey Island Bank ("Whidbey"), jointly announced the signing of a merger agreement pursuant to which Heritage and Washington Banking will enter into a strategic merger with Washington Banking merging into Heritage. Immediately following the merger, Whidbey will merge into the Bank. Washington Banking branches will adopt the Heritage Bank name in all markets, with the exception of six branches in Whidbey Island markets which will continue to operate using the Whidbey Island Bank name. The corporate headquarters of the combined company will be in Olympia, Washington. The merger is anticipated to be completed in the second quarter of 2014. For additional information on this proposed merger, see Note 22 of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data."

We are primarily engaged in the business of planning, directing, and coordinating the business activities of our wholly owned subsidiary Heritage Bank. The deposits of the Bank are insured by the FDIC. Heritage Bank is headquartered in Olympia, Washington and conducts business in its thirty-five branch offices located in Washington and the greater

Portland, Oregon area.

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. Historically the Bank would originate for sale purposes first mortgage loans on residential properties but this operation ceased in the second quarter of 2013.

The Company was a participant in the U.S. Department of the Treasury's ("Treasury") Troubled Asset Relief Program ("TARP") Capital Purchase Plan, pursuant to which the Company sold (i) 24,000 shares of the Company's

Table of Contents

Fixed Rate Cumulative Perpetual Preferred Stock, Series A ("Series A Preferred Stock") and (ii) a warrant (the "Warrant") to purchase 276,074 shares of the Company's common stock at $13.04 per share for an aggregate purchase price of $24.0 million in cash. Effective December 22, 2010, the Company redeemed all of the Series A Preferred Stock held by the Treasury. Effective August 17, 2011, the Company repurchased the Warrant and has no other obligations under TARP. For additional information, see Note 17 of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data."

Market Areas

We offer financial services to meet the needs of the communities we serve through our community-oriented financial institutions. Headquartered in Olympia, Thurston County, Washington, we conduct business through Heritage Bank and its thirty-five branch offices located along the I-5 corridor throughout Washington and the greater Portland, Oregon area. We additionally have offices located in eastern Washington primarily in the Yakima county.

Lending Activities

General. Lending activities are conducted through Heritage 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. Commercial and industrial loans, including owner occupied commercial real estate loans, totaled $494.4 million, or 50.6% of total originated loans, as of December 31, 2013, and $465.7 million, or 53.3% of total originated loans, as of December 31, 2012 and non-owner occupied commercial real estate totaled $354.5 million, or 36.3%, as of December 31, 2013 and $265.8 million, or 30.4% of total originated loans, as of December 31, 2012. One-to-four family residential loans totaled $39.2 million, or 4.0% of total originated loans, at December 31, 2013, and $38.8 million, or 4.4% of total originated loans, at December 31, 2012. Real estate construction and land development loans totaled $63.8 million, or 6.5% of total originated loans, at December 31, 2013, and $77.3 million, or 8.8% of total originated loans, at December 31, 2012.

Our loans are originated 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 perform internal loan reviews of our loan portfolio to check for credit quality, proper documentation and compliance with laws and regulations.

Table of Contents

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, 2013		2012		2011		2010		2009	
	Balance	% of Total (4)	Balance	% of Total (4)	Balance	% of Total (4)	Balance	% of Total (4)	Balance	% of Total (4)
	(Dollars in thousands)									
Originated loans:										
Commercial business:										
Commercial and industrial(1)	$494,362	50.6 %	$465,734	53.3 %	$440,471	52.5 %	$392,301	52.8 %	$408,622	52.8 %
Non-owner occupied commercial real estate(1)	354,451	36.3	265,835	30.4	251,049	30.0	221,739	29.9	194,613	25.2
Total commercial business	848,813	86.9	731,569	83.7	691,520	82.5	614,040	82.7	603,235	78.0
One-to-four family residential(2)	39,235	4.0	38,848	4.4	37,960	4.5	47,505	6.5	53,623	7.0
Real estate construction and land development:										
One-to-four family residential	18,593	1.9	25,175	2.9	22,369	2.7	29,377	4.0	46,060	6.0
Five or more family residential and commercial properties	45,184	4.6	52,075	5.9	54,954	6.6	28,588	3.8	49,665	6.4
Total real estate construction and land development(3)	63,777	6.5	77,250	8.8	77,323	9.3	57,965	7.8	95,725	12.4
Consumer	28,130	2.9	28,914	3.3	32,981	3.9	23,832	3.2	21,261	2.8
Gross originated loans	979,955	100.3	876,581	100.2	839,784	100.2	743,342	100.2	773,844	100.2
Less: deferred loan fees	(2,670)	(0.3)	(2,096)	(0.2)	(1,860)	(0.2)	(1,323)	(0.2)	(1,597)	(0.2)
Total originated loans	$977,285	100.0%	$874,485	100.0%	$837,924	100.0%	$742,019	100.0%	$772,247	100.0%

(1) Commercial and industrial loans include owner-occupied commercial real estate

(2) Excludes loans held for sale of $0, $1.7 million, $1.8 million, $764,000 and $825,000 as of December 31, 2013, 2012, 2011, 2010 and 2009, respectively.
(3) Balances are net of undisbursed loan proceeds
(4) Percent of total originated loan balance

Table of Contents

The following table provides information about our purchased covered loan portfolio by type of loan for the years ended December 31, 2013, 2012, 2011 and 2010. There were no purchased covered loans for the year ended December 31, 2009. These balances are the recorded investment balance and are prior to deduction for the allowance for loan losses.

	December 31, 2013			2012			2011			2010		
	Balance	% of Total (3)		Balance	% of Total (3)		Balance	% of Total (3)		Balance	% of Total (3)	
	(Dollars in thousands)											
Purchased covered loans:												
Commercial business:												
Commercial and industrial(1)	$39,056	61.3	%	$60,577	68.6	%	$76,674	70.1	%	$92,265	71.7	%
Non-owner occupied commercial real estate(1)	14,625	22.9		13,028	14.7		15,753	14.4		17,576	13.6	
Total commercial business	53,681	84.2		73,605	83.3		92,427	84.5		109,841	85.3	
One-to-four family residential	4,777	7.5		5,027	5.7		5,197	4.8		6,224	4.8	
Real estate construction and land development:												
One-to-four family residential	1,556	2.4		4,433	5.0		5,786	5.3		5,876	4.6	
Total real estate construction and land development(2)	1,556	2.4		4,433	5.0		5,786	5.3		5,876	4.6	
Consumer	3,740	5.9		5,265	6.0		5,947	5.4		6,774	5.3	
Gross purchased covered loans	$63,754	100.0	%	$88,330	100.0	%	$109,357	100.0	%	$128,715	100.0	%

(1)Commercial and industrial loans include owner-occupied commercial real estate
(2)Balances are net of undisbursed loan proceeds
(3)Percent of total purchased covered loans

Table of Contents

The following table provides information about our purchased non-covered loan portfolio by type of loan for the years ended December 31, 2013, 2012, 2011 and 2010. There were no purchased non-covered loans for the year ended December 31, 2009. These balances are the recorded investment balance and are prior to deduction for the allowance for loan losses.

	December 31, 2013			2012			2011			2010		
	Balance	% of Total (3)		Balance	% of Total (3)		Balance	% of Total (3)		Balance	% of Total (3)	
	(Dollars in thousands)											
Purchased non-covered loans:												
Commercial business:												
Commercial and industrial(1)	$123,487	64.7	%	$37,974	59.2	%	$52,659	59.8	%	$77,815	59.4	%
Non-owner occupied commercial real estate(1)	45,528	23.9		11,019	17.2		12,833	14.5		18,435	14.0	
Total commercial business	169,015	88.6		48,993	76.4		65,492	74.3		96,250	73.4	
One-to-four family residential	3,847	2.0		3,040	4.7		2,743	3.1		4,986	3.8	
Real estate construction and land development:												
One-to-four family residential	1,131	0.6		513	0.8		1,381	1.6		3,816	2.9	
Five or more family residential and commercial properties	3,471	1.8		864	1.4		1,078	1.2		1,244	1.0	
Total real estate construction and land development(2)	4,602	2.4		1,377	2.2		2,459	2.8		5,060	3.9	
Consumer	13,417	7.0		10,713	16.7		17,420	19.8		24,753	18.9	
Gross purchased non-covered loans	$190,881	100.0	%	$64,123	100.0	%	$88,114	100.0	%	$131,049	100.0	%

(1)Commercial and industrial loans include owner-occupied commercial real estate
(2)Balances are net of undisbursed loan proceeds
(3)Percent of total purchased non-covered loans

Table of Contents

The following table presents at December 31, 2013 (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	$141,527	$206,660	$500,626	$848,813
Real estate construction and land development	53,661	5,468	4,648	63,777
Total	$195,188	$212,128	$505,274	$912,590
Fixed rate loans, due after 1 year		$123,266	$160,110	$283,376
Variable or adjustable rate loans, due after 1 year		88,862	345,164	434,026
Total		$212,128	$505,274	$717,402

Commercial Business Lending

We offer different types of commercial business loans, including lines of credit, term equipment financing and term owner-occupied commercial real estate loans. We also originate loans that are guaranteed by the Small Business Administration (“SBA”), for which Heritage Bank is a “preferred lender.” Before extending credit to a business we analyze 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, 2013 we had $848.8 million, or 86.9%, of our total originated loans receivable in commercial business loans with an average loan size of approximately $303,000, excluding zero outstanding balance loans.

We originate commercial real estate loans within our primary market areas with a preference for loans secured by owner-occupied properties. 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 1.15 times for five or more family residential loans and 1.25 times for commercial real estate loans. Cash flow coverage is calculated using an “underwriting” interest rate that is higher than the note rate.

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

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

One-to-Four Family Residential Loans

The majority of our one-to-four family residential loans are secured by single-family residences located in our primary market areas. Our underwriting standards require that one-to-four family residential loans generally are owner-occupied and do not exceed 80% of the lower of appraised value at origination or cost of the underlying collateral. Terms typically range from 15 to 30 years. Until the second quarter of 2013, we sold a significant portion of

our one-to-four family residential loans in the secondary market.
See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations—Asset/Liability Management.”

Real Estate Construction and Land Development

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

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

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

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

Historically, as part of the asset/liability management strategy, we sold a significant portion of our one-to-four family residential loans into the secondary market. We discontinued this strategy in the second quarter of 2013, which also set forth a reduction in mortgage department staffing. Currently, all mortgage loan originations are retained in the Bank's portfolio.

When we sold mortgage loans, we typically sold the servicing of the loans (i.e., collection of principal and interest payments). However, we serviced a minimal $49,000 and $84,000 in mortgage loans for others as of December 31, 2012 and 2011, respectively. We did not service any mortgage loans for others as of December 31, 2013.

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

	Years Ended December 31,				
	2013	2012	2011	2010	2009
	(In thousands)				
One-to-four family residential loans:					
Originated(1)	$18,867	$35,730	$23,865	$18,605	$34,183
Sold	8,460	21,187	15,888	16,187	25,338
Gains on sales of loans, net(2)	142	295	285	226	288

(1) Includes loans originated for our loan portfolio or for sale in the secondary market.

(2) Excludes gains on sales of SBA loans.

Commitments and Contingent Liabilities

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

Table of Contents

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

	December 31, 2013	December 31, 2012
	(In thousands)	
Commercial business:		
Commercial and industrial	$169,079	$126,162
Owner-occupied commercial real estate	2,812	2,151
Non-owner occupied commercial real estate	2,405	7,006
Total commercial business	174,296	135,319
One-to-four family residential	45	—
Real estate construction and land development:		
One-to-four family residential	12,236	4,662
Five or more family residential and commercial properties	20,720	26,301
Total real estate construction and land development	32,956	30,963
Consumer	27,480	34,525
Total outstanding commitments	$234,777	$200,807

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. 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. If the estimated realizable value of the other real estate owned property declines after the acquisition date, the adjustment to the value is charged to other real estate owned expense, net.

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 the Bank periodically evaluates the risks inherent in its loan portfolio. 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

Table of Contents

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 closer monitoring.

The Bank routinely tests its problem loans for potential impairment. A loan is considered impaired when, based on current information and events, it is probable that the Bank 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 Bank's 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.

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.

Table of Contents

	December 31, 2013	2012	2011	2010	2009
	(Dollars in thousands)				
Nonaccrual originated loans:					
Commercial business	$5,524	$5,492	$8,266	$10,667	$9,728
One-to-four family residential	340	389	—	—	—
Real estate construction and land development	1,045	6,420	14,947	15,816	25,108
Consumer	38	157	125	—	—
Total nonaccrual originated loans(1)(2)	6,947	12,458	23,338	26,483	34,836
Noncovered other real estate owned	4,377	5,406	3,710	3,030	704
Total nonperforming originated assets	$11,324	$17,864	$27,048	$29,513	$35,540
Restructured originated performing loans:					
Commercial business	$14,043	$14,237	$12,606	$394	$425
One-to-four family residential	252	422	835	—	—
Real estate construction and land development	6,043	361	364	—	—
Consumer	101	19	—	—	—
Total restructured originated performing loans(3)	$20,439	$15,039	$13,805	$394	$425
Accruing originated loans past due 90 days or more(4)	$6	$214	$1,328	$1,313	$277
Potential problem originated loans(5)	$34,504	$28,270	$29,742	$56,088	$53,086
Allowance for loan losses on originated loans	$17,153	$19,125	$22,317	$22,062	$26,164
Nonperforming originated loans to total originated loans(6)	0.53 %	1.28 %	2.57 %	3.14 %	4.21 %
Allowance for loan losses on originated loans to total originated loans	1.76 %	2.19 %	2.66 %	2.97 %	3.38 %
Allowance for loan losses on originated loans to nonperforming originated loans(6)	329.40 %	170.44 %	103.52 %	94.73 %	79.34 %
Nonperforming originated assets to total originated assets(6)	0.68 %	1.39 %	2.14 %	2.38 %	3.32 %

(1) $2.5 million, $8.6 million, $11.7 million, $8.7 million and $17.0 million of originated nonaccrual loans were considered troubled debt restructures at December 31, 2013, 2012, 2011, 2010 and 2009, respectively.

(2) $1.7 million, $1.2 million, $1.8 million, $3.2 million and $2.3 million of originated nonaccrual loans were guaranteed by government agencies at December 31, 2013, 2012, 2011, 2010 and 2009, respectively.

(3) $1.2 million, $679,000 and $592,000 of originated performing restructured loans were guaranteed by government agencies at December 31, 2013, 2012 and 2011. There were no originated performing restructured loans guaranteed by government agencies at December 31, 2010 and 2009.

(4) There were no accruing originated loans past due 90 days or more that were guaranteed by government agencies at December 31, 2013, 2012, and 2009. There were accruing originated loans past due 90 days or more of $6,000 and $92,000 guaranteed by government agencies at December 31, 2011 and 2010, respectively.

(5) $1.8 million, $3.2 million, $2.8 million, $5.4 million and $7.2 million of originated potential problem loans were guaranteed by government agencies at December 31, 2013, 2012, 2011, 2010 and 2009, respectively.

(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 past due for 90 days or more, is less than fully collateralized, and is not in the process of collection. Payments received on nonaccrual loans generally are applied first to principal and then to interest only after all principal has been collected. Nonaccrual originated loans decreased to $6.9 million, or 0.53% of total originated loans, at December 31, 2013 from $12.5 million, or 1.28% of total originated loans, at December 31, 2012 due to the loan resolution efforts of our credit department. During the year ended December 31, 2013, approximately $3.9 million in principal payments were received on the nonaccrual loans and $2.4 million were transferred back to accrual. We also recorded $1.3 million in net charge-offs of originated nonaccrual loans of which $654,000 related to commercial business and $482,000 related to real estate construction loans. In addition, $663,000 of originated nonaccrual loans were transferred to other real estate owned during the year ended December 31, 2013. This decrease in total nonaccrual originated loans was partially offset by $2.7 million in additions to nonperforming originated loans which were outstanding as of December 31, 2013.

Nonperforming originated assets decreased to $11.3 million, or 0.68% of total originated assets, at December 31, 2013 from $17.9 million, or 1.39% of total originated assets, at December 31, 2012 due to a decrease in nonperforming originated loans discussed above as well as an overall decrease in the other real estate owned, noncovered. The other real estate owned balance decreased due to dispositions of $6.3 million offset partially by additions of $5.3 million ($2.3 million of which were acquired with the NCB Acquisition) during the year ended December 31, 2013.

Originated restructured performing loans as of December 31, 2013 and December 31, 2012 were $20.4 million and $15.0 million, respectively. The $5.4 million increase in originated restructured performing loans was primarily due to the addition of one borrowing relationship totaling $2.5 million at December 31, 2013 which was classified as performing troubled debt restructured during the second quarter of 2013. This relationship includes one-to-four family residential real estate construction and land development loans and the related specific valuation allowance on this relationship was $211,000 at December 31, 2013. The increase in the originated restructured performing loans as of December 31, 2013 was also due to a $2.4 million loan which was on nonaccrual at December 31, 2012 that was upgraded to accrual status during the year ended December 31, 2013 as the borrower continued to show sustainable financial improvement and further loss is not anticipated.

Troubled Debt Restructured Loans. A troubled debt restructured loan (“TDR”) is a restructuring in which the Bank, for economic or legal reasons related to a borrower’s financial difficulties, grants a concession to a borrower that it would not otherwise consider. The majority of the Bank's 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 remainder of the Bank's 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 Bank. 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 ("FASB") Accounting Standards Codification (“ASC”) 310-10-35, whether on accrual or nonaccrual status. At December 31, 2013 and December 31, 2012, the balance of accruing TDRs was $20.4 million and $15.0 million, respectively. The related allowance for loan losses on the accruing TDRs was $2.2 million as of December 31, 2013 and $2.1 million as of December 31, 2012. At December 31, 2013, non-accruing TDRs were $2.5 million and had a related allowance for loan losses of $133,000. At December 31, 2012, non-accruing TDRs of $9.3 million had a related allowance for loan losses of $2.0 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 Bank's policy is that the borrower must demonstrate

Table of Contents

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. Once a loan has been classified as a TDR, it will continue to be disclosed as an impaired loan until paid off or charged-off, even if the loan subsequently is no longer disclosed as a TDR.

Potential Problem Loans. Potential problem loans are those loans that are currently accruing interest and are not considered impaired, but which we are monitoring because the financial information of the borrower causes us concerns as to their ability to comply with their loan repayment terms. Loans that are past due 90 days or more and still accruing interest are both well secured and in the process of collection. Originated potential problem loans increased $6.2 million to $34.5 million at December 31, 2013 from $28.3 million at December 31, 2012.

Analysis of Allowance for Loan Losses

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

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

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

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

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

Table of Contents

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

	Years Ended December 31,				
	2013	2012	2011	2010	2009
	(Dollars in thousands)				
Allowance for loan losses on originated loans at beginning of the year	$19,125	$22,317	$22,062	$26,164	$15,423
Provision for loan losses on originated loans	890	695	5,180	11,990	19,390
Charge-offs:					
Commercial business	(2,985)	(3,702)	(2,690)	(8,106)	(2,668)
One-to-four family residential	—	(349)	(15)	(169)	(189)
Real estate construction and land development	(565)	(1,280)	(2,948)	(8,344)	(5,774)
Consumer	(241)	(293)	(316)	(73)	(192)
Total charge-offs	(3,791)	(5,624)	(5,969)	(16,692)	(8,823)
Recoveries:					
Commercial business	808	1,579	821	243	1
One-to-four family residential	—	—	—	15	1
Real estate construction and land development	32	125	201	285	50
Consumer	89	33	22	57	122
Total recoveries	929	1,737	1,044	600	174
Net charge-offs	(2,862)	(3,887)	(4,925)	(16,092)	(8,649)
Allowance for originated loan losses at end of the year	$17,153	$19,125	$22,317	$22,062	$26,164
Originated loans outstanding at end of the year(1)	$977,285	$874,485	$837,924	$742,019	$772,247
Average originated loans receivable during the year(1)	948,511	855,923	833,441	717,159	787,527
Ratio of net charge-offs during the year to average originated loans receivable	(0.30)%	(0.45)%	(0.59)%	(2.24)%	(1.10)%

(1)Excludes loans held for sale.

Table of Contents

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,														
	2013			2012			2011			2010			2009		
	Allowance for Loan Losses	% of Total (1)		Allowance for Loan Losses	% of Total (1)		Allowance for Loan Losses	% of Total (1)		Allowance for Loan Losses	% of Total (1)		Allowance for Loan Losses	% of Total (1)	
	(Dollars in thousands)														
Commercial business	$13,962	86.6	%	$12,554	83.5	%	$12,888	82.3	%	$14,350	82.5	%	$12,137	77.8	%
One-to-four family residential	564	4.0		637	4.4		416	4.5		500	6.5		550	7.0	
Real estate construction	1,495	6.5		4,316	8.8		7,556	9.3		5,435	7.8		12,892	12.4	
Consumer	531	2.9		748	3.3		547	3.9		846	3.2		361	2.8	
Unallocated	601	—		870	—		910	—		931	—		224	—	
Total allowance for originated loan losses (1)	$17,153	100.0	%	$19,125	100.0	%	$22,317	100.0	%	$22,062	100.0	%	$26,164	100.0	%

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

Investment Activities

At December 31, 2013, our investment securities portfolio totaled $199.3 million, which consisted of $163.1 million of securities available for sale and $36.2 million of securities held to maturity. This compares with a total portfolio of $154.4 million at December 31, 2012, which was comprised of $144.3 million of securities available for sale and $10.1 million of securities held to maturity. The composition of the two investment portfolios by type of security, at each respective date, is presented in Note 4 to the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data."

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 the Bank's lending activities. The policy dictates the criteria for classifying securities as either available for sale or held to maturity. The policy permits investment in various types of liquid assets permissible under applicable regulations, which include U.S. Treasury obligations, U.S. Government agency obligations, some certificates of deposit of insured banks, mortgage backed and mortgage related securities, corporate notes, municipal bonds, and federal funds. Investment in non-investment grade bonds and stripped mortgage backed securities are not permitted under the policy.

Table of Contents

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

	December 31, 2013		December 31, 2012		December 31, 2011	
	Fair Value	% of Total Investments	Fair Value	% of Total Investments	Fair Value	% of Total Investments
	(Dollars in thousands)					
U.S. Treasury and U.S. Government-sponsored agencies	$6,039	3.7 %	$11,035	7.7 %	$31,307	21.7 %
Municipal securities	49,060	30.1	47,360	32.8	33,423	23.1
Corporate securities	—	—	—	—	8,097	5.6
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	108,035	66.2	85,898	59.5	71,775	49.6
Total	$163,134	100.0 %	$144,293	100.0 %	$144,602	100.0 %

The following table provides information regarding our investment securities available for sale, by contractual maturity, at December 31, 2013.

	Less Than One Year		Over One to Five Years		Over Five to Ten Years		Over Ten Years	
	Fair Value	Weighted Average Yield(1)	Fair Value	Weighted Average Yield(1)	Fair Value	Weighted Average Yield(1)	Fair Value	Weighted Average Yield(1)
	(Dollars in thousands)							
U.S. Treasury and U.S. Government-sponsored agencies	$2,025	0.19 %	$2,960	1.04 %	$565	1.92 %	$489	1.25 %
Municipal securities	139	5.57	7,950	3.51	19,094	3.77	21,877	3.21
Mortgage backed securities and collateralized mortgage obligations-residential:								
U.S. Government-sponsored agencies	—	—	1,978	1.73	27,854	2.19	78,203	2.31
Total	$2,164	0.53 %	$12,888	2.63 %	$47,513	2.83 %	$100,569	2.50 %

(1)Taxable equivalent weighted average yield.

Table of Contents

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

	December 31, 2013			December 31, 2012			December 31, 2011		
	Amortized Cost	% of Total Investments		Amortized Cost	% of Total Investments		Amortized Cost	% of Total Investments	
	(Dollars in thousands)								
U.S. Treasury and U.S. Government-sponsored agencies	$1,687	4.7	%	$1,740	17.2	%	$1,799	14.9	%
Municipal securities	24,290	67.2		2,946	29.2		3,566	29.5	
Mortgage backed securities and collateralized mortgage obligations-residential:									
U.S. Government-sponsored agencies	9,129	25.2		4,245	42.0		5,412	44.7	
Private residential collateralized mortgage obligations	1,048	2.9		1,168	11.6		1,316	10.9	
Total	$36,154	100.0	%	$10,099	100.0	%	$12,093	100.0	%

The following table provides information regarding our investment securities held to maturity, by contractual maturity, at December 31, 2013.

	Less Than One Year			Over One to Five Years			Over Five to Ten Years			Over Ten Years		
	Fair Value	Weighted Average Yield(1)		Fair Value	Weighted Average Yield(1)		Fair Value	Weighted Average Yield(1)		Fair Value	Weighted Average Yield(1)	
	(Dollars in thousands)											
U.S. Treasury and U.S. Government-sponsored agencies	$73	4.98	%	$—	—	%	$1,767	3.74	%	$—	—	%
Municipal securities	1,714	1.53		10,707	2.10		9,883	3.53		2,002	3.95	
Mortgage backed securities and collateralized mortgage obligations-residential:												
U.S. Government-sponsored agencies	—	—		47	6.49		3,446	2.99		5,496	2.99	
Private residential collateralized mortgage obligations	—	—		—	—		—	—		1,205	3.42	
Total	$1,787	1.67	%	$10,754	2.20	%	$15,096	3.43	%	$8,703	3.27	%

(1)Taxable equivalent weighted average yield.

The Bank is 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, 2013 the Bank was required to maintain an investment in the stock of FHLB of Seattle of at least $1.3 million and had an investment in FHLB stock carried at a cost basis (par value) of $5.7 million.

Consistent with its accounting policy, the Company evaluated its investment in FHLB of Seattle stock for other-than-temporary impairment. The Company took into consideration that in September 2012, the FHLB of Seattle announced that it had been reclassified as adequately capitalized by its regulator, the Federal Housing Finance Agency("Finance Agency"). Further, during the year ended December 31, 2012, the Finance Agency granted the FHLB of Seattle authority to repurchase up to $25 million of excess capital stock per quarter at par ($100 per share), provided they receive a non-objection for each quarter's repurchase from the Finance Agency. The FHLB of Seattle has been repurchasing stock throughout 2013.

Based on the Company's evaluation of the underlying investment, including the long-term nature of the investment, the liquidity position of the FHLB of Seattle, the actions being taken by the FHLB of Seattle to address its regulatory situation and the Company's intent and ability to hold the investment for a period of time sufficient to recover the par value, the Company did not recognize an other-than-temporary impairment loss on its FHLB of Seattle stock during the years ended December 31, 2013, 2012 and 2011. Despite improvements in the FHLB of Seattle's regulatory situation, any deterioration in the FHLB of Seattle's financial position may result in future impairment losses.

Deposit Activities and Other Sources of Funds

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

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

During the year ended December 31 2013, non-maturity deposits (total deposits less certificate of deposit accounts) increased by $260.7 million, or 31.4%, to $1.09 billion. The increase was primarily a result of the non-maturity deposits acquired in the Northwest and Valley Acquisitions. The percentage of non-maturity deposits to total deposits increased to 77.9% at December 31, 2013 compared to 74.2% at December 3, 2012. As a result of this increase, the certificate of deposit accounts to total deposits decreased to 22.1% at December 31, 2013 from 25.8% at December 31, 2012.

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

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

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

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

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

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

Table of Contents

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

	December 31, 2013		December 31, 2012		December 31, 2011	
	Amount	Percent	Amount	Percent	Amount	Percent
	(Dollars in thousands)					
Noninterest demand deposits	$349,902	25.0 %	$247,048	22.1 %	$230,993	20.4 %
NOW accounts	352,051	25.2	303,487	27.2	304,818	26.8
Money market accounts	232,016	16.6	157,728	14.1	166,913	14.7
Savings accounts	155,790	11.1	120,781	10.8	103,716	9.1
Total non-maturity deposits	1,089,759	77.9	829,044	74.2	806,440	71.0
CDs	309,430	22.1	288,927	25.8	329,604	29.0
Total deposits	$1,399,189	100.0 %	$1,117,971	100.0 %	$1,136,044	100.0 %

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

	Years Ended December 31,					
	2013		2012		2011	
	Average Balance	Average Yield/Rate	Average Balance	Average Yield/Rate	Average Balance	Average Yield/Rate
	(Dollars in thousands)					
NOW accounts and money market accounts	$541,793	0.19 %	$466,268	0.27 %	$453,509	0.41 %
Savings accounts	143,412	0.11	113,119	0.18	103,170	0.35
CDs	307,464	0.81	306,772	0.98	355,167	1.20
Total interest bearing deposits	992,669	0.37	886,159	0.50	911,846	0.71
Noninterest demand deposits	308,582	—	237,888	—	205,862	—
Total deposits	$1,301,251	0.28 %	$1,124,047	0.40 %	$1,117,708	0.58 %

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

	December 31, 2013
	(In thousands)
Remaining maturity:	
Three months or less	$44,895
Over three months through twelve months	78,144
Over twelve months through three years	37,040
Over three years	11,237
Total	$171,316

Borrowings. Deposits are the primary source of funds for our lending and investment activities and our general business purposes. We rely upon advances from the FHLB to supplement our supply of lendable funds and meet deposit withdrawal requirements. The FHLB of Seattle serves as one of our secondary sources of liquidity. Advances from the FHLB of Seattle are typically secured by our first lien single family mortgage loans, commercial real estate loans and stock issued by the FHLB, which is owned by us. At December 31, 2013, the Bank maintained an uncommitted credit facility with the FHLB of Seattle of $283.6 million and an uncommitted credit facility with the Federal Reserve Bank of San Francisco of $56.7 million, of which there were no advances or borrowings outstanding. The Bank also maintains advance lines with Zions Bank, Wells Fargo Bank, US Bank and Pacific Coast Bankers' Bank to purchase federal funds of up to $50.0 million as of December 31, 2013. At December 31, 2013 we had securities sold under agreement to repurchase of $29.4 million which were secured by available for sale investment securities.

The FHLB functions provide credit for member financial institutions. As a member, 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 the Bank's assets.

There were no FHLB advances or federal funds purchased for the years ended December 31, 2013, 2012 or 2011.

Supervision and Regulation

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

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

Heritage Financial. As a bank holding company registered with the Board of Governors of the Federal Reserve System ("Federal Reserve"), we are subject to regulation and supervision under the Bank Holding Company Act of 1956, as amended. This regulation and supervision is generally intended to ensure that we limit our activities to those allowed by law and that we operate in a safe and sound manner without endangering the financial health of Heritage Bank. As a bank holding company supervised by the Federal Reserve, 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 assess us for the cost of such examination.

The Federal Reserve has extensive enforcement authority over bank holding companies, including the ability to assess civil money penalties and to issue cease and desist or removal orders. The Federal Reserve may also 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.

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 is generally 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 codified the source of strength policy and requires the issuance of implementing regulations. Under the prompt corrective action provisions of the Federal Deposit Insurance Act, a bank holding company parent of an undercapitalized subsidiary bank must guarantee, within limitations, the capital restoration plan that is required to be implemented of an undercapitalized subsidiary bank. If an undercapitalized subsidiary bank fails to file an acceptable capital restoration plan or fails to implement an accepted plan the Federal Reserve may prohibit the bank holding company parent or the undercapitalized subsidiary bank from paying any dividend or making any other form of capital distribution without the prior approval of the Federal Reserve. In addition, the Federal Reserve policy is that a bank holding company should pay cash dividends only to the extent that the company's net income for the past year is consistent with the company's capital needs, asset quality and

overall condition.
We, and any subsidiaries which we may control, are considered “affiliates” within the meaning of the Federal Reserve Act, and transactions between our bank subsidiary 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 4%. 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 available for sale), 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. In July 2013, the Federal Reserve and the FDIC approved a new rule that will substantially amend the regulatory risk-based capital rules to implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act.

For additional information, see “—Capital Adequacy” below.

Subsidiary Bank. Heritage Bank is a Washington-chartered commercial bank, the deposits of which are insured by the FDIC. Heritage Bank is 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 Bank is required to file periodic reports with the FDIC and the Division, and is 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 Bank provide substantially all of our cash flow. Applicable Federal and Washington State regulations restrict capital distributions by our Bank, including dividends. Such restrictions are tied to the institution’s capital levels after giving effect to such distributions. For an additional discussion of restrictions on the payment of dividends, see Part II of “Item 5. Market for the Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities” herein.

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 available for sale), 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, 2013 were 4% and 8%, respectively. At December 31, 2013, we had consolidated Tier 1 risk-based capital and total risk-based capital of 15.5% and 16.8%, 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, 2013, we had a consolidated leverage ratio of 11.3%.

In July 2013, the Federal banking regulators approved a final rule to implement the revised capital adequacy standards of the Basel Committee on Banking Supervision, commonly called Basel III, and to address relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). The final rule strengthens the definition of regulatory capital, increases risk-based capital requirements, makes selected changes to the calculation of risk-weighted assets, and adjusts the prompt corrective action thresholds. Community

Table of Contents

banking organizations, such as the Company and the Bank, become subject to the new rule on January 1, 2015 and certain provisions of the new rule will be phased in over the period of 2015 through 2019. The final rule:

- Permits banking organizations that had less than $15 billion in total consolidated assets as of December 31, 2009, or were mutual holding companies as of May 19, 2010, to include in Tier 1 capital trust preferred securities and cumulative perpetual preferred stock that were issued and included in Tier 1 capital prior to May 19, 2010, subject to a limit of 25% of Tier 1 capital elements, excluding any non-qualifying capital instruments and after all regulatory capital deductions and adjustments have been applied to Tier 1 capital.
- Establishes new qualifying criteria for regulatory capital, including new limitations on the inclusion of deferred tax assets and mortgage servicing rights.
- Requires a minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5%.
- Increases the minimum Tier 1 capital to risk-weighted assets ratio requirement from 4% to 6%.
- Retains the minimum total capital to risk-weighted assets ratio requirement of 8%.
- Establishes a minimum leverage ratio requirement of 4%.
- Retains the existing regulatory capital framework for 1-4 family residential mortgage exposures.
- Permits banking organizations that are not subject to the advanced approaches rule, such as the Company and the Bank, to retain, through a one-time election, the existing treatment for most accumulated other comprehensive income, such that unrealized gains and losses on securities available for sale will not affect regulatory capital amounts and ratios.
- Implements a new capital conservation buffer requirement for a banking organization to maintain a common equity capital ratio more than 2.5% above the minimum common equity Tier 1 capital, Tier 1 capital and total risk-based capital ratios in order to avoid limitations on capital distributions, including dividend payments, and certain discretionary bonus payments. The capital conservation buffer requirement will be phased in beginning on January 1, 2016 at 0.625% and will be fully phased in at 2.50% by January 1, 2019. A banking organization with a buffer of less than the required amount would be subject to increasingly stringent limitations on such distributions and payments as the buffer approaches zero. The new rule also generally prohibits a banking organization from making such distributions or payments during any quarter if its eligible retained income is negative and its capital conservation buffer ratio was 2.5% or less at the end of the previous quarter. The eligible retained income of a banking organization is defined as its net income for the four calendar quarters preceding the current calendar quarter, based on the organization’s quarterly regulatory reports, net of any distributions and associated tax effects not already reflected in net income.
- Increases capital requirements for past-due loans, high volatility commercial real estate exposures, and certain short-term commitments and securitization exposures.
- Expands the recognition of collateral and guarantors in determining risk-weighted assets.
- Removes references to credit ratings consistent with the Dodd-Frank Act and establishes due diligence requirements for securitization exposures.

The FDIC may impose additional restrictions on institutions that are undercapitalized and generally is authorized to reclassify an institution into a lower capital category and impose the restrictions applicable to such category if the institution is engaged in unsafe or unsound practices or is in an unsafe or unsound condition. An institution is deemed “well capitalized” if it has at least a 5.0% Tier 1 capital ratio, a 6.0% Tier 1 risk-based capital ratio and 10.0% total risk-based capital ratio. At December 31, 2013, the Bank was considered a “well capitalized” institution. For a complete description of the Company’s and the Bank's required and actual capital levels as of December 31, 2013, see Note 19 of the Notes to Consolidated Financial Statements included in “Item 8. Financial Statements and Supplementary Data.”

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

Undercapitalized institutions are subject to certain prompt corrective action requirements, regulatory controls and restrictions which become more extensive as an institution becomes more severely undercapitalized. Failure by Heritage 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, 2013, the Bank 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.

The recently adopted final rule to strengthen regulatory capital standards will adjust the prompt corrective action categories accordingly.

Deposit Insurance and Other FDIC Programs. The deposits of the Bank 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 Bank's deposits, the FDIC has supervisory and enforcement authority over Heritage 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.

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

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

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

The Dodd-Frank Act: The Dodd-Frank-Act imposes new restrictions and an expanded framework of regulatory oversight for financial institutions, including depository institutions and implements new capital regulations that we will become subject to and that are discussed above under “- Capital Adequacy.”

In addition, among other changes, the Dodd-Frank Act requires public companies, like us, to (i) provide their shareholders with a non-binding vote (a) at least once every three years on the compensation paid to executive officers and (b) at least once every six years on whether they should have a “say on pay” vote every one, two or three years; (ii) have a separate, non-binding shareholder vote regarding golden parachutes for named executive officers when a shareholder vote takes place on mergers, acquisitions, dispositions or other transactions that would trigger the parachute payments; (iii) provide disclosure in annual proxy materials concerning the relationship between the executive compensation paid and the financial performance of the issuer; and (iv) amend Item 402 of Regulation S-K to require

Table of Contents

companies to disclose the ratio of the Chief Executive Officer's annual total compensation to the median annual total compensation of all other employees. For certain of these changes, the implementing regulations have not been promulgated, so the full impact of the Dodd-Frank Act on public companies cannot be determined at this time.

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 Bank's 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.

Table of Contents

Employees

We had 373 full-time equivalent employees at December 31, 2013. We believe that employees play a vital role in the success of a service company. Employees are provided with a variety of benefits such as medical, vision, dental and life insurance, a retirement plan, and paid vacations and sick leave. None of our employees are covered by a collective bargaining agreement.

Executive Officers

The following table sets forth certain information with respect to the executive officers of the Company at December 31, 2013.

Name	Age as of December 31, 2013	Position	Has Served the Company or Heritage Bank Since
Brian L. Vance	59	President and Chief Executive Officer of Heritage; Chief Executive Officer of Heritage Bank	1996
Jeffrey J. Deuel	55	Executive Vice President, Heritage; President and Chief Operating Officer of Heritage Bank	2010
Donald J. Hinson	52	Executive Vice President and Chief Financial Officer of Heritage and Heritage Bank	2005
D. Michael Broadhead	68	President of Central Valley Bank, a division of Heritage Bank	1986
David A. Spurling	60	Senior Vice President and Chief Credit Officer of Heritage Bank	1999

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

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

Jeffrey J. Deuel was promoted to President and Chief Operating Officer of Heritage Bank and Executive Vice President of Heritage in September 2012. 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 joined Heritage Bank in February 2010 as Executive Vice President. 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. He earned his Bachelor’s degree at Gettysburg College.

Donald J. Hinson became Executive Vice President and Chief Financial Officer of Heritage Bank in September 2012. In 2007 Mr. Hinson was appointed the Senior Vice President and Chief Financial Officer of Heritage and Heritage Bank. Mr. Hinson joined Heritage Bank in 2005 as Vice President and Controller. Prior to that, he served in the banking audit practice of local and national accounting firms of Knight, Vale and Gregory and RSM McGladrey from 1994 to 2005. Mr. Hinson holds a Bachelors of Science degree in Accounting from Central Washington University and is a licensed Certified Public Accountant.

D. Michael Broadhead has served as the President of Central Valley Bank since 1990 and in June 2013, Central Valley Bank merged into Heritage Bank but continues to operate as a division of Heritage Bank. The Company acquired Central Valley Bank in March 1999, and Mr. Broadhead had been with the bank since 1986. Previously, Mr. Broadhead held positions with Farmers Home Administration and First Bank and Trust of Idaho where he held the position of Chief Executive Officer.

Table of Contents

David A. Spurling became Executive Vice President and Chief Credit Officer of Heritage Bank in January 2014. Prior to that, he was the Senior Vice President and Chief Credit Officer of Heritage Bank beginning in 2007. Mr. Spurling joined Heritage Bank in 2001 as a commercial lender, followed by a role as a commercial team leader. He began his banking career as a middle market lender at Seafirst Bank, followed by positions as a commercial lender at Bank of America in Small Business Banking and as a regional manager for Bank of America's government-guaranteed lending division. Mr. Spurling holds a Master's Degree in Business Administration from the University of Washington and is Credit Risk Certified by the Risk Management Association.

ITEM 1A. RISK FACTORS

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

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

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

- we may be exposed to potential asset quality issues or unknown or contingent liabilities of the banks, businesses, assets and liabilities we acquire. If these issues or liabilities exceed our estimates, our results of operations and financial condition may be materially negatively affected;
- prices at which acquisitions can be made fluctuate with market conditions. We have experienced times during which acquisitions could not be made in specific markets at prices we considered acceptable and expect that we may continue to experience this condition in the future;
- the acquisition of other entities generally requires integration of systems, procedures and personnel of the acquired entity into our company to make the transaction economically successful. This integration process is complicated and time consuming and can also be disruptive to the customers of the acquired business. If the integration process is not conducted successfully and with minimal effect on the acquired business and its customers, we may not realize the anticipated economic benefits of an acquisition within the expected time frame, and we may lose customers or employees of the acquired business. We may also experience greater than anticipated customer losses even if the integration process is successful. These risks are present in our completed FDIC-assisted transactions involving our assumption of deposits and the acquisition of assets of Cowlitz Bank (the "Cowlitz Acquisition") and Pierce Commercial Bank (the "Pierce Commercial Acquisition"), and together with the Cowlitz Acquisition, the "Cowlitz and Pierce Commercial Acquisitions" in 2010 and in the recently completed open-bank acquisitions of Northwest Commercial Bank and Valley Community Bancshares on January 9, 2013 and July 15, 2013, respectively. This risk is also present in the pending merger with Washington Banking Company;
- to finance an acquisition, we may borrow funds, thereby increasing our leverage and diminishing our liquidity, or raise additional capital, which could dilute the interests of our existing shareholders.
- we completed two acquisitions during 2010 and two acquisitions during 2013 that enhanced our rate of growth. We also announced the merger of Washington Banking Company and its subsidiary, Whidbey Island Bank, in October 2013, which is currently expected to be completed in the second quarter of 2014. We may not be able to continue to sustain our past rate of growth or to grow at all in the future;
- we expect our net income will increase following our acquisitions, however, we also expect our general and administrative expenses and consequently our efficiency ratios will also increase. Ultimately, we would expect our efficiency ratio to improve; however, if we are not successful in our integration process, this may not occur, and our acquisitions or branching activities may not be accretive to earnings in the short or long-term; and
- the purchase and assumption agreement and the shared-loss agreements we entered into with the FDIC in connection with the Cowlitz and Pierce Commercial Acquisitions, have specific, detailed and cumbersome compliance, servicing,

notification and reporting requirements. Our failure to comply with the terms of the agreements or to properly service the loans and real estate owned under the

27

Table of Contents

requirements of the shared-loss agreements may cause individual loans or large pools of loans to lose eligibility for loss share payments from the FDIC. This could result in material losses that are currently not anticipated.

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

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

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

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

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

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

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

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

Table of Contents

We operate in a highly regulated environment and may be adversely affected by changes in federal and state laws and regulations.

We are subject to extensive examination, supervision and comprehensive regulation by the Federal Reserve and Heritage Bank is subject to examination, supervision and comprehensive regulation by the FDIC and the Division. The Federal Reserve, FDIC and Division govern the activities in which we may engage, primarily for the protection of depositors and the Deposit Insurance Fund. These regulatory authorities have extensive discretion in connection with their supervisory and enforcement activities, including the requirement for additional capital, the imposition of restrictions on an institution’s operations, the reclassification of assets and the adequacy of an institution’s allowance for loan losses, the determination of the level of deposit insurance premiums assessed and the approval of merger transactions.

The potential exists for additional Federal or state laws and regulations regarding capital requirements, lending and funding practices and liquidity standards, and bank regulatory agencies are expected to remain active in responding to concerns and trends identified in examinations, including the potential issuance of formal enforcement orders. Actions taken to date, as well as potential actions, may not have the beneficial effects that are intended. In addition, new laws, regulations, and other regulatory changes could increase our costs of regulatory compliance and of doing business, and otherwise affect our operations. New laws, regulations, and other regulatory changes, along with negative developments in the financial industry and the domestic and international credit markets, may significantly affect the markets in which we do business, the markets for and value of our loans and investments, and our on-going operations, costs and profitability.

The Dodd-Frank Act, among other things, created a new CFPB, tightened capital standards and will continue to result in new laws and regulations that are expected to increase our costs of operations.

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

The Dodd-Frank Act created a new Consumer Financial Protection Bureau (“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 such as Heritage Bank with $10 billion or less in assets will continue to be examined for compliance with the consumer laws by their primary bank regulators.

Effective July 21, 2011, the Dodd-Frank Act eliminated the federal prohibitions on paying interest on demand deposits, thus allowing businesses to have interest bearing checking accounts, which could result in an increase in our interest expense.

The Dodd-Frank Act also broadens the base for FDIC insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution. The Dodd-Frank Act also permanently increased the maximum amount of deposit insurance for banks, savings institutions and credit unions to $250,000 per depositor retroactive to January 1, 2009, and non-interest bearing transaction accounts had unlimited deposit insurance through December 31, 2012. The legislation also increases the required minimum reserve ratio for the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits, and directs the FDIC to offset the effects of increased assessments on depository institutions with less than $10 billion in assets.

The Dodd-Frank Act requires publicly traded companies to give stockholders a non-binding vote on executive compensation and so-called “golden parachute” payments and authorizes the SEC to promulgate rules that would allow stockholders to nominate their own candidate using a company’s proxy materials. It also provides that the listing standards of the national securities exchanges shall require listed companies to implement and disclose “clawback” policies mandating the recovery of incentive compensation paid to executive officers in connection with accounting restatements. The legislation also directs the Federal Reserve to promulgate rules prohibiting excessive compensation paid to bank holding company executives, regardless of whether the company is publicly traded.

Effective December 10, 2013, pursuant to the Dodd-Frank Act, federal banking and securities regulators issued final rules to implement Section 619 of the Dodd-Frank Act (the “Volcker Rule”). Generally, subject to a transition period and certain exceptions, the Volcker Rule restricts insured depository institutions and their affiliated companies from engaging in short-term proprietary trading of certain securities, investing in funds with collateral comprised of less than

29

Table of Contents

100% loans that are not registered with the SEC and from engaging in hedging activities that do not hedge a specific identified risk. After the transition period, the Volcker Rule prohibitions and restrictions will apply to banking entities, including the Company, unless an exception applies. We are analyzing the impact of the Volcker Rule on our investment portfolio and we anticipate changes to our investment strategies, which could negatively affect our earnings.

The full impact of the Dodd-Frank Act on our business and operations may not be known for years until final regulations implementing the statute are adopted. The Dodd-Frank Act may have a material impact on our operations, particularly through increased regulatory burden and compliance costs. Any future legislative changes could have a material impact on our profitability, the value of assets held for investment or the value of collateral for loans. Future legislative changes could also require changes to business practices or force us to discontinue businesses and potentially expose us to additional costs, liabilities, enforcement action and reputational risk.

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

In July 2013, the FDIC and the Federal Reserve Board approved a new rule that will substantially amend the regulatory risk-based capital rules applicable to the Company and the Bank. The final rule implements the “Basel III” regulatory capital reforms and changes required by the Dodd-Frank Act.

The final rule includes new capital requirements under regulations adopted by the federal banking regulators to implement the Basel III regulatory capital reform and changes required by the Dodd-Frank Act. These new requirements are effective for the Company and the Bank on January 1, 2015 and establish the following minimum capital ratios: (1) a common equity Tier 1 (“CET1”) capital ratio of 4.5% of risk-weighted assets; (2) a Tier 1 capital ratio of 6.0% of risk-weighted assets; (3) a total capital ratio of 8.0% of risk-weighted assets; and (4) a leverage ratio of 4.0%. In addition, there is a new requirement to maintain a capital conservation buffer, comprised of CET1 capital, in an amount greater than 2.5% of risk-weighted assets over the minimum capital required by each of the minimum risk-based capital ratios in order to avoid limitations on the organization’s ability to pay dividends, repurchase shares or pay discretionary bonuses. The capital conservation buffer requirement will be phased in, beginning January 1, 2016, requiring during 2016 a buffer amount greater than 0.625% in order to avoid these limitations, and increasing the amount each year until beginning January 1, 2019, the buffer amount must be greater than 2.5% in order to avoid the limitation.

The new regulations also change what qualifies as capital for purposes of meeting these various capital requirements, as well as the risk-weights of certain assets for purposes of the risk-based capital ratios. Under the new regulations, in order to be considered well-capitalized for prompt corrective action purposes, Heritage Bank will be required to maintain the following ratios: (1) a CET1 ratio of at least 6.5% of risk-weighted assets; (2) a Tier 1 capital ratio of at least 8.0% of risk-weighted assets; (3) a total capital ratio of at least 10.0% of risk-weighted assets; and (4) a leverage ratio of at least 5.0%.

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

New regulations could restrict our ability to originate and sell mortgage loans.

The CFPB has issued a rule designed to clarify for lenders how they can avoid monetary damages under the Dodd-Frank Act, which would hold lenders accountable for ensuring a borrower’s ability to repay a mortgage. Loans that meet this “qualified mortgage” definition will be presumed to have complied with the new ability-to-repay standard. Under the CFPB’s rule, a “qualified mortgage” loan must not contain certain specified features, including:

- excessive upfront points and fees (those exceeding 3% of the total loan amount, less “bona fide discount points” for prime loans);
- interest-only payments;
- Negative-amortization; and
- terms longer than 30 years.

Also, to qualify as a “qualified mortgage,” a borrower’s total debt-to-income ratio may not exceed 43%. Lenders must also verify and document the income and financial resources relied upon to qualify the borrower for the loan and underwrite the loan based on a fully amortizing payment schedule and maximum interest rate during the first five years, taking into account all applicable taxes, insurance and assessments. The CFPB’s rule on qualified mortgages could limit our ability or desire to make certain types of loans or loans to certain borrowers, or could make it more expensive/and or time consuming to make these loans, which could limit our growth or profitability.

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

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

At December 31, 2013, 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 $848.8 million, or approximately 86.9% of our total originated loan portfolio. Approximately $5.5 million, or 0.7%, of our total originated commercial business loans were nonperforming at December 31, 2013. The majority of the nonperforming commercial business loans were commercial and industrial loans.

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

Commercial and five or more family residential real estate loans also expose us to greater credit risk than loans secured by residential real estate because the collateral securing these loans typically cannot be sold as easily as residential real estate. In addition, many of our commercial and five or more family residential real estate loans are not fully amortizing and contain large balloon payments upon maturity. Such balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default

or non-payment. If we foreclose on a commercial and five or more family residential real estate loan, our holding period for the collateral typically is longer than for one-to-four family residential mortgage loans because there are fewer potential purchasers of the collateral. Additionally, commercial and five or more family residential real estate loans generally have relatively large balances to single borrowers or related groups of borrowers. Accordingly, if we make any errors in judgment in the collectability of our commercial and five or more family residential real estate loans, any resulting charge-offs may be larger on a per loan basis than those incurred with our residential or consumer loan portfolios.
As of December 31, 2013, our non-owner occupied commercial real estate loans totaled $354.5 million, or 36.3% of our total originated loan portfolio.

Table of Contents

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

As of December 31, 2013, our originated real estate construction and land development loans totaled $63.8 million, or 6.5% of our total originated loan portfolio. Of these loans, $18.6 million, or 1.9% of our total originated loan portfolio, were one-to-four family residential construction related and $45.2 million, or 4.6% of our total originated loan portfolio, were five-or-more family residential and commercial construction related. Approximately $1.0 million, or 1.6%, of our total originated construction loans were nonperforming at December 31, 2013.

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

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

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

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

- our general reserve, based on our historical default and loss experience;
- our specific reserve, based on our evaluation of nonperforming loans and their underlying collateral or discounted cash flows; and
- current macroeconomic factors and management's expectation of future events.

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

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

For the year ended December 31, 2013 we recorded a total provision for loan losses of $3.7 million compared to $2.0 million for the year ended December 31, 2012. The provision related to the originated portfolio was $890,000 and $695,000 for the years ended December 31, 2013 and 2012, respectively. Our provision for loan losses on purchased loans was $2.8 million and $1.3 million for the years ended December 31, 2013 and 2012, respectively. We recorded net loan charge-offs of $3.4 million for the year ended December 31, 2013 compared to $4.3 million for the year ended December 31, 2012. The net charge-offs related to the originated portfolio was $2.9 million and $3.9 million for the years ended December 31, 2013 and 2012, respectively. Recently, we have been experiencing decreasing loan delinquencies and decreasing loan charge-offs. Generally, our nonperforming loans and assets reflect operating

Table of Contents

difficulties of individual borrowers resulting from weakness in the local economy. The deterioration in the general economy has been a significant contributing factor to our current level of delinquencies and nonperforming loans. The economy has significantly impacted our commercial and industrial loan portfolio, which represented 64.7% of our nonaccrual originated loans at December 31, 2013. 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 15.0% of our nonperforming originated loans at December 31, 2013. At December 31, 2013 our total nonperforming originated loans were $6.9 million, or 0.53% of total originated loans, compared to $12.5 million or 1.28% of total originated loans at December 31, 2012. If economic conditions deteriorate, we expect that we could experience significantly higher delinquencies and loan charge-offs. As a result, we may be required to make further increases in our provision for loan losses in the future, which could adversely affect our financial condition and results of operations, perhaps materially.

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

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

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

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

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

Accounting standards require that we account for acquisitions using the purchase method of accounting. Under purchase accounting, if the purchase price of an acquired company exceeds the fair value of its net assets, the excess is carried on the acquirer's balance sheet as goodwill. In accordance with generally accepted accounting principles, our goodwill is evaluated for impairment on an annual basis or more frequently if events or circumstances indicate that a potential impairment exists. Such evaluation is based on a variety of factors, including the quoted price of our common stock, market prices of common stock of other banking organizations, common stock trading multiples, discounted cash flows, and data from comparable acquisitions. At December 31, 2013, we had goodwill with a carrying amount of $29.4 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.
Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on our results of operations, any substantial, unexpected or prolonged change in market interest rates could have a material adverse effect on our financial condition and results

of operations. Also, our interest rate risk modeling techniques and assumptions likely may not fully predict or capture the impact of actual interest rate changes on our balance sheet.

Historically low interest rates may adversely affect our net interest income and profitability.

During the past four years it has been the policy of the Federal Reserve Board to maintain interest rates at historically low levels through its targeted federal funds rate and the purchase of mortgage-backed securities. As a result, market rates on the loans we have originated and the yields on securities we have purchased have been at lower levels than available prior to 2008. As a general matter, our interest-bearing liabilities reprice or mature more quickly than our interest-earning assets, which has been one factor contributing to the increase in our interest rate spread as interest rates decreased. However, our ability to lower our interest expense will be limited at these interest rate levels while the average yield on our interest-earning assets may continue to decrease. The Federal Reserve Board has recently indicated its intention to maintain low interest rates through at least late 2014. Accordingly, our net interest income may be adversely affected and may decrease, which may have an adverse effect on 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 are able to raise capital it may not be on terms that are acceptable to us. If we cannot raise additional capital when needed, our ability to further expand our operations through internal growth and acquisitions could be materially impaired and our financial condition and liquidity could be materially and adversely affected. Accordingly, we cannot make assurances that we will be able to raise additional capital when needed.

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

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

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

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, 2013, we owned $5.7 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 pursuant to applicable accounting standards. In December 2008, the FHLB 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, on October 25, 2010, the FHLB received a consent order from the FHFA, which it has been operating under since that time. In September 2012, the FHLB of Seattle announced that its financial condition had improved and that the FHFA had authorized the FHLB Seattle to repurchase up to $25 million of excess capital stock per quarter at par ($100 per share) as long as its financial condition does not deteriorate. After receiving FHFA approval, the FHLB of Seattle repurchased $24.1 million in excess capital stock in late September 2012. In July 2013 the FHLB announced that, based on its second quarter 2013 financial results, their Board of Directors had declared a $0.025 per share cash dividend. This represented the first dividend in a number of years and represents a significant milestone in FHLB's return to normal operations. Subsequently, the FHLB declared an additional dividend of $0.025 per share based on its third quarter 2013 financial results. In addition, the FHLB of Seattle repurchased $74.0 million in excess capital stock from January 1, 2013 to September 30, 2013. As a result of the FHLB of Seattle's improved financial condition, we have not recorded an impairment on our investment in FHLB stock. Further deterioration in the FHLB's financial position may, however, result in future impairment in the value of those securities. We will continue to monitor the financial condition of the FHLB as it relates to, among other things, the recoverability of our investment.

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

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

We rely heavily on the proper functioning of our technology.

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

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

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

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

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

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

ITEM 1B. UNRESOLVED STAFF COMMENTS

The Company has no unresolved staff comments from the Securities and Exchange Commission ("SEC") as it relates to the Company's financial information as reported on Form 10-K.

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. The Company's branch network at December 31, 2013 is comprised of 35 branches located throughout Washington and Oregon counties. The number of branches per county, as well as occupancy type, is detailed in the following table.

		Occupancy Type	
County	Number of Branches	Owned	Leased
Pierce	13	8	5
King	6	2	4
Thurston	5	5	—
Yakima	5	5	—
Cowlitz	2	2	—
Clark	1	—	1
Multnomah	1	—	1
Mason	1	1	—
Kittitas	1	1	—
Total	35	24	11

One Thurston County branch and the one Kittitas County branch have land leases, which are not included in the leased section above as the building is owned.

For additional information concerning our premises and equipment and lease obligations, see Notes 9 and 20, respectively, to the Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data."

ITEM 3. LEGAL PROCEEDINGS

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

Washington Banking, its directors and Heritage are named as defendants in two lawsuits pending in the Superior Court for the State of Washington in King County, Washington, which have been consolidated under the caption In Re Washington Banking Company Shareholder Litigation, Lead Case No. 13-2-38689-5 SEA. The consolidated litigation generally alleges that Washington Banking’s directors breached their fiduciary duties to Washington Banking and its shareholders by agreeing to the proposed merger at an unfair price and without an adequate sales process, because they have interests in the merger different from shareholders and by agreeing to deal protection provisions in the merger agreement that are alleged to prevent bids by third parties. The consolidated litigation also alleges that the disclosures in connection with the merger are misleading in various respects. Heritage is alleged to have aided and abetted the directors' alleged breaches of their fiduciary duties. The consolidated litigation

Table of Contents

seeks, among other things, an order enjoining the defendants from consummating the proposed merger, as well as attorneys' and experts' fees and certain other damages.
Heritage believes that the aiding and abetting claim against it lacks merit. Washington Banking and its directors and Heritage separately filed motions to dismiss the claims against them.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

Table of Contents

PART II

ITEM 5. MARKET FOR THE REGISTRANTS 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, 2013, we had approximately 1,302 shareholders of record (not including the number of persons or entities holding stock in nominee or street name through various brokerage firms) and 16,210,747 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 25, 2014 was $17.50 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.

	2013 Quarter ended,			
	March 31	June 30	September 30	December 31
High	$15.22	$14.65	$16.45	$17.48
Low	$13.84	$13.25	$14.75	$15.01

For the interim period subsequent to the 2013 fiscal year through the last reported sales price on February 25, 2014, the high and low sales information price per share of our common stock as reported on the NASDAQ Global Selected Market was $18.48 and $16.18, respectively.

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

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

The dividend activities for the years ended December 31, 2013 and 2012 and subsequent through the date of this filing are listed below:

Declared	Cash Dividend per Share	Record Date	Paid
February 1, 2012	$0.06	February 10, 2012	February 24, 2012
April 26, 2012	$0.08	May 10, 2012	May 24, 2012
June 26, 2012	$0.20	July 10, 2012	July 24, 2012
July 25, 2012	$0.08	August 14, 2012	August 24, 2012
October 30, 2012	$0.08	November 9, 2012	November 21, 2012
November 30, 2012	$0.30	November 26, 2012	December 6, 2012
January 30, 2013	$0.08	February 8, 2013	February 22, 2013
April 24, 2013	$0.08	May 10, 2013	May 24, 2013
July 23, 2013	$0.18	August 6, 2013	August 15, 2013
October 23, 2013	$0.08	November 5, 2013	November 15, 2013
January 29, 2014	$0.08	February 10, 2014	February 24, 2014

The primary source for dividends paid to our shareholders is dividends paid to us from Heritage Bank. There are regulatory restrictions on the ability of our subsidiary bank to pay dividends. Under federal regulations, the dollar amount of dividends the bank may pay depends upon its 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.

Table of Contents

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

The Company has had various stock repurchase programs since March 1999. On August 30, 2012, the Board of Directors approved the Company's tenth stock repurchase plan, authorizing the repurchase of up to 5% of the Company's outstanding shares of common stock, or approximately 757,000 shares. There is no time limit on the tenth plan. On August 30, 2011, the Board of Directors approved the Company's ninth stock repurchase plan, authorizing the repurchase of up to 5% of the Company's outstanding share of common stock, or approximately 782,000 shares over a set period of twelve months.

The following table provides total repurchased shares and average share prices under the applicable Plans and years:

	Years Ended December 31,		
	2013	2012	Plan Total
Ninth Plan			
Repurchased shares	—	389,627	590,832
Stock repurchase average share price	—	$13.45	$12.83
Tenth Plan			
Repurchased shares	544,000	52,900	596,900
Stock repurchase average share price	$15.88	$13.88	$15.70

During the years ended December 31, 2013 and 2012, the Company repurchased 13,138 and 3,419 shares at an average price of $14.29 and $14.08 to pay withholding taxes on restricted stock that vested during the years ended December 31, 2013 and 2012, respectively.

The following table sets forth information about the Company's purchases of its outstanding common stock during the quarter ended December 31, 2013.

Period	Total Number of Shares Purchased(1)	Average Price Paid Per Share(1)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
October 1, 2013—October 31, 2013	277	$16.06	7,205,348	160,100
November 1, 2013—November 30, 2013	—	—	7,205,348	160,100
December 1, 2013—December 31, 2013	52	16.72	7,205,348	160,100
Total	329	$16.16	7,205,348	160,100

(1) Common shares repurchased by the Company between October 1, 2013 and December 31, 2013 included solely the cancellation of 329 shares of restricted stock to pay withholding taxes at an average price per share of $16.16.

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

Table of Contents

Stock Performance Graph

The chart shown below depicts total return to stockholders during the period beginning December 31, 2008 and ending December 31, 2013. Total return includes appreciation or depreciation in market value of the Company’s common stock as well as actual cash and stock dividends paid to common stockholders. Indices shown below, for comparison purposes only, are the Total Return Index for the NASDAQ Stock Market (U.S. Companies), which is a broad nationally recognized index of stock performance by publicly traded companies 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, 2008, and that all dividends were reinvested in Heritage common stock.

	Year Ended December 31,					
Index	2008	2009	2010	2011	2012	2013
Heritage Financial Corporation	$100.00	$113.44	$114.60	$106.78	$132.13	$158.12
NASDAQ Composite	100.00	145.36	171.74	170.38	200.63	281.22
NASDAQ Bank	100.00	83.70	95.55	85.52	101.50	143.84

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.”

Table of Contents

	Years Ended December 31,				
	2013	2012	2011	2010	2009
	(Dollars in thousands, except per share amounts)				
Operations Data:					
Interest income	$71,428	$69,109	$74,120	$59,522	$53,341
Interest expense	3,724	4,534	6,582	8,511	11,645
Net interest income	67,704	64,575	67,538	51,011	41,696
Provision for loan losses	3,672	2,016	14,430	11,990	19,390
Noninterest income	9,651	7,272	5,746	18,779	5,988
Noninterest expense	59,515	50,392	49,703	38,011	28,216
Income tax expense (benefit)	4,593	6,178	2,633	6,435	(503)
Net income	9,575	13,261	6,518	13,354	581
Net income (loss) applicable to common shareholders	9,575	13,261	6,518	11,668	(739)
Earnings (loss) per common share(1)					
Basic	0.61	0.87	0.42	1.05	(0.10)
Diluted	0.61	0.87	0.42	1.04	(0.10)
Dividend payout ratio to common shareholders(2)	68.9%	92.0%	90.5%	—%	(100.0)%
Performance Ratios:					
Net interest spread(3)	4.69%	5.03%	5.23%	4.56%	4.25%
Net interest margin(4)	4.80	5.17	5.41	4.78	4.57
Efficiency ratio(5)	76.94	70.14	67.82	54.46	59.17
Return on average assets	0.62	0.98	0.48	1.16	0.06
Return on average common equity	4.58	6.52	3.17	8.15	(0.72)

Table of Contents

	December 31, 2013	2012	2011	2010	2009
	(Dollars in thousands)				
Balance Sheet Data:					
Total assets	$1,659,038	$1,345,540	$1,368,985	$1,367,684	$1,014,859
Originated loans receivable, net	960,132	855,360	815,607	719,957	746,083
Purchased covered loans receivable, net	57,587	83,978	105,394	128,715	—
Purchased noncovered loans receivable, net	185,377	59,006	83,479	131,049	—
Loans receivable, net	1,203,096	998,344	1,004,480	979,721	746,083
Loans held for sale	—	1,676	1,828	764	825
FDIC indemnification asset	4,382	7,100	10,350	16,071	—
Deposits	1,399,189	1,117,971	1,136,044	1,136,276	840,128
Securities sold under agreement to repurchase	29,420	16,021	23,091	19,027	10,440
Stockholders’ equity	215,762	198,938	202,520	202,279	158,498
Book value per common share	13.31	13.16	13.10	12.99	12.21
Equity to assets ratio	13.0 %	14.8 %	14.8 %	14.8 %	15.6 %
Capital Ratios:					
Total risk-based capital ratio	16.8 %	19.9 %	20.3 %	21.5 %	20.7 %
Tier 1 risk-based capital ratio	15.5	18.7	19.0	20.2	19.4
Leverage ratio	11.3	13.6	13.8	13.9	14.6
Asset Quality Ratios:					
Nonperforming originated loans to total originated loans (6)	0.53 %	1.28 %	2.57 %	3.14 %	4.21 %
Allowance for loan losses on originated loans to total originated loans (6)	1.76	2.19	2.66	2.97	3.38
Allowance for loan losses on originated loans to nonperforming originated loans (6)	329.40	170.44	103.52	94.73	79.34
Nonperforming originated assets to total originated assets (6)	0.68	1.39	2.14	2.38	3.32
Other Data:					
Number of banking offices	35	33	33	31	20
Number of full-time equivalent employees	373	363	354	321	222

(1) Effective January 1, 2009, the Company adopted FASB ASC 03-6-1.

(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 interest bearing liabilities.

(4) Net interest margin is net interest income divided by average interest earning assets.

(5) The efficiency ratio is noninterest expense divided by the sum of net interest income and noninterest income.

(6) Nonperforming originated loan balances exclude portions guaranteed by governmental agencies of $1.7 million, $1.2 million, $1.8 million, $3.2 million and $2.3 million as of December 31, 2013, 2012, 2011, 2010 and 2009, respectively.

Table of Contents

ITEM 7. MANGEMENT'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, 2013 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,” “potentially,” “probably,” “projects,” “outlook” or similar expressions or future or co verbs such as “may,” “will,” “should,” “would” and “could.” These 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 those from Cowlitz Bank, Pierce Commercial Bank, Northwest Commercial Bank, Valley Community Bancshares and the proposed Washington Banking Company transactions described in this Form 10-K, or may in the future acquire, into our operations and our ability to realize related revenue synergies and cost savings within expected time frames or at all, and any goodwill charges related thereto and costs or difficulties relating to integration matters, including but not limited to customer and employee retention, which might be greater than expected;
- the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets, which may lead to increased losses and non-performing assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses, and require us to increase our allowance for loan losses;
- changes in general economic conditions, either nationally or in our market areas;
- changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources;
- risks related to acquiring assets in or entering markets in which we have not previously operated and may not be familiar;
- fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas;
- results of examinations of us by the Federal Reserve and of our bank subsidiary by the FDIC, the Division or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our allowance for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings;
- legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules as a result of Basel III;
- our ability to control operating costs and expenses;
- the impact of the Dodd-Frank Act and implementing regulations;
- further increases in premiums for deposit insurance;
- the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;
- difficulties in reducing risk associated with the loans on our consolidated statement of financial condition;
- staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges;
- failure or security breach of computer systems on which we depend;
- our ability to retain key members of our senior management team;
- costs and effects of litigation, including settlements and judgments;

- our ability to implement our expansion strategy of pursuing acquisitions and de novo branching;
- our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired or may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto;
- increased competitive pressures among financial service companies;
- changes in consumer spending, borrowing and savings habits;

Table of Contents

- 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 FASB, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; and
- other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and the other risks described elsewhere in this Form 10-K.

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

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

Critical Accounting Policies

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

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

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

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

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

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

While we believe we use the best information available to determine the allowance for loan losses, our results of operations could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance. A further decline in local and national economic conditions, or other factors, could result in a material increase in the allowance for loan losses and may adversely affect the Company's financial condition and results of operations. In addition, the determination of the amount of the allowance for loan losses is subject to review by bank regulators, as part of their routine examination process, which may result in the establishment of additional allowance for loan losses based upon their judgment of information available to them at the time of their examination. For additional information regarding the allowance for loan losses, its relation to the provision for loan losses, risk related to asset quality and lending activity, see "—Results of Operations for the Years Ended December 31, 2013 and 2012—Provision for Loan Losses" below, Part I of "Item 1. Business—Analysis of Allowance for Loan Losses" as well as Note 6 of the Notes to Consolidated Financial Statements included in "Item 8. Financial Statements and Supplementary Data."

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

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

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

Business Combinations. The Company applies the acquisition method of accounting for business combinations. Under the acquisition method, the acquiring entity in a business combination recognizes all of the identifiable assets acquired and liabilities assumed at their acquisition date fair values. Management utilizes prevailing valuation techniques appropriate for the asset or liability being measured in determining these fair values. Any excess of the purchase price over amounts allocated to assets acquired, including identifiable intangible assets, and liabilities assumed is recorded as goodwill. Where amounts allocated to assets acquired and liabilities assumed is greater than the purchase price, a bargain purchase gain is recognized. Acquisition-related costs are expensed as incurred unless they are directly attributable to the issuance of the Company's common stock in a business combination.

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

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

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

During 2011, ASU 2011-08 Intangibles—Goodwill and Other (Topic 350) was issued. Under the ASU, an entity is not required to calculate the fair value of a reporting unit unless the entity determines that it is more likely than not that its fair value is less than its carrying amount. In other words, before the first step of the existing guidance, the entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that the fair value of goodwill is less than carrying value. The qualitative assessment includes adverse events or circumstances identified that could negatively affect the reporting units' fair value as well as positive and mitigating events. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step process is unnecessary. While the Company adopted the ASU in 2011, for the year ended December 31, 2013, the Company completed step one of the two-step process and concluded that the reporting unit's fair value was greater than its carrying value and there was no impairment of goodwill.

Our Strategy

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

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

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

Maintain Strong Balance Sheet. In addition to our focus on underwriting, we believe that the strength of our balance sheet has allowed us to endure the economic downturn afflicting the Pacific Northwest better than many of our competitors. As of December 31, 2013, the ratio of our allowance for loan losses on originated loans to total originated loans was 1.76% and the ratio of the allowance for loan losses on originated loans to nonperforming originated loans was 329.40%. Our liquidity position is also strong, with $130.4 million in cash and cash equivalents as of December 31, 2013. As of December 31, 2013, the regulatory capital ratios of our subsidiary bank was well in excess of the levels required for “well-capitalized” status, and our consolidated total risk-based capital, Tier 1 risk-based capital and leverage capital ratios were 16.8%, 15.5% and 11.3%, respectively.

Deposit Growth. Our strategic focus is to continuously grow deposits with emphasis on total relationship banking with our business and retail customers. We continue to seek to increase our market share in the communities we serve by providing exceptional customer service, focusing on relationship development with local businesses and strategic branch expansion. Our primary focus is to maintain a high level of non-maturity deposits to internally fund our loan growth with a low reliance on maturity (certificate) deposits. At December 31, 2013, as a percentage of our total deposits, non-maturity deposits were 77.9%. We maintain state-of-the-art technology-based products, including on-line personal financial management, business cash management, and business remote deposit products that enable us to compete effectively with banks of all sizes. Our retail management team is well-seasoned and has strong ties to the communities we serve with a strong focus on relationship building and customer service.

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

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

Financial Overview

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

The Company has focused on expanding business over the past five years. In 2010, the Company completed two FDIC-assisted transactions of Cowlitz Bank in July 2010 and Pierce Commercial Bank in November 2010. In 2013, the Company completed two open-bank acquisitions of Northwest Commercial Bank in January 2013 and Valley Community Bancshares in July 2013. In October 2013, the Company announced its proposed merger with Washington Banking Company. These acquisitions, together with organic growth of the business, has significantly increased the Company's net assets.

During the period from December 31, 2009 through December 31, 2013 our total assets have increased $644.2 million, or 63.5%, to $1.66 billion as of December 31, 2013 from $1.01 billion at December 31, 2009. The purchased loans receivable, net grew $243.0 million during this five year period due to the Company's acquisition focus. The originated loans receivable, net grew $214.0 million, or 28.7%, to $960.1 million as of December 31, 2013 from $746.1 million at December 31, 2009. Our emphasis in growing our commercial business loan portfolio resulted in an increase in originated commercial business loans of $245.6 million, or 40.7%, since December 31, 2009. Loan increases have benefited from both our emphasis in increasing our lending in our market areas, and also from the acquisitions of Valley, Northwest Commercial Bank, Pierce Commercial Bank and Cowlitz Bank.

Deposits increased $559.1 million, or 66.5%, to $1.40 billion at December 31, 2013 from $840.1 million at December 31, 2009. From December 31, 2009 to December 31, 2013, non-maturity deposits (total deposits less certificate of deposit accounts) increased $553.5 million, or 103.2% to $1.09 billion at December 31, 2013. As a result, the percentage of certificate of deposit accounts to total deposits decreased to 22.1% at December 31, 2013 from 36.1% at December 31, 2009.

Stockholders’ equity has increased by $57.3 million to $215.8 million at December 31, 2013 from $158.5 million at December 31, 2009 due primarily to a combination of earnings and issuances of common stock, partially offset by redemption of preferred stock, repurchases of common stock and declaration of cash dividends. Our annual net income increased by 1,548.0%, or $9.0 million, to $9.6 million for the year ended December 31, 2013 from $581,000 for the year ended December 31, 2009 due primarily to an increase of $26.0 million in net interest income that exceeded an increase in noninterest expense of $31.3 million, and a decrease in the provision for loan losses of $15.7 million.

Table of Contents

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.

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.

	Years Ended December 31,								
	2013			2012			2011		
	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, net	$1,124,828	$67,630	6.01 %	$996,186	$65,588	6.58 %	$981,848	$70,114	7.14 %
Taxable securities	117,132	1,918	1.64	118,124	2,195	1.86	129,217	2,912	2.25
Nontaxable securities	64,018	1,539	2.40	42,272	1,097	2.60	25,122	821	3.27
Other interest earning assets	104,770	341	0.33	92,324	229	0.25	111,430	273	0.24
Total interest earning assets	$1,410,748	$71,428	5.06 %	$1,248,906	$69,109	5.53 %	$1,247,617	$74,120	5.94 %
Noninterest earning assets	129,324			105,166			102,691		
Total assets	$1,540,072			$1,354,072			$1,350,308		
Interest Bearing Liabilities:									
Certificates of deposit	$307,464	$2,478	0.81 %	$306,772	$3,016	0.98 %	$355,167	$4,274	1.20 %
Savings accounts	143,412	164	0.11	113,119	204	0.18	103,170	361	0.35
Interest bearing demand and money market accounts	541,793	1,031	0.19	466,268	1,249	0.27	453,509	1,868	0.41
Total interest bearing	992,669	3,673	0.37	886,159	4,469	0.50	911,846	6,503	0.71

deposits											
FHLB advances and other borrowings	—	—	—		—	—	—		1	—	0.30	
Securities sold under agreement to repurchase	19,102	51	0.26		18,314	65	0.35		19,301	79	0.41	
Total interest bearing liabilities	$1,011,771	$3,724	0.37	%	$904,473	$4,534	0.50	%	$931,148	$6,582	0.71	%

48

Table of Contents

	Years Ended December 31,								
	2013			2012			2011		
	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)								
Demand and other noninterest bearing deposits	308,582			237,888			205,862		
Other noninterest bearing liabilities	10,543			8,310			7,795		
Stockholders' equity	209,176			203,401			205,503		
Total liabilities and stock-holders' equity	$1,540,072			$1,354,072			$1,350,308		
Net interest income		$67,704			$64,575			$67,538	
Net interest spread			4.69 %			5.03 %			5.23 %
Net interest margin			4.80 %			5.17 %			5.41 %
Average interest earning assets to average interest bearing liabilities			139.43 %			138.08 %			133.99 %

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.

Table of Contents

	Year Ended December 31,					
	2013 Compared to 2012			2012 Compared to 2011		
	Increase (Decrease) Due to			Increase (Decrease) Due to		
	Volume	Rate	Total	Volume	Rate	Total
	(In thousands)					
Interest Earning Assets:						
Loans	$7,735	$(5,693)	$2,042	$944	$(5,470)	$(4,526)
Taxable securities	(16)	(261)	(277)	(139)	(578)	(717)
Nontaxable securities	523	(81)	442	388	(112)	276
Other interest earning assets	40	72	112	(50)	6	(45)
Interest income	$8,282	$(5,963)	$2,319	$1,143	$(6,154)	$(5,012)
Interest Bearing Liabilities:						
Certificates of deposit	$5	$(543)	$(538)	$(475)	$(783)	$(1,258)
Savings accounts	35	(75)	(40)	18	(174)	(156)
Interest bearing demand and money market accounts	144	(362)	(218)	34	(653)	(619)
Total interest bearing deposits	184	(980)	(796)	(423)	(1,610)	(2,033)
FHLB advances and other borrowings	—	—	—	—	—	—
Securities sold under agreement to repurchase	2	(16)	(14)	(4)	(11)	(15)
Interest expense	$186	$(996)	$(810)	$(427)	$(1,621)	$(2,048)
Net Interest Income	$8,096	$(4,967)	$3,129	$1,570	$(4,533)	$(2,964)

Results of Operations for the Years Ended December 31, 2013 and 2012

Earnings Summary. Net income applicable to common shareholders of $0.61 per diluted common share was recorded for the year ended December 31, 2013 compared to $0.87 per diluted common share for the year ended December 31, 2012. Net income for the year ended December 31, 2013 was $9.6 million compared to net income of $13.3 million for the same period in 2012. The $3.7 million decrease was primarily the result of a $9.1 million increase in noninterest expense and a $1.7 million increase in the provision for loan losses, partially offset by a $2.3 million increase in interest income, a $2.4 million increase in noninterest income, a $1.6 million decrease in income tax expense and a $810,000 decrease in interest expense. The Company’s efficiency ratio increased to 76.9% for the year ended December 31, 2013 from 70.1% for the year ended December 31, 2012 primarily due to increases in the noninterest expense of $5.1 million related to the 2013 Company initiatives including the acquisitions and system conversions of Northwest Commercial Bank and Valley Bank, the merger of Central Valley Bank, the core system conversion, the consolidation of existing branches and the proposed Washington Banking Company merger. The details of these expenses are included in the "Noninterest Expense" section below.

Net Interest Income. Net interest income increased $3.1 million, or 4.8%, to $67.7 million for the year ended December 31, 2013 compared to $64.6 million for the previous year. The increase in net interest income was due primarily to increases in average interest earning assets, substantially attributable to the NCB and Valley Acquisitions, and the results of the positive effects of the discount accretion on the acquired loan portfolios for the year ended December 31, 2013. The increase in net interest income was partially offset by the decrease in the net interest margins due primarily to lower contractual loan note rates in the current lending environment. Net interest income as a percentage of average interest earning assets (net interest margin) for the year ended December 31, 2013 decreased 37 basis points to 4.80% from 5.17% for the previous year. Our net interest spread for the year ended December 31, 2013 decreased to 4.69% from 5.03% for the prior year.

Total interest income increased $2.3 million, or 3.4%, to $71.4 million for the year ended December 31, 2013, from $69.1 million for the year ended December 31, 2012. The increase in interest income was due primarily to the effects of the NCB and Valley Acquisitions and the positive effects of the accretable discount, offset partially by lower yields on interest earning assets. During the year ended December 31, 2013, the Company recorded approximately $2.7 million of discount accretion into interest income that related to the NCB and Valley Acquisitions. This income would be in addition to the acquired loans' contractual interest income. The balance of average interest earning assets (including nonaccrual loans) increased $161.9 million, or 13.0%, to $1.41 billion for the year ended December 31, 2013 from $1.25 billion for the year ended December 31, 2012. The majority of this increase in interest earning assets was a result of the NCB and Valley Acquisitions. The Company acquired combined fair value at respective acquisition dates of $14.9 million in interest earning deposits, $57.1 million in investment securities and $168.6 million in noncovered loans. The Company additionally generated organic growth by increasing the originated loan receivable balance by $102.8 million, or 11.8%, to $977.3 million at December 2013 from $874.5 million at December 2012.

The yield on interest earning assets decreased 47 basis points to 5.06% for the year ended December 31, 2013 from 5.53% for the year ended December 31, 2012. The decrease in the yield on interest earning assets for the year ended December 31, 2013 reflects the decreased loan yields due primarily to lower contractual note rates as well as the effects of the overall discount accretion on all the acquired loan portfolios. The effect of discount accretion on net interest margin for the year ended December 31, 2013 and December 31, 2012 is as follows:

	Years Ended December 31,			
	2013		2012	
Net interest margin, excluding incremental accretion on purchased loans (1)	4.32	%	4.67	%
Impact on net interest margin from incremental accretion on purchased loans (1)	0.48		0.50	
Net interest margin	4.80	%	5.17	%

(1) The incremental accretion income represents the amount of income recorded on the purchased loans above the contractual stated interest rate in the individual loan notes. This income results from the discount established at the time these loan portfolios were acquired and modified as a result of quarterly cash flow re-estimation.

Yield on interest earning assets was additionally reduced by nonaccruing loans. For the years ended December 31, 2013 and December 31, 2012, originated nonaccruing loans reduced the yield on interest earning assets by approximately five basis points and seven basis points, respectively. Originated nonaccrual loans totaled $6.9 million at December 31, 2013 compared to $12.5 million at December 31, 2012.

Interest income on taxable and nontaxable investment securities increased $165,000 to $3.5 million for the year ended December 31, 2013 from $3.3 million for the year ended December 31, 2012 due primarily to an increase in the average investment securities as a result of the NCB and Valley Acquisitions offset by lower yields earned on the investment securities in 2013 as a result of declining interest rates. The changes in average balances and interest income on interest earning deposits and FHLB stock and Pacific Coast Bankers Bank ("PCBB") stock had minimal impact on net interest margins for the years ended December 31, 2013 and 2012.

Total interest expense decreased by $810,000, or 17.9%, to $3.7 million for the year ended December 31, 2013 from $4.5 million for the year ended December 31, 2012. The decrease in interest expense was due to lower rates paid on interest bearing liabilities, reflecting the relatively low interest rate environment. The average rate paid on interest bearing liabilities decreased to 0.37% for the year ended December 31, 2013 from 0.50% for the year ended December 31, 2012. Total average interest bearing liabilities increased by $107.3 million, or 11.9%, to $1.012 billion for the year ended December 31, 2013 from $904.5 million for the year ended December 31, 2012. The increase in average interest bearing liabilities was due primarily to the NCB and Valley Acquisitions which had a combined fair value at the acquisitions dates of $267.5 million, offset by deposit run-off anticipated from the acquisitions and consolidation of existing bank branches.

Provision for Loan Losses. The provision for loan losses increased $1.7 million, or 82.1%, to $3.7 million for the year ended December 31, 2013 from $2.0 million for the year ended December 31, 2012. The Bank has established a comprehensive methodology for determining the allowance for loan losses and related provision for loan losses on originated loans. On a quarterly basis, the Bank performs 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 and the related provision for loan losses.

The provision for loan losses on originated loans increased $195,000, or 28.1%, to $890,000 for the year ended December 31, 2013 from $695,000 for the year ended December 31, 2012. The increase in provision expense for originated loans was due to the default of one significant borrower offset by an improvement in the environmental factors as well as lower net charge-offs on originated loans during the year ended December 31, 2013 compared the prior year.

Table of Contents

The Bank had net charge-offs on originated loans of $2.9 million for the year ended December 31, 2013 compared to $3.9 million for the year ended December 31, 2012. The ratio of net charge-offs to average total originated loans outstanding was 0.30% for the year ended December 31, 2013 and 0.45% for the year ended December 31, 2012. For the year ended December 31, 2013, the Company had $3.8 million of gross charge-offs of which $1.6 million related to one borrower. At December 31, 2012, the Bank had not provided for a related specific valuation allowance for this borrower and had generally reserved (based on ALL allocation) $389,000, resulting in an estimated provision expense of $1.2 million during 2013 based on the unfavorable resolution of this loan. Total originated loans at December 31, 2013 and 2012 were $980.0 million and $876.6 million, respectively. The general allowance as a percentage of non-impaired loans was 1.48% and 1.74% at December 31, 2013 and 2012, respectively. The decrease in the percentage during the noted periods is due to reduction in the historical loss factors, change in the mix of loans, and a general improvement in the credit environment.

The following table outlines the allowance for loan losses and related outstanding loan balances at December 31, 2013 and 2012:

	December 31, 2013	December 31, 2012
	(Dollars in thousands)	
General Valuation Allowance:		
Allowance for loan losses	$14,054	$14,766
Gross originated loan balance of non-impaired loans	952,569	849,084
Percentage	1.48 %	1.74 %
Specific Valuation Allowance:		
Allowance for loan losses	$3,099	$4,359
Gross originated loan balance of impaired loans	27,386	27,497
Percentage	11.32 %	15.85 %
Total Allowance for Loan Losses:		
Allowance for loan losses	$17,153	$19,125
Gross originated loan balance	979,955	876,581
Percentage	1.75 %	2.18 %

The allowance for loan losses on originated loans decreased by $2.0 million, or 10.3%, to $17.2 million at December 31, 2013 from $19.1 million at December 31, 2012. As of December 31, 2013, the Bank identified $6.9 million of originated nonperforming loans and $20.4 million of originated performing restructured loans for a total of$27.4 million of impaired loans. Of these impaired loans, $16.5 million have no allowances for credit losses as their estimated collateral value or expected cash flow is equal to or exceeds their carrying costs. The remaining $10.9 million have related allowances for credit losses totaling $3.1 million. Based on the comprehensive methodology, management deemed the allowance for loan losses on originated loans of $17.2 million at December 31, 2013 (1.76% of total originated loans and 329.4% of nonperforming originated loans, excluding government guarantees) appropriate to provide for probable incurred losses based on an evaluation of known and inherent risks in the loan portfolio at that date.

The provision for loan losses on purchased loans increased $1.5 million, or 110.6%, to $2.8 million for the year ended December 31, 2013 compared to $1.3 million for the year ended December 31, 2012. As of the acquisition date, purchased loans were recorded at their estimated fair value, incorporating our estimate of future expected cash flows until the ultimate resolution of these credits. To the extent actual or remaining projected cash flows are less than originally estimated, additional provisions for loan losses on the purchased loan portfolios will be recognized. However, provisions on the purchased covered loans would be primarily offset by a corresponding increase in the FDIC indemnification asset recognized within noninterest income. To the extent actual or remaining projected cash flows are more than originally estimated, the increase in cash flows is recognized prospectively in interest income.

The provision for loan losses on purchased loans recorded for the year ended December 31, 2013 was a result of several specific loan events. The Bank resolved one significant covered loan which generated approximately $585,000 in provision expense. There was also the default of three large borrowers which caused $950,000 in provision expense. The Bank also experienced significant collateral deficiency on one borrower which added an additional $1.1 million in provision expense. The impact of these events was partially offset by the general improvements in the remaining loans' expected cash flows. The balance of the purchased other impaired loans (loans which showed credit quality issues after acquisition) increased to $6.7 million at December 31, 2013 from $2.2 million at December 31, 2012. The Bank recorded charge-offs of $580,000 for the purchased other loans for the year ended December 31, 2013 as compared to $450,000 for the year ended December 31, 2012.

The allowance for loan losses on purchased loans increased $2.2 million, or 23.3% to $11.7 million at December 31, 2013 from $9.5 million at December 31, 2012. The increase was primarily the result of the specific purchased loans described above, offset by the general improvements in the expected cash flow of the purchased loans. To the extent that the loan pools have allowance for loan losses, the yields on the loan pools will generally remain constant until such time that the pool's estimated cash flows become greater than the allowance.

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

Noninterest Income. Total noninterest income increased $2.4 million, or 32.7%, to $9.7 million for the year ended December 31, 2013 compared to $7.3 million for the prior year. The components of the noninterest income and the changes from prior year are as follows:

	Years Ended December 31,			
	2013	2012	Change 2013 vs. 2012	Percentage Change
	(Dollars in thousands)			
Bargain purchase gain on bank acquisition	$399	$—	$399	100.0 %
Service charges and other fees	5,936	5,516	420	7.6
Merchant Visa income, net	862	685	177	25.8
FDIC loss sharing income, net	(181)	(1,033)	852	82.5
Other income	2,635	2,104	531	25.2
Total noninterest income	$9,651	$7,272	$2,379	32.7 %

The FDIC loss sharing income, net includes amortization of the FDIC indemnification asset and increases to the FDIC indemnification asset as a result of decreases in projected remaining cash flows of the purchased covered loans. The increase in net FDIC loss sharing income was primarily due to the $609,000 decrease in amortization expense of $1.3 million for the year ended December 31, 2013 compared to $1.9 million for the year ended December 31, 2012. The decrease in the amortization expense was primarily due to the declining indemnification asset balance. The balance of the indemnification asset at December 31, 2013 was $4.4 million compared to $7.1 million at December 31, 2012. The net FDIC loss sharing income also increased due to an increase in the FDIC share of additional estimated losses which was an increase of income of $1.1 million for the year ended December 31, 2013 compared to $878,000 in prior year. Under the symmetrical accounting for acquired covered loans, an increase in the provision for loan losses on covered loans will generally have a related increase in the FDIC share of additional estimated losses. The provision for loan losses on covered loans was $1.9 million for the year ended December 31, 2013 compared to $446,000 for the year ended December 31, 2012.

Other income increased $531,000, or 25.2%, to $2.6 million for the year ended December 31, 2013 from $2.1 million for the year ended December 31, 2012 primarily due to the gain on sale of a bank branch of $596,000. The $420,000 increase in service charges and other fees to $5.9 million for the year ended December 31, 2013 compared to $5.5 million for the prior year was primarily the result of increased deposits and an expanded customer base. Deposits at December 31, 2013 increased to $1.40 billion at December 31, 2013 from $1.12 billion at December 31, 2012 primarily as a result of the NCB and Valley Acquisitions. The bargain purchase gain on bank acquisition of $399,000 for the year ended December 31, 2013 was the result of the NCB Acquisition in January 2013. See Note 2 of the

Consolidated Financial Statements in "Item 8. Financial Statements and Supplementary Data" for additional information on the NCB Acquisition.

Noninterest Expense. Noninterest expense increased $9.1 million or 18.1% to $59.5 million for the year ended December 31, 2013 compared to $50.4 million for the year ended December 31, 2012.

Table of Contents

The following table presents the key components of noninterest expense and the change from prior year:

	Years Ended December 31,			
	2013	2012	Change 2013 vs. 2012	Percentage Change
	(Dollars in thousands)			
Compensation and employee benefits	$31,612	$29,020	$2,592	8.9 %
Occupancy and equipment	9,724	7,365	2,359	32.0
Data processing	4,806	2,555	2,251	88.1
Marketing	1,598	1,517	81	5.3
Professional services	3,936	2,543	1,393	54.8
State and local taxes	1,150	1,226	(76)	(6.2)
Impairment loss on investment securities, net	38	78	(40)	(51.3)
Federal deposit insurance premium	1,001	1,002	(1)	(0.1)
Other real estate owned, net	309	316	(7)	(2.2)
Other expense	5,341	4,770	571	12.0
Total noninterest expense	$59,515	$50,392	$9,123	18.1 %

The increase in total noninterest expense for the year ended December 31, 2013 was due primarily to increased expenses related to 2013 Company initiatives. These initiatives include the NCB and Valley Acquisitions, the merger of Central Valley Bank and the proposed merger of Washington Banking Company, all of which are discussed in Notes 1 and 2 to the Consolidated Financial Statements in "Item. 8 Financial Statements and Supplementary Data". Additionally, a core system conversion occurred in fourth quarter of 2013 whereby after 18 years of using FiServ's Total Plus core system, the Company converted to FiServ's DNA platform which provides a variety of efficiencies in all operation areas of the Bank. The consolidation of existing branches also occurred in the fourth quarter of 2013 with the Company consolidating three Heritage branch locations to nearby branches. The table below includes each of the Company's major initiatives as well as the direct costs associated with the initiatives for the years ended December 31, 2013 and 2012. The amounts include identifiable costs paid to third party providers as well as any retention bonuses or severance payment made in conjunction with these initiatives. The amounts do not include costs of additional staffing required to be maintained or utilized during a period of time in order to complete the initiatives.

	Years Ended December 31,	
	2013	2012
	(In thousands)	
Company Initiatives:		
NCB Acquisition	$794	$616
CVB Merger	220	—
Valley Acquisition	2,118	—
Core system conversion	842	—
Consolidation of existing branches	238	—
Proposed Washington Banking merger	890	—
Total noninterest expense	$5,102	$616

Table of Contents

The following table further segregates the Company initiative costs by financial statement caption.

	Years Ended December 31,	
	2013	2012
	(In thousands)	
Expense Caption:		
Compensation and employee benefits	$475	$—
Occupancy and equipment	1,328	—
Data processing	1,291	—
Marketing	34	—
Professional services	1,876	610
Other expense	98	6
Total noninterest expense	$5,102	$616

The types of expenses associated with the significant expense categories in the table above are summarized as follows:

- Compensation and employee benefits expense consisted substantially of retention bonus and severances packages paid to transition employees.
- Occupancy and equipment expense consisted primarily of lease termination costs.
- Data processing expense consisted of costs relating to the Company’s core system conversion as well as conversions of Northwest Commercial Bank and Valley Bank.
- Professional services expense related to fees paid to: (1) financial advisors for the NCB Acquisition, the Valley Acquisition and the proposed Washington Banking Merger, (2) attorney, accountant and consultant fees related to mergers and acquisitions, and (3) consultant fees relating to the core system conversion.

Other expense includes, but is not limited to, items such as amortization of intangible assets, courier services, travel expenses, investor relations, and certain employee-related costs such as travel and meals. The increase in other expense for the year ended December 31, 2013 as compared to the year ended December 31, 2012 was partly due to the increase in amortization of intangible assets of approximately $116,000 as a result of the NCB and Valley Acquisitions. The investor relations expense increased $115,000 as a result of the NCB and Valley Acquisitions as well as the proposed Washington Banking merger. The remaining increases in other expense are the result of a general increase due to the growth of the Company during the year ended December 31, 2013 which is demonstrated by the increase in total assets from $1.35 billion at December 31, 2012 to $1.66 billion at December 31, 2013.

The efficiency ratio for the year ended December 31, 2013 was 76.9% compared to 70.1% for the same period in the prior year. The efficiency ratio consists of noninterest expense divided by the sum of net interest income before provision for loan losses plus noninterest income. The increase in the ratio for the year ended December 31, 2013 was primarily related to the increase in noninterest expense as described above. While growth strategies are being executed, the Company expects to incur higher noninterest expenses as evidenced by the current increasing efficiency ratio. Noninterest expenses are expected to be more in line with income when these growth strategies begin producing long term results.

Income Tax Expense.   The provision for income taxes decreased by $1.6 million to an expense of $4.6 million for the year ended December 31, 2013 from an expense of $6.2 million for the year ended December 31, 2012. The Company’s effective income tax rate was 32.4% for the year ended December 31, 2013 compared to 31.8% for the same period in 2012. The increase in the Company’s effective income tax rate from the prior year was primarily due to increased non-deductible acquisition expenses.

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

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

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

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

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

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

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

The allowance for loan losses on originated loans decreased by $3.2 million, or 14.3%, to $19.1 million at December 31, 2012 from $22.3 million at December 31, 2011. As of December 31, 2012, the Bank identified $12.5 million of originated impaired loans and $15.0 million of originated performing restructured loans. Of those impaired and performing restructured loans, $12.6 million have no allowances for credit losses as their estimated collateral value or expected cash flow is equal to or exceeds their carrying costs. The remaining $14.9 million have related allowances for credit losses totaling $4.4 million. Based on the comprehensive methodology, management deemed the allowance for loan losses on originated loans of $19.1 million at December 31, 2012 (2.19% of total originated loans and 170.44% of nonperforming originated loans, excluding government guarantees) appropriate to provide for probable incurred losses based on an evaluation of known and inherent risks in the loan portfolio at that date.

Table of Contents

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

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

Noninterest Income. Total noninterest income increased $1.5 million, or 26.6%, to $7.3 million for the year ended December 31, 2012 compared to $5.7 million for the prior year. The components of the noninterest income and the changes from prior year are as follows:

	Years Ended December 31,			
	2012	2011	Change 2012 vs. 2011	Percentage Change
	(Dollars in thousands)			
Service charges and other fees	$5,516	$5,419	$97	1.8 %
Merchant Visa income, net	685	556	129	23.2
FDIC loss sharing income, net	(1,033)	(2,250)	1,217	54.1
Other income	2,104	2,021	83	4.1
Total noninterest income	$7,272	$5,746	$1,526	26.6 %

The increase in noninterest income was due primarily to an increase in the net FDIC loss sharing income, which was a reduction of income of $2.3 million for the year ended December 31, 2012 compared to a reduction of income of $1.0 million for the year ended December 31, 2011. The FDIC loss sharing income, net includes amortization of the FDIC indemnification asset and increases to the FDIC indemnification asset as a result of decreases in projected remaining cash flows of the purchased covered loans. For the year ended December 31, 2012, the amortization expense for the indemnification asset decreased to $1.9 million from $4.4 million for the year ended December 31, 2011. The FDIC share of additional estimated losses decreased to $878,000 for the year ended December 31, 2012 compared to $2.2 million for the same period in prior year.

Noninterest Expense. Noninterest expense increased $689,000 or 1.4% to $50.4 million for the year ended December 31, 2012 compared to $49.7 million for the year ended December 31, 2011.

The following table presents the key components of noninterest expense and the change from prior year:

	Years Ended December 31,			
	2012	2011	Change 2012 vs. 2011	Percentage Change
	(Dollars in thousands)			
Compensation and employee benefits	$29,020	$27,109	$1,911	7.0 %
Occupancy and equipment	7,365	7,127	238	3.3
Data processing	2,555	2,628	(73)	(2.8)
Marketing	1,517	1,361	156	11.5
Professional services	2,543	2,062	481	23.3
State and local taxes	1,226	1,336	(110)	(8.2)
Impairment loss on investment securities, net	78	98	(20)	(20.4)
Federal deposit insurance premium	1,002	1,558	(556)	(35.7)
Other real estate owned, net	316	921	(605)	(65.7)
Other expense	4,770	5,503	(733)	(13.3)
Total noninterest expense	$50,392	$49,703	$689	1.4 %

The increase in noninterest expense was due primarily to increased compensation and employee benefits expense in the amount of $1.9 million as the Company's full-time equivalent employees increased from 354 at December 31, 2011 to 363 at December 31, 2012 and the Company paid more in incentive plans during the year ended December 31, 2012 as compared to prior year based on the Company's performance. The $481,000 increase in professional services was primarily the result of costs related to the NCB Acquisition of approximately $610,000. The increase to noninterest expense was partially offset by decreases of $605,000 in net other real estate owned expense as a result of net gains on sales of the assets of $587,000 during the year ended December 31, 2012 compared to net losses of $71,000 during the year ended December 31, 2011. The other expense decreased $733,000 from the year ended December 31, 2011 due primarily to a decrease in other loan expenses recorded primarily during resolution of nonperforming loans.

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

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

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.

Table of Contents

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, 2013, cash and cash equivalents totaled $130.4 million, or 7.9% of total assets. Other interest earning deposits totaled $15.7 million at December 31, 2013. These assets are easily converted to liquidity. Available for sale investment securities totaled $163.1 million at December 31, 2013; however, management generally does not consider those with maturities beyond one year to be a viable source of liquidity given that many available for sale securities are pledged to secure borrowing arrangements. The fair value of investment securities classified as either available for sale or held to maturity with maturities of one year or less amounted to $4.0 million, or 0.2% of total assets. At December 31, 2013, the Bank maintained credit facilities with the FHLB of Seattle for $283.6 million and credit facilities with the Federal Reserve Bank of San Francisco for $56.7 million, of which there were no borrowings outstanding as of December 31, 2013. The Banks also maintain advance lines with Zions Bank, Wells Fargo Bank, US Bank and Pacific Coast Bankers' Bank to purchase federal funds totaling $50.0 million as of December 31, 2013. As of December 31, 2013, there were no overnight federal funds purchased.

During 2013 total assets increased $313.5 million, or 23.3%, to $1.66 billion at December 31, 2013 from $1.35 billion at December 31, 2012. The increase was primarily due to the assets acquired in the NCB and Valley Acquisitions. The components of the change in assets and the fair value of assets acquired at effective dates are included in the following table:

	December 31, 2013	December 31, 2012	Change 2013 vs. 2012	Fair Value of NCB and Valley Bank at respective Acquisition Dates
	(Dollars in thousands)			
Cash and cash equivalents	$130,400	$104,268	$26,132	$43,355
Other interest earning deposits	15,662	2,818	12,844	14,869
Investment securities available for sale	163,134	144,293	18,841	34,197
Investment securities held to maturity	36,154	10,099	26,055	22,908
Loans held for sale	—	1,676	(1,676)	—
Originated loans receivable, net	960,132	855,360	104,772	—
Purchased covered loans receivable, net	57,587	83,978	(26,391)	—
Purchased non-covered loans receivable, net	185,377	59,006	126,371	168,580
FDIC indemnification asset	4,382	7,100	(2,718)	—
Other real estate owned	4,559	5,666	(1,107)	2,279
Premises and equipment, net	34,348	24,755	9,593	6,772
FHLB stock, at cost	5,741	5,495	246	454
Accrued interest receivable	5,462	4,821	641	697
Prepaid expenses and other assets	25,120	22,107	3,013	7,135
Other intangible assets, net	1,615	1,086	529	1,072
Goodwill	29,365	13,012	16,353	16,353
Total assets	$1,659,038	$1,345,540	$313,498	$318,671

Our strategy has been to acquire core deposits (which we define to include all deposits except public funds, brokered CDs and other wholesale deposits) from our retail accounts, acquire noninterest bearing demand deposits from our commercial customers, and use our available borrowing capacity to fund growth in assets. We anticipate that we will continue to rely on the same sources of funds in the future and use those funds primarily to make loans and purchase investment securities.

Stockholders' equity was $215.8 million at December 31, 2013 and $198.9 million at December 31, 2012. During the year ended December 31, 2013, we issued 1.5 million shares of common stock valued at $24.2 million for the purpose of acquiring Valley Community Bancshares, realized net income of $9.6 million, paid common stock dividends of $6.7 million, repurchased $8.8 million in common stock, recorded $3.0 million in net unrealized losses on securities available for sale, net of tax, recorded $59,000 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 restricted and unrestricted stock shares totaling $1.5 million.

The Company and the Bank are subject to various regulatory capital requirements. As of December 31, 2013, the Company and the Bank were classified as “well capitalized” institutions under the criteria established by the Federal Deposit Insurance Act.

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 Bank, which is the Company’s predominant sources of income. On January 29, 2014, the Company’s Board of Directors declared a dividend of $0.08 per share payable on February 24, 2014 to shareholders of record on February 10, 2014.

Our capital levels were also modestly impacted by our 401(k) Employee Stock Ownership Plan and Trust (“KSOP”). The Employee Stock Ownership Plan (“ESOP”) purchased 2% of the common stock issued in the January 1998 stock offering and borrowed from the Company to fund the purchase of the Company’s common stock. The loan to the ESOP was repaid in full as of December 31, 2012. While outstanding, the loan was repaid principally from the Bank’s contributions to the ESOP. The Bank's contributions were sufficient to service the debt over the 15 year loan term at the interest rate of 8.5%. As the debt was repaid, shares were released, and allocated to plan participants based on the proportion of debt service paid during the year. As shares were released, compensation expense was recorded equal to the then current market price of the shares, our capital was increased, and the shares became outstanding for earnings per common share calculations. For the year ended December 31, 2013, the Company did not allocate or commit to be released to the ESOP any shares and the Company has no unearned, restricted shares remaining to be released.

Contractual Obligations

The following table provides the amounts due under specified contractual obligations for the periods indicated as of December 31, 2013:

	December 31, 2013					
	Less than 1 year	Over 1-3 years	Over 3-5 years	More than 5 years	Other (1)	Total
	(In thousands)					
Contractual payments by period:						
Deposits	$222,817	$67,787	$18,826	$—	$1,089,759	$1,399,189
Operating leases	1,755	3,358	2,522	3,951	—	11,586
Total contractual obligations	$224,572	$71,145	$21,348	$3,951	$1,089,759	$1,410,775

(1) Represents interest bearing and noninterest bearing checking, money market and checking accounts which can generally be withdrawn on demand and thereby have an undefined maturity

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: 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-rate interest bearing demand deposits, money market accounts, and savings deposits relative to certificates of deposit to reduce our overall cost of funds.

Our asset and liability management strategies have resulted in a positive 0-3 month “gap” of 21.7% and a negative 4-12 month “gap” of 4.2% as of December 31, 2013. These “gaps” measure the difference between the dollar

Table of Contents

amount of our interest earning assets and interest bearing liabilities that mature or reprice within the designated period (three months and 4-12 months) as a percentage of total interest earning assets, based on certain estimates and assumptions as discussed below. We believe that the implementation of our operating strategies has reduced the potential effects of changes in market interest rates on our results of operations. The positive gap for the 0-3 month period indicates that decreases in market interest rates may adversely affect our results over that period.

The following table provides the estimated maturity or repricing and the resulting interest rate sensitivity gap of our interest earning assets and interest bearing liabilities at December 31, 2013 based upon estimates of expected deposit run off rates consistent with national trends. 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.

Table of Contents

	December 31, 2013 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)	$244,230	$68,174	$439,147	$164,968	$63,436	$979,955
Investment securities	86,847	20,643	23,006	25,230	43,562	199,288
FHLB stock	5,741	—	—	—	—	5,741
Interest earning deposits	90,238	—	—	—	—	90,238
Other interest earning deposits	497	5,698	9,467	—	—	15,662
Total interest earning assets	$427,553	$94,515	$471,620	$190,198	$106,998	$1,290,884
Percentage of interest-earning assets	33.1 %	7.3 %	36.6 %	14.7 %	8.3 %	100.0 %
Interest Bearing Liabilities:						
Total interest bearing deposits(2)	$118,620	$148,177	$782,490	$—	$—	$1,049,287
Total securities sold under agreement to repurchase	29,420	—	—	—	—	29,420
Total interest bearing liabilities	$148,040	$148,177	$782,490	$—	$—	$1,078,707
Interest-bearing liabilities, as a percentage of total interest earning assets	11.5 %	11.5 %	60.6 %	— %	— %	83.6 %
Interest rate sensitivity gap	$279,513	$(53,662)	$(310,870)	$190,198	$106,998	$212,177
Interest rate sensitivity gap, as a percentage of total interest earning assets	21.7 %	(4.2)%	(24.1)%	14.7 %	8.3 %	16.4 %
Cumulative interest rate sensitivity gap	$279,513	$225,851	$(85,019)	$105,179	$212,177	
Cumulative interest rate sensitivity gap, as a percentage of total interest earning assets	21.7 %	17.5 %	(6.6)%	8.1 %	16.4 %	

(1) Originated loans receivable, excluding deferred loan fees.

(2) Adjustable-rate liabilities are included in the period in which interest rates are next scheduled to adjust rather than in the period they are due to mature. Although regular savings, demand, NOW, and money market deposit accounts are subject to immediate withdrawal, based on historical experience management considers a substantial amount of such accounts to be core deposits having significantly longer maturities. For the purpose of the gap analysis, these accounts have been assigned decay rates to reflect their longer effective maturities. If all of these accounts had been assumed to be short-term, the 0-3 month cumulative gap of interest-sensitive assets would have been $(416.4) million, or (32.3%) of total interest earning assets at December 31, 2013.

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.

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 Bank, maintain a trading account for any class of financial instrument, nor do we, or the Bank, engage in hedging activities or purchase high risk derivative instruments. Moreover, neither we, nor the Bank, 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, 2013. 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.

Table of Contents

	By Expected Maturity Date Year Ended December 31,						
	0-3 months	Over 3 months-12 months	1-5 years	Over 5 years -15 years	Over 15 years	Total	Fair Value
	(Dollars in thousands)						
Investment Securities(1)							
Amounts maturing:							
Fixed rate	$1,004	$2,463	$15,087	$30,111	$43,563	$92,228	
Weighted average interest rate	2.4 %	4.3 %	2.9 %	3.8 %	3.6 %	3.6 %	
Adjustable rate	$—	$470	$8,444	$59,603	$38,543	$107,060	
Weighted average interest rate	— %	4.2 %	4.0 %	4.1 %	4.3 %	4.1 %	
Total	$1,004	$2,933	$23,531	$89,714	$82,106	$199,288	$199,474
Loans(2)							
Amounts maturing:							
Fixed rate	$14,640	$27,141	$126,571	$137,009	$63,435	$368,796	
Weighted average interest rate	5.2 %	5.3 %	5.0 %	4.6 %	4.6 %	4.8 %	
Adjustable rate	$229,591	$41,034	$312,575	$27,959	$—	$611,159	
Weighted average interest rate	5.2 %	5.5 %	4.9 %	4.2 %	— %	4.8 %	
Total	$244,231	$68,175	$439,146	$164,968	$63,435	$979,955	$985,952
Certificates of Deposit							
Amounts maturing:							
Fixed rate	$74,640	$148,177	$86,613	$—	$—	$309,430	$311,064
Weighted average interest rate	0.5 %	0.6 %	1.3 %	— %	— %	0.8 %	

(1)Balances represent carrying value.
(2)Originated loans receivable, excluding 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 WTIH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

On February 27, 2012, the Audit Committee of Heritage Financial Corporation (the “Company”), on behalf of the Company and its subsidiaries, Heritage Bank and Central Valley Bank, notified KPMG LLP that they would be dismissed as the Company’s independent public accountants upon completion of the audit for the fiscal year ended December 31, 2011. The decision to change independent accountants was approved by the Audit Committee.
During the fiscal year ended December 31, 2011, and the subsequent interim period through March 2, 2012, there were no disagreements with KPMG LLP on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedures, which disagreements, if not resolved to the satisfaction of KPMG LLP, would have caused them to make reference to such disagreements in their report on the financial statements for such years. During the fiscal year ended December 31, 2011 and the subsequent period through March 2, 2012, there were no reportable events (as defined in Regulation S-K Item 304 (a)(1)(v)). The audit report of KPMG LLP on the Company’s Consolidated Financial Statements as of and for the years ended December 31, 2011 and 2010 did not contain an

adverse opinion or a disclaimer of opinion and was not qualified or modified as to uncertainty, audit scope or accounting principles.

On February 27, 2012, the Audit Committee engaged the firm of Crowe Horwath LLP as independent certified public accountants of the Company and its subsidiaries for the fiscal year ending December 31, 2012. During the years ended December 31, 2013 and 2012, there were no disagreements with Crowe Horwath LLP, and the audit reports of Crowe Horwath LLP on the Company's Consolidated Financial Statements as of and for the years ended December 31, 2013 and 2012 did not contain an adverse opinion or a disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principles. The audit report of Crowe Horwath LLP on the effectiveness of internal control over financial reporting as of December 31, 2013 did not contain any adverse opinion or disclaimer of opinion, nor was it qualified or modified as to uncertainty, audit scope or accounting principles.

ITEM 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures.

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

Internal Control Over Financial Reporting.

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

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

The Company's management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2013. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in the 1992 Internal Control—Integrated Framework. Based on our assessment, we believe that, as of December 31, 2013, the Company's internal control over financial reporting is effective based on these criteria.

Crowe Horwath LLP, an independent registered public accounting firm, has audited the effectiveness of our internal control over financial reporting as of December 31, 2013, and their report is included in "Item 8. Financial Statements and Supplementary Data."

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

See "Item 8. Financial Statements and Supplementary Data."

(c) Changes in internal control over financial reporting.

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

ITEM 9B. OTHER INFORMATION

None

Table of Contents

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 on April 14, 2014 (“Proxy Statement”).

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

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

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

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

ITEM 11. EXECUTIVE COMPENSATION

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

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

The following table summarizes the consolidated activity within the Company’s stock option plans as of December 31, 2013, 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	397,421	$15.82	110,436

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

ITEM 13. CERTAIN RELATIONSHIP AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

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

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, Jensen, Lyon, Rhodes and Watson are all independent. Only Brian L. Vance, who serves as President and Chief Executive Officer of Heritage Financial Corporation and Chief Executive Officer of Heritage Bank, and David H. Brown, former Chief Executive Officer of Valley Community Bancshares, Inc. and Valley Bank, were not independent.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

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

Table of Contents

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

(a)(1) Financial Statements: The Consolidated Financial Statements are contained as listed on the "Index to Consolidated Financial Statements" on page F-1.
(2) Financial Statements Schedules: 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: Included in schedule below.

Exhibit No.	
2.1 & 2.2	Purchase and Assumption Agreements for Cowlitz & Pierce—reference Q3 2012 Form 10-Q Exhibits (1)
3.1	Articles of Incorporation (2)
3.2	Bylaws of the Company (3)
4.2	Warrant for purchase (4)
10.1	1998 Stock Option and Restricted Stock Award Plan (5)
10.2	1997 Stock Option and Restricted Stock Award Plan (6)
10.3	2002 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan (7)
10.4	2006 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan (8)
10.5	Employment Agreement between Central Valley Bank and D. Michael Broadhead, effective December 3, 2010 (9)
10.6	Letter of Understanding between Heritage Financial Corporation and Donald V. Rhodes dated August 18, 2009 (10)
10.7	Annual Incentive Compensation Plan (11)
10.8	2010 Omnibus Equity Plan (12)
10.9	Deferred Compensation Plan and Participation Agreements for Brian L. Vance, Jeffrey J. Deuel and Donald J. Hinson (13)
10.10	Employment Agreements for Brian L. Vance, Jeffrey J. Deuel and Donald J. Hinson (13)
10.12	Change in Control Agreement by and between Heritage Bank and David A. Spurling (14)

11	Statement regarding computation of earnings per share (15)
14.0	Code of Ethics and Conduct Policy (16)
21.0	Subsidiaries of the Company
23.1	Consent of Independent Registered Public Accounting Firm—Crowe Horwath LLP
23.2	Consent of Independent Registered Public Accounting Firm—KPMG LLP
24.0	Power of Attorney

Exhibit No.	
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	The following materials from Heritage Financial Corporation's Annual Report on Form 10-K for the year ended December 31, 2013, formatted in Extensible Business Reporting Language ("XBRL"): (i) Consolidated Statements of Financial Condition, (ii) Consolidated Statements of Income; (iii) Consolidated Statements of Comprehensive Income, (iv) Consolidated Statements of Stockholders' Equity; (v) Consolidated Statements of Cash Flows, and (vi) the Notes to Consolidated Financial Statements (17)

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

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange act of of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 11th day of March

2014.

HERITAGE FINANCIAL CORPORATION
(Registrant)

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

Table of Contents

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 11th day of March 2014.

Principal Executive Officer:
/S/ BRIAN L. VANCE
Brian L. Vance
President and Chief Executive Officer

Principal Financial Officer:
/S/ DONALD J. HINSON
Donald J. Hinson
Executive Vice President and Chief Financial Officer

Remaining Directors:
*David H. Brown
*Brian S. Charneski
*Gary B. Christensen
*Kimberly T. Ellwanger
*Daryl D. Jensen
*Jeffrey S. Lyon
*Donald V. Rhodes
*Ann Watson

*By	/S/ BRIAN L. VANCE
	Brian L. Vance