HERITAGE FINANCIAL CORP /WA/
Form 10-Q
August 04, 2011

# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 10-Q

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

**For the quarterly period ended June 30, 2011**

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

**(360) 943-1500**

**(Registrant s telephone number, including area code)**

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

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

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

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

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the last practicable date:

As of July 19, 2011 there were 15,651,703 common shares outstanding, with no par value, of the registrant.

**HERITAGE FINANCIAL CORPORATION**

**FORM 10-Q**

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FORWARD LOOKING STATEMENT


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**Forward Looking Statements**

Safe Harbor statement under the Private Securities Litigation Reform Act of 1995: This Form 10-Q contains forward-looking statements that are subject to risks and uncertainties, including, but not limited to: the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; 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 Board of Governors of the Federal Reserve System (the Federal Reserve Board ) and of our bank subsidiaries by the Federal Deposit Insurance Corporation (the FDIC ), the Washington State Department of Financial Institutions, Division of Banks (the Washington DFI ) or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our reserve for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, including the interpretation of regulatory capital or other rules including changes from the Dodd-Frank Wall Street Reform and Consumer Protection Act and regulations that have been or will be promulgated thereunder; our ability to control operating costs and expenses; the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our balance sheet; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges; computer systems on which we depend could fail or experience a security breach; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our expansion strategy; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired including the Cowlitz Bank and Pierce Commercial Bank transactions 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; risks relating to acquiring assets or entering markets in which we have not previously operated and may not be familiar; changes in consumer spending, borrowing and savings habits; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services; and other risks detailed from time to time in our filings with the Securities and Exchange Commission.

The Company cautions readers not to place undue reliance on any forward-looking statements. Moreover, you should treat these statements as speaking only as of the date they are made and based only on information then actually known to the Company. The Company does not undertake and specifically disclaims any obligation to revise any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements. These risks could cause our actual results for 2011 and beyond to differ materially from those expressed in any forward-looking statements by, or on behalf of, us, and could negatively affect the Company s operating and stock price performance.

As used throughout this report, the terms we , our , us , or the Company refer to Heritage Financial Corporation and its consolidated subsidiaries, unless the context otherwise requires.

**ITEM 1. HERITAGE FINANCIAL CORPORATION**

**HERITAGE FINANCIAL CORPORATION**

**CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**

**(Dollars in thousands, except for per share amounts)**

**(Unaudited)**

| | June 30, 2011 | December 31, 2010 |
|---|---|---|
| **Assets** | | |
| Cash on hand and in banks | $ 31,069 | $ 37,179 |
| Interest earning deposits | 86,323 | 129,822 |
| Federal funds sold | | 1,990 |
| Investment securities available for sale | 147,864 | 125,175 |
| Investment securities held to maturity (market value of $13,898 and $14,290) | 13,175 | 13,768 |
| Loans held for sale | 673 | 764 |
| Originated loans receivable | 782,497 | 742,019 |
| Less: Allowance for loan losses | (22,011) | (22,062) |
| Originated loans receivable, net | 760,486 | 719,957 |
| Purchased covered loans receivable, net of allowance for loan losses of ($2,516 and $0) | 117,604 | 128,715 |
| Purchased non-covered loans receivable, net of allowance for loan losses of ($791 and $0) | 103,473 | 131,049 |
| Total loans receivable, net | 981,563 | 979,721 |
| FDIC indemnification asset | 14,485 | 16,071 |
| Other real estate owned | 1,911 | 3,030 |
| Premises and equipment, at cost, net | 22,456 | 21,750 |
| Federal Home Loan Bank stock, at cost | 5,594 | 5,594 |
| Accrued interest receivable | 5,069 | 4,626 |
| Prepaid expenses and other assets | 10,103 | 8,974 |
| Deferred income taxes, net | 3,711 | 4,255 |
| Intangible assets, net | 1,727 | 1,953 |
| Goodwill | 13,012 | 13,012 |
| Total assets | $ 1,338,735 | $ 1,367,684 |
| **Liabilities and Stockholders Equity** | | |
| Deposits | $ 1,107,720 | $ 1,136,276 |
| Securities sold under agreement to repurchase | 17,272 | 19,027 |
| Accrued expenses and other liabilities | 8,092 | 10,102 |
| Total liabilities | 1,133,084 | 1,165,405 |
| Stockholders equity: | | |
| Common stock, no par, 50,000,000 shares authorized; 15,649,383 and 15,568,471 shares outstanding at June 30, 2011 and December 31, 2010, respectively | 128,825 | 128,436 |
| Unearned compensation ESOP and other | (138) | (182) |
| Retained earnings | 75,628 | 73,648 |
| Accumulated other comprehensive income , net | 1,336 | 377 |
| Total stockholders equity | 205,651 | 202,279 |
| Total liabilities and stockholders equity | $ 1,338,735 | $ 1,367,684 |

See Notes to Condensed Consolidated Financial Statements.

**HERITAGE FINANCIAL CORPORATION**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

**(Dollars in thousands, except for per share amounts)**

**(Unaudited)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| INTEREST INCOME: | | | | |
| Interest and fees on loans | $ 18,829 | $ 11,903 | $ 35,401 | $ 23,873 |
| Taxable interest on investment securities | 768 | 675 | 1,431 | 1,420 |
| Nontaxable interest on investment securities | 199 | 78 | 378 | 151 |
| Interest on federal funds sold and interest bearing deposits | 61 | 60 | 141 | 120 |
| Total interest income | 19,857 | 12,716 | 37,351 | 25,564 |
| INTEREST EXPENSE: | | | | |
| Deposits | 1,682 | 1,929 | 3,557 | 4,092 |
| Other borrowings | 20 | 21 | 42 | 41 |
| Total interest expense | 1,702 | 1,950 | 3,599 | 4,133 |
| Net interest income | 18,155 | 10,766 | 33,752 | 21,431 |
| Provision for loan losses | 1,995 | 3,150 | 4,590 | 6,900 |
| Provision for loan losses on purchased loans | 1,529 | | 3,307 | |
| Net interest income after provision for loan losses | 14,631 | 7,616 | 25,855 | 14,531 |
| NON-INTEREST INCOME: | | | | |
| Gains on sales of loans, net | 35 | 35 | 186 | 101 |
| Service charges on deposits | 1,278 | 1,082 | 2,516 | 2,107 |
| Merchant Visa income | 731 | 795 | 1,430 | 1,510 |
| Change in FDIC indemnification asset | (1,712) | | (912) | |
| Other income | 521 | 224 | 1,111 | 483 |
| Total non-interest income | 853 | 2,136 | 4,331 | 4,201 |
| NON-INTEREST EXPENSE: | | | | |
| Impairment loss on investment securities | 19 | 68 | 64 | 263 |
| Less: Portion recorded as other comprehensive income | | (13) | (20) | (18) |
| Impairment loss on investment securities, net | 19 | 55 | 44 | 245 |
| Salaries and employee benefits | 7,075 | 4,200 | 13,712 | 8,215 |
| Occupancy and equipment | 1,719 | 990 | 3,565 | 2,018 |
| Data processing | 636 | 416 | 1,458 | 835 |
| Marketing | 379 | 423 | 694 | 634 |
| Merchant Visa | 602 | 660 | 1,171 | 1,257 |
| Professional services | 413 | 338 | 1,047 | 625 |
| State and local taxes | 369 | 156 | 725 | 373 |
| Federal deposit insurance premium | 432 | 347 | 889 | 701 |
| Other real estate owned | 48 | 28 | 565 | (38) |
| Other expense | 1,483 | 861 | 2,957 | 1,593 |
| Total non-interest expense | 13,175 | 8,474 | 26,827 | 16,458 |
| Income before income taxes | 2,309 | 1,278 | 3,359 | 2,274 |

| | | | | |
|---|---|---|---|---|
| Income tax expense | 624 | 423 | 909 | 723 |
| Net income | $ 1,685 | $ 855 | $ 2,450 | $ 1,551 |
| Dividends accrued and discount accreted on preferred shares | | 332 | | 663 |
| Net income applicable to common shareholders | $ 1,685 | $ 523 | $ 2,450 | $ 888 |
| Earnings per share: | | | | |
| Basic | $ 0.11 | $ 0.05 | $ 0.16 | $ 0.08 |
| Diluted | $ 0.11 | $ 0.05 | $ 0.16 | $ 0.08 |
| Dividends declared per common share: | $ 0.03 | $ | $ 0.03 | $ |

See Notes to Condensed Consolidated Financial Statements.

**HERITAGE FINANCIAL CORPORATION**

**CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY FOR THE SIX MONTHS ENDED**

**JUNE 30, 2011 AND COMPREHENSIVE INCOME FOR THE THREE AND SIX MONTHS ENDED**

**JUNE 30, 2011 AND 2010**

**(Dollars and shares in thousands)**

**(Unaudited)**

| | Number of common shares | Common stock | Unearned Compensation-ESOP and other | Retained earnings | Accumulated other comprehensive income, net | Total stockholders equity |
|---|---|---|---|---|---|---|
| Balance at December 31, 2010 | 15,568 | $ 128,436 | $ (182) | $ 73,648 | $ 377 | $ 202,279 |
| Restricted stock awards issued | 79 | | | | | |
| Restricted stock awards canceled | (2) | | | | | |
| Stock option compensation expense | | 95 | | | | 95 |
| Exercise of stock options (including tax benefits from nonqualified stock options) | | 1 | | | | 1 |
| Share based payment and earned ESOP | 4 | 441 | 44 | | | 485 |
| Tax provision associated with share based payment and unallocated ESOP | | (148) | | | | (148) |
| Net income | | | | 2,450 | | 2,450 |
| Change in fair value of securities available for sale, net of reclassification adjustments | | | | | 908 | 908 |
| Other-than-temporary impairment on securities held to maturity, net of tax | | | | | (13) | (13) |
| Accretion of other-than-temporary impairment on securities held to maturity, net of tax | | | | | 64 | 64 |
| Cash dividends declared on common stock | | | | (470) | | (470) |
| Balance at June 30, 2011 | 15,649 | $ 128,825 | $ (138) | $ 75,628 | $ 1,336 | $ 205,651 |

| Comprehensive Income | Three Months Ended June 30, 2011 | Three Months Ended June 30, 2010 | Six Months Ended June 30, 2011 | Six Months Ended June 30, 2010 |
|---|---|---|---|---|
| Net income | $ 1,685 | $ 855 | $ 2,450 | $ 1,551 |
| Change in fair value of securities available for sale, net of tax of $178, $216, $174 and $378 | 902 | 402 | 894 | 701 |
| Reclassification adjustment of net gain from sale of available for sale securities included in income, net of tax of $7, $0, $8 and $0 | 13 | | 14 | |
| Other-than-temporary impairment on securities held-to-maturity, net of tax of $0, $(5), $(7) and $(6) | | (8) | (13) | (12) |
| Accretion of other-than-temporary impairment in securities held-to-maturity, net of tax of $15, $21, $35 and $75 | 28 | 38 | 64 | 139 |
| Comprehensive income | $ 2,628 | $ 1,287 | $ 3,409 | $ 2,379 |

See Notes to Condensed Consolidated Financial Statements.

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**HERITAGE FINANCIAL CORPORATION**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**For the six months ended June 30, 2011 and 2010**

**(Dollars in thousands)**

**(Unaudited)**

| | Six Months Ended June 30, | |
|---|---|---|
| | 2011 | 2010 |
| Cash flows from operating activities: | | |
| Net income | $ 2,450 | $ 1,551 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 531 | 736 |
| Deferred loan fees, net of amortization | 301 | (54) |
| Provision for loan losses | 7,897 | 6,900 |
| Net change in accrued interest receivable, prepaid expenses and other assets, accrued expenses and other liabilities | (2,141) | (1,390) |
| Recognition of compensation related to ESOP shares and share based payment | 485 | 240 |
| Stock option compensation expense | 95 | 114 |
| Tax provision realized from stock options exercised, share based payment and dividends on unallocated ESOP shares | 147 | 5 |
| Amortization of intangible assets | 226 | 39 |
| Deferred income tax | 332 | 15 |
| (Gain) loss on sale of investment securities | (23) | 4 |
| Impairment loss on investment securities | 44 | 245 |
| Origination of loans held for sale | (6,259) | (4,195) |
| Gain on sale of loans | (186) | (101) |
| Proceeds from sale of loans | 6,536 | 5,121 |
| Valuation adjustment on other real estate owned | 595 | |
| Loss (gain) on sale of other real estate owned | 53 | (93) |
| Loss on sale of premises and equipment | 1 | |
| Net cash provided by operating activities | 11,084 | 9,137 |
| Cash flows from investing activities: | | |
| Loans originated, net of principal payments | (11,377) | 1,884 |
| Maturities of investment securities available for sale | 11,843 | 8,551 |
| Maturities of investment securities held to maturity | 976 | 1,229 |
| Purchase of investment securities available for sale | (33,559) | (8,372) |
| Purchase of investment securities held to maturity | (271) | (1,826) |
| Purchase of premises and equipment | (1,587) | (769) |
| Proceeds from sales of other real estate owned | 1,808 | 1,647 |
| Proceeds from sales of premises and equipment | | 209 |
| Proceeds from sales of securities available for sale | 412 | |
| Net cash (used in) provided by investing activities | (31,755) | 2,553 |
| Cash flows from financing activities: | | |
| Net decrease in deposits | (28,556) | (11,098) |
| Preferred stock cash dividends paid | | (600) |
| Common stock cash dividends paid | (470) | |
| Net (decrease) increase in securities sold under agreement to repurchase | (1,755) | 4,912 |
| Proceeds from exercise of stock options | | 201 |

| | | |
|---|---|---|
| Tax provision realized from stock options exercised, share based payment and dividends on unallocated ESOP shares | (147) | (5) |
| Net cash used in financing activities | (30,928) | (6,590) |
| Net (decrease) increase in cash and cash equivalents | (51,599) | 5,100 |
| Cash and cash equivalents at beginning of period | 168,991 | 107,231 |
| Cash and cash equivalents at end of period | $ 117,392 | $ 112,331 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid for interest | $ 3,692 | $ 4,143 |
| Cash paid for income taxes | 3,089 | 1,283 |
| Loans transferred to other real estate owned | $ 1,337 | $ 2,440 |

See Notes to Condensed Consolidated Financial Statements.

**HERITAGE FINANCIAL CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Three and Six Months Ended June 30, 2011 and 2010**

**(Unaudited)**

**NOTE 1. Description of Business and Basis of Presentation**

*(a) Description of Business*

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

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

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

*(b) Basis of Presentation*

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with Generally Accepted Accounting Principles, or GAAP, for interim financial information, pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ). Accordingly, they do not include all of the information and footnotes required by U.S. Generally Accepted Accounting Principles for complete financial statements. These condensed consolidated financial statements should be read with our December 31, 2010 audited consolidated financial statements and its accompanying notes included in our Annual Report on Form 10-K ( 2010 Form 10-K ). In our opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and six months ended June 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. In preparing the condensed consolidated financial statements, we are required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Actual results could differ from those estimates.

Certain prior year amounts have been reclassified to conform to the current year s presentation.

*(c) Significant Accounting Policies*

The significant accounting policies used in preparation of our consolidated financial statements are disclosed in our 2010 Annual Form 10-K. There have not been any material changes in our significant accounting policies compared to those contained in our Form 10-K disclosure for the year ended December 31, 2010.

*(d) Recently Issued Accounting Pronouncements*

ASU 2011-02, *A Creditor s Determination of Whether a Restructuring is a Troubled Debt Restructuring*, provides an update for factors to be considered when evaluating whether a restructuring constitutes a troubled debt restructuring. ASU 2011-02 provides that a creditor must separately conclude that both of the following exist: (1) the restructuring constitutes a concession; and (2) the debtor is experiencing financial difficulties. In addition, the amendments to Topic 310 clarify that a creditor is precluded from using the effective interest rate test in the debtor s guidance on restructuring of payables (paragraph 470-60-55-10) when evaluating whether a restructuring constitutes a troubled debt restructuring. The amendments in this Update are effective for the first interim or annual period beginning on or after June 15, 2011 (third quarter of 2011), and will be applied retrospectively to the beginning of the year. The Company is currently assessing the potential impact of adopting this guidance.

FASB ASU 2011-03, *Reconsideration of Effective Control for Repurchase Agreements*, was issued April 2011 addressing the accounting for repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. The amendments remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (2) the collateral maintenance implementation guidance related to that criterion. The provisions of this Update are effective for the first interim or annual period beginning on or after December 15, 2011, and should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Management does not expect the adoption of the Update to have a material effect on the Company s financial statements at the date of adoption.

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

FASB ASU 2011-05, *Presentation of Comprehensive Income*, was issued June 2011 requiring that all nonowner changes in stockholders equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. This Update also requires that reclassification adjustments for items that are reclassified from other comprehensive income to net income be presented on the face of the financial statements. The provisions of this Update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011, and are to be applied retrospectively. Early adoption is permitted. Management does not expect the adoption of the Update to have a material effect on the Company s financial statements at the date of adoption.

**NOTE 2. Loans Receivable**

*(a) Loan Origination/Risk Management*

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

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

Commercial Business

There are three significant classes of loans in the commercial portfolio segment, including commercial and industrial loans, owner-occupied commercial real estate, and non-owner occupied commercial real estate. The owner and non-owner occupied commercial real estate are both considered commercial real estate loans. As each of the classes carries different risk characteristics, management will discuss them separately.

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

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

One-to-Four Family Residential

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

Real Estate Construction and Land Development

The Company originates construction loans for one-to-four family residential and for five or more residential properties and commercial properties. The one-to-four family residential construction loans generally include construction of custom homes whereby the home buyer is the borrower. The Company also provides financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. Substantially all construction loans are short-term in nature and priced with a variable rate of interest. Construction lending can involve a higher level of risk than other types of lending because funds are advanced partially based upon the value of the project, which is uncertain prior to the project s completion. Because of the uncertainties inherent in estimating construction costs as well as the market value of a completed project and the effects of governmental regulation of real property, the Company s estimates with regards to the total funds required to complete a project and the related loan-to-value ratio may vary from actual results. As a result, construction loans often involve the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project and the ability of the borrower to sell or lease the property or refinance the indebtedness. If the Company s estimate of the value of a project at completion proves to be overstated, it may have inadequate security for repayment of the loan and may incur a loss. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

Consumer

The Company originates consumer loans and lines of credit that are both secured and unsecured. The underwriting process is developed to ensure a qualifying primary and secondary source of repayment. Underwriting standards for home equity loans are heavily influenced by statutory requirements, which include, but are not limited to, a maximum loan-to-value percentage of 80%, collection remedies, the number of such loans a borrower can have at one time and documentation requirements. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed. The majority of the consumer loans are relatively small amounts spread across many individual borrowers which minimizes the credit risk. Additionally, trend reports are reviewed by management on a regular basis.

During the quarter ended June 30, 2011, certain loans were reclassified to better represent the class of loan based on the Bank s methodology. Therefore, the December 31, 2010 loan balances have been re-classified since being reported in the Annual Report on Form 10-K.

Originated loans receivable at June 30, 2011 and December 31, 2010 consisted of the following portfolio segments and classes:

| | June 30, 2011 | December 31, 2010 |
|---|---|---|
| | (In thousands) | |
| Commercial business: | | |
| Commercial and industrial | $ 272,313 | $ 233,875 |
| Owner-occupied commercial real estate | 156,615 | 159,445 |
| Non-owner occupied commercial real estate | 219,154 | 221,718 |
| Total commercial business | 648,082 | 615,038 |
| One-to-four family residential | 38,704 | 38,850 |
| Real estate construction and land development: | | |
| One-to-four family residential | 23,845 | 28,989 |
| Five or more family residential and commercial properties | 42,043 | 28,411 |
| Total real estate construction and land development | 65,888 | 57,400 |
| Consumer | 31,447 | 32,054 |

| | | |
|---|---|---|
| Gross originated loans receivable | 784,121 | 743,342 |
| Deferred loan fees | (1,624) | (1,323) |
| Total originated loans receivable | $ 782,497 | $ 742,019 |

Loans acquired in a business acquisition are designated as purchased loans. Purchased loans subject to loss-sharing agreements with the FDIC are identified as covered loans. Loans purchased with evidence of credit deterioration since origination for which it is probable that all contractually required payments will not be collected are accounted for under Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( FASB ASC ) 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*, formerly AICPA SOP 03-3 *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*. These loans are identified as impaired loans. Loans purchased that are not accounted for under FASB ASC 310-30 are accounted for under FASB ASC 310-20, *Receivables Nonrefundable fees and Other Costs,* formerly SFAS 91 *Nonrefundable fees and Other Costs.* These loans are identified as other loans. Funds advanced on the covered loans subsequent to acquisition, identified as subsequent advances, are included in the purchased covered loan balances as these subsequent advances are covered under the loss-sharing agreements. The subsequent advances for loans accounted for under FASB ASC 310-30 are reported with the balances of the purchased impaired covered loans despite the fact that the subsequent advances are not accounted for under FASB ASC 310-30. The total balance of subsequent advances on the purchased impaired covered loans was $10.3 million and $6.0 million as of June 30, 2011 and December 31, 2010, respectively.

The recorded investment of purchased covered loans receivable at June 30, 2011 and December 31, 2010 consisted of the following portfolio segments and classes:

| | June 30, 2011 | December 31, 2010 |
|---|---|---|
| | (In thousands) | |
| Commercial business: | | |
| Commercial and industrial | $ 45,223 | $ 47,046 |
| Owner-occupied commercial real estate | 39,959 | 45,219 |
| Non-owner occupied commercial real estate | 17,009 | 17,576 |
| Total commercial business | 102,191 | 109,841 |
| One-to-four family residential | 5,138 | 6,224 |
| Real estate construction and land development: | | |
| One-to-four family residential | 5,943 | 5,876 |
| Five or more family residential and commercial properties | | |
| Total real estate construction and land development | 5,943 | 5,876 |
| Consumer | 6,848 | 6,774 |
| Total purchased loans receivable | 120,120 | 128,715 |
| Allowance for loan losses | (2,516) | |
| Purchased loans receivable, net | $ 117,604 | $ 128,715 |

The June 30, 2011 and December 31, 2010 gross recorded investment balance of impaired purchased covered loans accounted for under FASB ASC 310-30 was $85.2 million and $90.1 million, respectively. The gross recorded investment balance of other purchased covered loans was $35.0 million and $38.6 million at June 30, 2011 and December 31, 2010, respectively.

The recorded investment of purchased non-covered loans receivable at June 30, 2011 and December 31, 2010 consisted of the following portfolio segments and classes:

| | June 30, 2011 | December 31, 2010 |
|---|---|---|
| | (In thousands) | |
| Commercial business: | | |
| Commercial and industrial | $ 43,880 | $ 58,938 |
| Owner-occupied commercial real estate | 17,623 | 18,877 |
| Non-owner occupied commercial real estate | 14,833 | 18,435 |
| Total commercial business | 76,336 | 96,250 |
| One-to-four family residential | 3,424 | 4,986 |
| Real estate construction and land development: | | |

| | | |
|---|---|---|
| One-to-four family residential | 3,424 | 3,816 |
| Five or more family residential and commercial properties | 1,332 | 1,244 |
| Total real estate construction and land development | 4,756 | 5,060 |
| Consumer | 19,748 | 24,753 |
| Total purchased loans receivable | 104,264 | 131,049 |
| Allowance for loan losses | (791) | |
| Purchased loans receivable, net | $ 103,473 | $ 131,049 |

The June 30, 2011 and December 31, 2010 gross recorded investment balance of impaired purchased non-covered loans accounted for under FASB ASC 310-30 was $66.3 million and $80.2 million, respectively. The recorded investment balance of other purchased non-covered loans was $37.9 million and $50.8 million at June 30, 2011 and December 31, 2010, respectively.

*(b) Concentrations of Credit*

Most of the Company s lending activity occurs within the State of Washington, and to a lesser extent the State of Oregon. The primary market areas include Thurston, Pierce, King, Mason, Cowlitz and Clark counties in Washington and Multnomah County in Oregon, as well as other markets. The majority of the Company s loan portfolio consists of commercial and industrial, non-owner occupied commercial real estate, and owner occupied commercial real estate. As of June 30, 2011 and December 31, 2010, there were no concentrations of loans related to any single industry in excess of 10% of total loans.

*(c) Credit Quality Indicators*

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

*Grades 0 to 5* These grades are considered pass grade with negligible to above average but acceptable risk. These borrowers generally have strong to acceptable capital levels and consistent earnings and debt service capacity. Loans with the higher grades within the pass category may include borrowers who are experiencing unusual operating difficulties, but have acceptable payment performance to date. Increased monitoring of financials and/or collateral may be appropriate. Overall, loans with this grade show no immediate loss exposure.

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

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

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

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

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

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

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

The following tables present the balance of the originated loans receivable by credit quality indicator as of June 30, 2011 and December 31, 2010.

| | June 30, 2011 | | | | |
|---|---|---|---|---|---|
| | Pass | OAEM | Substandard (in thousands) | Doubtful | Total |
| Commercial business: | | | | | |
| Commercial and industrial | $ 237,758 | $ 4,043 | $ 29,980 | $ 532 | $ 272,313 |
| Owner-occupied commercial real estate | 149,839 | 2,777 | 3,999 | | 156,615 |
| Non-owner occupied commercial real estate | 211,644 | 2,085 | 5,425 | | 219,154 |
| Total commercial business | 599,241 | 8,905 | 39,404 | 532 | 648,082 |
| One-to-four family residential | 38,298 | | 406 | | 38,704 |
| Real estate construction and land development: | | | | | |
| One-to-four family residential | 10,338 | 1,615 | 11,892 | | 23,845 |
| Five or more family residential and commercial properties | 28,731 | 4,813 | 8,499 | | 42,043 |
| Total real estate construction and land development | 39,069 | 6,428 | 20,391 | | 65,888 |
| Consumer | 31,213 | | 135 | 99 | 31,447 |
| Gross originated loans | $ 707,821 | $ 15,333 | $ 60,336 | $ 631 | $ 784,121 |

| | December 31, 2010 | | | | |
|---|---|---|---|---|---|
| | Pass | OAEM | Substandard (in thousands) | Doubtful | Total |
| Commercial business: | | | | | |
| Commercial and industrial | $ 200,583 | $ 2,615 | $ 29,872 | $ 805 | $ 233,875 |
| Owner-occupied commercial real estate | 154,890 | 913 | 3,642 | | 159,445 |
| Non-owner occupied commercial real estate | 206,177 | 12,991 | 2,550 | | 221,718 |
| Total commercial business | 561,650 | 16,519 | 36,064 | 805 | 615,038 |
| One-to-four family residential | 38,000 | | 848 | 2 | 38,850 |
| Real estate construction and land development: | | | | | |
| One-to-four family residential | 9,948 | 2,317 | 16,724 | | 28,989 |
| Five or more family residential and commercial properties | 18,901 | 793 | 8,717 | | 28,411 |
| Total real estate construction and land development | 28,849 | 3,110 | 25,441 | | 57,400 |
| Consumer | 31,877 | | 177 | | 32,054 |

| | | | | | |
|---|---|---|---|---|---|
| Gross originated loans | $ 660,376 | $ 19,629 | $ 62,530 | $ 807 | $ 743,342 |

The tables above include impaired loan balances. Potential problem loans are those loans that are currently accruing interest and are not considered impaired, but which management is monitoring because the financial information of the borrower causes concern

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as to their ability to meet their loan repayment terms. Potential problem originated loans as of June 30, 2011 and December 31, 2010 were $47.3 million and $56.1 million, respectively. The balance of potential problem originated loans guaranteed by a governmental agency was $4.8 million and $5.9 million as of June 30, 2011 and December 31, 2010, respectively. This guarantee reduces the Company s credit exposure.

The following tables present the recorded balance of the other purchased covered and non-covered loans receivable by credit quality indicator as of June 30, 2011 and December 31, 2010.

| | June 30, 2011 | | | | |
|---|---|---|---|---|---|
| | Pass | OAEM | Substandard (in thousands) | Doubtful | Total |
| Commercial business: | | | | | |
| Commercial and industrial | $ 16,881 | $ 54 | $ 455 | $ | $ 17,390 |
| Owner-occupied commercial real estate | 31,343 | | 593 | | 31,936 |
| Non-owner occupied commercial real estate | 6,427 | 505 | 998 | | 7,930 |
| Total commercial business | 54,651 | 559 | 2,046 | | 57,256 |
| One-to-four family residential | 1,622 | | | | 1,622 |
| Real estate construction and land development: | | | | | |
| One-to-four family residential | 53 | | | | 53 |
| Five or more family residential and commercial properties | | | | | |
| Total real estate construction and land development | 53 | | | | 53 |
| Consumer | 13,676 | | 283 | | 13,959 |
| Gross other purchased covered loans | $ 70,002 | $ 559 | $ 2,329 | $ | $ 72,890 |

| | December 31, 2010 | | | | |
|---|---|---|---|---|---|
| | Pass | OAEM | Substandard (in thousands) | Doubtful | Total |
| Commercial business: | | | | | |
| Commercial and industrial | $ 23,833 | $ 261 | $ 40 | $ | $ 24,134 |
| Owner-occupied commercial real estate | 34,365 | | 398 | | 34,763 |
| Non-owner occupied commercial real estate | 11,186 | 575 | | | 11,761 |
| Total commercial business | 69,384 | 836 | 438 | | 70,658 |
| One-to-four family residential | 1,879 | | | | 1,879 |
| Real estate construction and land development: | | | | | |
| One-to-four family residential | 54 | | | | 54 |
| Five or more family residential and commercial properties | | | | | |
| Total real estate construction and land development | 54 | | | | 54 |
| Consumer | 16,795 | | | | 16,795 |
| Gross other purchased covered loans | $ 88,112 | $ 836 | $ 438 | $ | $ 89,386 |

Originated nonaccrual loans, segregated by class of loans, were as follows as of June 30, 2011 and December 31, 2010:

| | June 30, 2011 (1) | December 31, 2010 (1) |
|---|---|---|
| | (In thousands) | |
| Commercial business: | | |
| Commercial and industrial | $ 9,359 | $ 8,155 |
| Owner-occupied commercial real estate | 760 | 779 |
| Non-owner occupied commercial real estate | 1,447 | 1,907 |
| Total commercial business | 11,566 | 10,841 |
| Real estate construction and land development: | | |
| One-to-four family residential | 6,239 | 10,226 |
| Five or more family residential and commercial properties | 5,884 | 5,416 |
| Total real estate construction and land development | 12,123 | 15,642 |
| Consumer | 105 | |
| Gross originated loans | $ 23,794 | $ 26,483 |

(1) $3.7 million and $3.2 million of nonaccrual originated loans were guaranteed by governmental agencies at June 30, 2011 and December 31, 2010, respectively.

There was a recorded investment balance of $283,000 related to nonaccrual consumer loans recorded in the other purchased loan categories as of June 30, 2011. There were no nonaccrual loans recorded in the other purchased loan categories as of December 31, 2010.

The Company performs aging analysis of past due loans using the categories of 30-89 days past due and 90 or more days past due. This policy is consistent with regulatory reporting requirements. The balances of originated past due loans, segregated by class of loans, as of June 30, 2011 and December 31, 2010 are as follows.

| | June 30, 2011 | | | | | |
|---|---|---|---|---|---|---|
| | 30-89 Days | 90 Days or Greater | Total Past Due | Current | Total | > 90 Days and Still Accruing |
| | | | (in thousands) | | | |
| Commercial business: | | | | | | |
| Commercial and industrial | $ 1,461 | $ 5,297 | $ 6,758 | $ 265,555 | $ 272,313 | $ 53 |
| Owner-occupied commercial real estate | 128 | 1,004 | 1,132 | 155,483 | 156,615 | 372 |
| Non-owner occupied commercial real estate | | 778 | 778 | 218,376 | 219,154 | |
| Total commercial business | 1,589 | 7,079 | 8,668 | 639,414 | 648,082 | 425 |
| One-to-four family residential | | | | 38,704 | 38,704 | |
| Real estate construction and land development: | | | | | | |
| One-to-four family residential | 486 | 6,239 | 6,725 | 17,120 | 23,845 | |
| Five or more family residential and commercial properties | | 5,498 | 5,498 | 36,545 | 42,043 | |
| Total real estate construction and land development | 486 | 11,737 | 12,223 | 53,665 | 65,888 | |
| Consumer | 79 | 111 | 190 | 31,257 | 31,447 | 106 |
| Gross originated loans | $ 2,154 | $ 18,927 | $ 21,081 | $ 763,040 | $ 784,121 | $ 531 |

| | December 31, 2010 | | | | | |
|---|---|---|---|---|---|---|
| | 30-89 Days | 90 Days or Greater | Total Past Due (in thousands) | Current | Total | > 90 days and still accruing |
| Commercial business: | | | | | | |
| Commercial and industrial | $ 2,585 | $ 3,562 | $ 6,147 | $ 227,728 | $ 233,875 | $ 199 |
| Owner-occupied commercial real estate | 187 | 1,373 | 1,560 | 157,885 | 159,445 | 594 |
| Non-owner occupied commercial real estate | 3,396 | 1,201 | 4,597 | 217,121 | 221,718 | |
| Total commercial business | 6,168 | 6,136 | 12,304 | 602,734 | 614,038 | 793 |
| One-to-four family residential | 624 | 47 | 671 | 38,179 | 38,850 | 47 |
| Real estate construction and land development: | | | | | | |
| One-to-four family residential | | 2,844 | 2,844 | 26,145 | 28,989 | 381 |
| Five or more family residential and commercial properties | 941 | 5,416 | 6,357 | 22,054 | 28,411 | |
| Total real estate construction and land development | 941 | 8,260 | 9,201 | 48,199 | 57,400 | 381 |
| Consumer | 42 | | 42 | 32,012 | 32,054 | |
| Gross originated loans | $ 7,775 | $ 14,443 | $ 22,218 | $ 721,124 | $ 743,342 | $ 1,221 |

The balances of other purchased past due loans, segregated by class of loans, as of June 30, 2011 and December 31, 2010 are as follows:

| | June 30, 2011 | | | | | |
|---|---|---|---|---|---|---|
| | 30-89 Days | 90 Days or Greater | Total Past Due (in thousands) | Current | Total | > 90 Days and Still Accruing |
| Commercial business: | | | | | | |
| Commercial and industrial | $ 86 | $ | $ 86 | $ 17,304 | $ 17,390 | $ |
| Owner-occupied commercial real estate | 154 | | 154 | 31,782 | 31,936 | |
| Non-owner occupied commercial real estate | | 444 | 444 | 7,486 | 7,930 | |
| Total commercial business | 240 | 444 | 684 | 56,572 | 57,256 | |
| One-to-four family residential | | | | 1,622 | 1,622 | |
| Real estate construction and land development: | | | | | | |
| One-to-four family residential | | | | 53 | 53 | |
| Five or more family residential and commercial properties | | | | | | |
| Total real estate construction and land development | | | | 53 | 53 | |
| Consumer | 232 | 283 | 515 | 13,444 | 13,959 | |
| Gross other purchased covered loans | $ 472 | $ 727 | $ 1,199 | $ 71,691 | $ 72,890 | $ |

| | December 31, 2010 | | | | | |
|---|---|---|---|---|---|---|
| | 30-89 Days | 90 Days or Greater | Total Past Due (in thousands) | Current | Total | > 90 days and still accruing |
| Commercial business: | | | | | | |
| Commercial and industrial | $ 774 | $ | $ 774 | $ 23,360 | $ 24,134 | $ |
| Owner-occupied commercial real estate | 9,898 | | 9,898 | 24,865 | 34,763 | |
| Non-owner occupied commercial real estate | | | | 11,761 | 11,761 | |
| Total commercial business | 10,672 | | 10,672 | 59,986 | 70,658 | |
| One-to-four family residential | 103 | | 103 | 1,776 | 1,879 | |
| Real estate construction and land development: | | | | | | |
| One-to-four family residential | | | | 54 | 54 | |
| Five or more family residential and commercial properties | | | | | | |
| Total real estate construction and land development | | | | 54 | 54 | |
| Consumer | 81 | | 81 | 16,714 | 16,795 | |
| Gross other purchased covered loans | $ 10,856 | $ | $ 10,856 | $ 78,530 | $ 89,386 | $ |

Impaired originated loans (including restructured loans) at June 30, 2011 and December 31, 2010 are set forth in the following tables.

| | June 30, 2011 | | | | | |
|---|---|---|---|---|---|---|
| | Recorded Investment With No Specific Valuation Allowance | Recorded Investment With Specific Valuation Allowance | Total Recorded Investment | Unpaid Contractual Principal Balance | Related Specific Valuation Allowance | Average Recorded Investment |
| | (in thousands) | | | | | |
| Commercial business: | | | | | | |
| Commercial and industrial | $ 4,258 | $ 5,101 | $ 9,359 | $ 13,201 | $ 1,511 | $ 10,176 |
| Owner-occupied commercial real estate | 167 | 593 | 760 | 774 | 107 | 741 |
| Non-owner occupied commercial real estate | 1,829 | | 1,829 | 1,160 | | 1,163 |
| Total commercial business | 6,254 | 5,694 | 11,948 | 15,135 | 1,618 | 12,080 |
| One-to-four family residential | | | | | | |
| Real estate construction and land development: | | | | | | |
| One-to-four family residential | 1,057 | 5,182 | 6,239 | 7,578 | 1,061 | 6,570 |
| Five or more family residential and commercial properties | 4,709 | 5,988 | 10,697 | 13,425 | 211 | 10,202 |
| Total real estate construction and land development | 5,766 | 11,170 | 16,936 | 21,003 | 1,272 | 16,772 |
| Consumer | 6 | 99 | 105 | 105 | 99 | 52 |
| Gross originated loans | $ 12,026 | $ 16,963 | $ 28,989 | $ 36,243 | $ 2,989 | $ 28,904 |

| | December 31, 2010 | | | | | |
|---|---|---|---|---|---|---|
| | Recorded Investment With No Specific Valuation Allowance | Recorded Investment With Specific Valuation Allowance | Total Recorded Investment | Unpaid Contractual Principal Balance | Related Specific Valuation Allowance | Average Recorded Investment |
| | (in thousands) | | | | | |
| Commercial business: | | | | | | |
| Commercial and industrial | $ 2,462 | $ 5,691 | $ 8,153 | $ 9,261 | $ 2,569 | $ 8,909 |
| Owner-occupied commercial real estate | 129 | 650 | 779 | 822 | 163 | 771 |
| Non-owner occupied commercial real estate | 2,301 | | 2,301 | 3,972 | | 2,175 |
| Total commercial business | 4,892 | 6,341 | 11,233 | 14,055 | 2,732 | 11,855 |
| One-to-four family residential | | 2 | 2 | 2 | 2 | 2 |
| Real estate construction and land development: | | | | | | |
| One-to-four family residential | 1,804 | 8,423 | 10,227 | 10,183 | 1,664 | 11,228 |
| Five or more family residential and commercial properties | | 5,416 | 5,416 | 6,453 | 201 | 5,697 |
| Total real estate construction and land development | 1,804 | 13,839 | 15,643 | 16,636 | 1,865 | 16,925 |
| Consumer | | | | | | |
| Gross originated loans | $ 6,696 | $ 20,182 | $ 26,878 | $ 30,693 | $ 4,599 | $ 28,782 |

For the three and six months ended June 30, 2011 and June 30, 2010, no interest income was recognized subsequent to a loan s classification as impaired. For the year ended December 31, 2010, $13,000 of interest income was recognized on impaired loans.

The Company had governmental guarantees of $3.7 million and $3.2 million related to the impaired originated loan balances at June 30, 2011 and December 31, 2010, respectively.

*(f) Troubled Debt Restructured Loans*

At June 30, 2011, the Company had $10.5 million in originated restructured loans, of which $5.2 million were accruing and $5.3 million were non-accruing and considered impaired. Originated restructured loans consisted of $4.8 million of real estate construction commercial loans, $4.5 million of real estate construction one-to-four family residential loans, $858,000 of commercial and industrial loans and $382,000 of non-owner occupied commercial properties. At December 31, 2010, the Company had $9.1 million in originated restructured loans, of which $394,000 were accruing and $8.7 million were non-accruing and considered impaired. The majority of originated restructured loans were real estate construction one-to-four family residential loans in the amount of $7.8 million, followed by commercial and industrial loans of $900,000 and non-owner occupied commercial properties of $400,000.

*(g) Impaired Purchased Loans*

As indicated above, the Company purchased impaired loans from the Cowlitz and Pierce Commercial Acquisitions which are accounted for under FASB ASC 310-30.

The following tables reflect the outstanding balance at June 30, 2011 and December 31, 2010 of the purchased impaired loans:

| | Cowlitz Bank | |
|---|---|---|
| | **June 30, 2011** | **December 31, 2010** |
| | **(In thousands)** | |
| Covered purchased loans: | | |
| Commercial business: | | |
| Commercial and industrial | $ 42,045 | $ 44,797 |
| Owner-occupied commercial real estate | 20,425 | 23,216 |
| Non-owner occupied commercial real estate | 19,434 | 22,063 |
| Total commercial business | 81,904 | 90,076 |
| One-to-four family residential | 4,326 | 5,122 |
| Real estate construction and land development: | | |
| One-to-four family residential | 10,525 | 10,913 |
| Five or more family residential and commercial properties | | |
| Total real estate construction and land development | 10,525 | 10,913 |
| Consumer | 4,682 | 4,839 |
| Gross impaired purchased covered loans | 101,437 | 110,950 |
| Non-covered purchased loans: | | |
| Consumer | 518 | 676 |
| Total impaired purchased loans | $ 101,955 | $ 111,626 |

The total balance of subsequent advances on the purchased impaired covered loans was $10.3 million and $6.0 million as of June 30, 2011 and December 31, 2010, respectively.

| | Pierce Commercial Bank | |
|---|---|---|
| | June 30, 2011 | December 31, 2010 |
| | (In thousands) | |
| Non-covered purchased loans: | | |
| Commercial business: | | |
| Commercial and industrial | $ 44,529 | $ 54,845 |
| Owner-occupied commercial real estate | 7,780 | 7,759 |
| Non-owner occupied commercial real estate | 8,703 | 8,927 |
| Total commercial business | 61,012 | 71,531 |
| One-to-four family residential | 3,772 | 5,178 |
| Real estate construction and land development: | | |
| One-to-four family residential | 11,184 | 11,925 |
| Five or more family residential and commercial properties | 4,315 | 4,333 |
| Total real estate construction and land development | 15,499 | 16,258 |
| Consumer | 9,787 | 11,506 |
| Gross impaired purchased non-covered loans | $ 90,070 | $ 104,473 |

On the acquisition date, the amount by which the undiscounted expected cash flows of the purchased impaired loans exceed the estimate fair value of the loan is the accretable yield . The accretable yield is then measured at each financial reporting date and represents the difference between the remaining undiscounted expected cash flows and the current carrying value of the purchased impaired loan.

The following table summarizes the accretable yield on the Cowlitz Bank and Pierce Commercial Bank impaired purchased loans for the three and six months ended June 30, 2011:

| | Three Months Ended June 30, 2011 | | Six Months Ended June 30, 2011 | |
|---|---|---|---|---|
| | Cowlitz Bank | Pierce Commercial Bank | Cowlitz Bank | Pierce Commercial Bank |
| | (in thousands) | | | |
| Balance at the beginning of period | $ 25,485 | $ 10,251 | $ 20,082 | $ 10,943 |
| Accretion | (3,370) | (1,731) | (5,438) | (2,856) |
| Disposals and other | (462) | 1,219 | 1,056 | 1,652 |
| Change in accretable yield | 569 | 6,536 | 6,522 | 6,536 |
| Balance at the end of period | $ 22,222 | $ 16,275 | $ 22,222 | $ 16,275 |

**NOTE 3. Allowance for Loan Losses**

The allowance for loan losses is maintained at a level deemed appropriate by management to adequately provide for known and inherent risks in the loan portfolio. A summary of the changes in the originated loans allowance for loan losses for the three and six months ended June 30, 2011 and June 30, 2010 are as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| | (in thousands) | | | |
| Balance at the beginning of period | $ 21,382 | $ 24,797 | $ 22,062 | $ 26,164 |
| Loans charged off | (1,552) | (1,736) | (5,546) | (7,173) |
| Recoveries of loans charged off | 186 | 57 | 905 | 377 |
| Provision charged to operations | 1,995 | 3,150 | 4,590 | 6,900 |

| | | | | |
|---|---|---|---|---|
| Balance at the end of period | $ 22,011 | $ 26,268 | $ 22,011 | $ 26,268 |

A summary of the changes in the purchased loans   allowance for loan losses for the three and six months ended June 30, 2011 are as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | Purchased Covered | Purchased Non-Covered | Purchased Covered | Purchased Non-Covered |
| | (in thousands) | | | |
| Balance at the beginning of period | $ 1,512 | $ 266 | $ | $ |
| Provision charged to operations | 1,004 | 525 | 2,516 | 791 |
| Balance at the end of period | $ 2,516 | $ 791 | $ 2,516 | $ 791 |

The following table details activity in the allowance for loan losses disaggregated on the basis of the Company s impairment method for the three and six months ended June 30, 2011:

| | Commercial and industrial | Owner-occupied commercial real estate | Non-owner occupied commercial real estate | One-to-four family residential | Real estate construction and land development: one-to-four family residential | Real estate construction and land development: five or more family residential and commercial real estate | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | (in thousands) | | | | |
| Allowance for loan losses for the three month ended June 30, 2011: | | | | | | | | | |
| Beginning balance | $ 10,585 | $ 2,410 | $ 2,796 | $ 407 | $ 3,726 | $ 1,817 | $ 777 | $ 642 | $ 23,160 |
| Charge-offs | (1,237) | | | | (147) | (153) | (15) | | (1,552) |
| Recoveries | 77 | | | | | 103 | 6 | | 186 |
| Provisions | 1,612 | 283 | 518 | 140 | 686 | (71) | 330 | 26 | 3,524 |
| Ending balance | 11,037 | 2,693 | 3,314 | 547 | 4,265 | 1,696 | 1,098 | 668 | 25,318 |
| Allowance for loan losses for the six month ended June 30, 2011: | | | | | | | | | |
| Beginning balance | $ 10,487 | $ 1,674 | $ 2,189 | $ 500 | $ 4,321 | $ 1,114 | $ 846 | $ 931 | $ 22,062 |
| Charge-offs | (2,465) | | | (15) | (2,053) | (895) | (118) | | (5,546) |
| Recoveries | 765 | | 25 | | | 103 | 12 | | 905 |
| Provisions | 2,250 | 1,019 | 1,100 | 62 | 1,997 | 1,374 | 358 | (263) | 7,897 |
| Ending balance | 11,037 | 2,693 | 3,314 | 547 | 4,265 | 1,696 | 1,098 | 668 | 25,318 |
| Period-end amount allocated to:: | | | | | | | | | |
| Originated loans individually evaluated for impairment | 1,511 | 107 | | | 1,061 | 211 | 99 | | 2,989 |
| Originated loans collectively evaluated for impairment | 8,402 | 1,786 | 2,673 | 402 | 2,878 | 1,485 | 728 | 668 | 19,022 |
| Purchased other covered loans collectively evaluated for impairment | 67 | 141 | 2 | 9 | | | 15 | | 234 |
| Purchased other non-covered loans collectively evaluated for impairment | 121 | 75 | 53 | 6 | | | 11 | | 266 |
| Purchased impaired covered loans collectively evaluated for impairment | 777 | 584 | 511 | 74 | 326 | | 10 | | 2,282 |
| Purchased impaired non-covered loans collectively evaluated for impairment | 159 | | 75 | 56 | | | 235 | | 525 |
| Ending balance | $ 11,037 | $ 2,693 | $ 3,314 | $ 547 | $ 4,265 | $ 1,696 | $ 1,098 | $ 668 | $ 25,318 |

The purchased loans acquired in the Cowlitz and Pierce Commercial Acquisitions are subject to the Company s internal and external credit review. If and when credit deterioration occurs subsequent to the acquisition dates, a provision for loan losses will be charged to earnings for the full amount without regard to the FDIC loss-sharing agreement for the covered loan balances. The portion of the estimated loss reimbursable from the FDIC is recorded in noninterest income and increases the FDIC Indemnification Asset. During the three and six months ended June 30,

2011, the Company recorded provision for loan losses related to further credit deterioration of the purchased impaired covered loans of $1.0 million and $2.1 million, respectively. The related increase in the FDIC indemnification asset was $89,000 and $1.2 million, respectively. There were no purchased loans classified as impaired, meaning no purchased loan was individually evaluated for impairment in the table above.

The following table details the recorded investment balance of the loan receivables disaggregated on the basis of the Company s impairment method as of June 30, 2011:

| | Commercial and industrial | Owner-occupied commercial real estate | Non-owner occupied commercial real estate | One-to-four family residential | Real estate construction and land development: one-to-four family residential | Real estate construction and land development: five or more family residential and commercial real estate | Consumer | Total |
|---|---|---|---|---|---|---|---|---|
| | | | | (in thousands) | | | | |
| Originated loans individually evaluated for impairment | $ 9,359 | $ 760 | $ 1,829 | $ | $ 6,239 | $ 10,697 | $ 105 | $ 28,989 |
| Originated loans collectively evaluated for impairment | 262,954 | 155,855 | 217,325 | 38,704 | 17,606 | 31,346 | 31,342 | 755,132 |
| Other purchased covered loans collectively evaluated for impairment | 10,050 | 20,801 | 328 | 1,479 | 53 | | 2,254 | 34,965 |
| Other purchased non-covered loans collectively evaluated for impairment | 7,340 | 11,135 | 7,602 | 143 | | | 11,705 | 37,925 |
| Impaired purchased covered loans collectively evaluated for impairment | 35,173 | 19,158 | 16,681 | 3,659 | 5,890 | | 4,594 | 85,155 |
| Impaired purchased non-covered loans collectively evaluated for impairment | $ 36,540 | $ 6,488 | $ 7,231 | $ 3,281 | $ 3,424 | $ 1,332 | $ 8,043 | $ 66,339 |

The following table details the balance in the allowance for loan losses disaggregated on the basis of the Company s impairment method for the year ended December 31, 2010:

| | Commercial and industrial | Owner-occupied commercial real estate | Non-owner occupied commercial real estate | One-to-four family residential | Real estate construction and land development: one-to-four family residential | Real estate construction and land development: five or more family residential and commercial real estate | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | (in thousands) | | | | |
| Allowance for loan losses allocated to: | | | | | | | | | |
| Originated loans individually evaluated for impairment | $ 2,569 | $ 163 | $ | $ 2 | $ 1,664 | $ 201 | $ | $ | $ 4,599 |
| Originated loans collectively evaluated for impairment | 7,918 | 1,511 | 2,189 | 498 | 2,657 | 913 | 846 | 931 | 17,463 |
| Balance of allowance for loan losses at December 31, 2010 | $ 10,487 | $ 1,674 | $ 2,189 | $ 500 | $ 4,321 | $ 1,114 | $ 846 | $ 931 | $ 22,062 |

The following table details the recorded investment balance of the loan receivables disaggregated on the basis of the Company s impairment method for the year ended December 31, 2010:

| | Commercial and industrial | Owner-occupied commercial real estate | Non-owner occupied commercial real estate | One-to-four family residential | Real estate construction and land development: one-to-four family residential | Real estate construction and land development: five or more family residential and commercial real estate | Consumer | Total |
|---|---|---|---|---|---|---|---|---|
| | | | | (in thousands) | | | | |
| Originated loans individually evaluated for impairment | $ 8,153 | $ 779 | $ 2,301 | $ 2 | $ 10,227 | $ 5,416 | $ | $ 26,878 |
| Originated loans collectively evaluated for impairment originated | 225,722 | 158,666 | 219,417 | 38,848 | 18,762 | 22,995 | 32,054 | 716,464 |
| Non-impaired purchased covered loans collectively evaluated for impairment | 11,304 | 22,856 | 331 | 1,475 | 54 | | 2,565 | 38,585 |
| Non-impaired purchased non-covered loans collectively evaluated for impairment | 12,830 | 11,907 | 11,430 | 404 | | | 14,230 | 50,801 |
| Impaired purchased covered loans collectively evaluated for impairment | 35,742 | 22,363 | 17,245 | 4,749 | 5,822 | | 4,209 | 90,130 |
| Impaired purchased non-covered loans collectively evaluated for impairment | $ 46,108 | $ 6,970 | $ 7,005 | $ 4,582 | $ 3,816 | $ 1,244 | $ 10,523 | $ 80,248 |

**NOTE 4. FDIC Indemnification Asset**

Changes in the FDIC indemnification asset during the three and six months ended June 30, 2011 are as follows:

| | Three months ended June 30, 2011 | Six months ended June 30, 2011 |
|---|---|---|
| | (in thousands) | |
| Beginning Balance | $ 16,869 | $ 16,071 |
| Cash payments received from the FDIC | (672) | (674) |
| FDIC share of additional estimated losses | 89 | 1,310 |
| Net amortization | (1,801) | (2,222) |
| Balance at June 30, 2011 | $ 14,485 | $ 14,485 |

**NOTE 5. Stockholders Equity**

*(a) Earnings Per Common Share*

The following table illustrates the reconciliation of weighted average shares used for earnings per common share computations for the noted periods:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 |
| | (Dollars in thousands) | | | |
| Net income: | | | | |
| Net income | $ 1,685 | $ 855 | $ 2,450 | $ 1,551 |
| Dividends accrued and discount accreted on preferred shares | | (332) | | (663) |
| Net income applicable to common shareholders | 1,685 | 523 | 2,450 | 888 |
| Dividends and undistributed earnings allocated to participating securities | 5 | | 5 | |
| Earnings allocated to common shareholders | $ 1,680 | $ 523 | $ 2,445 | $ 888 |
| Basic: | | | | |
| Weighted average common shares outstanding | 15,648,496 | 11,096,841 | 15,624,412 | 11,084,405 |
| Less: Restricted stock awards | (185,236) | (85,171) | (168,686) | (77,752) |
| Total basic weighted average common shares outstanding | 15,463,260 | 11,011,670 | 15,455,726 | 11,006,653 |
| Diluted: | | | | |
| Basic weighted average common shares outstanding | 15,463,260 | 11,011,670 | 15,455,726 | 11,006,653 |
| Incremental shares from stock options, restricted stock awards and common stock warrant | 69,765 | 50,576 | 71,498 | 46,867 |
| Weighted average common shares outstanding | 15,533,025 | 11,062,246 | 15,527,224 | 11,053,520 |

Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. For the three and six months ended June 30, 2011 anti-dilutive shares outstanding related to options and warrants to acquire common stock totaled 483,927 and 522,620, respectively, as the exercise price was in excess of the market value. For the three and six months ended June 30, 2010 anti-dilutive shares outstanding related to options and warrants to acquire common stock totaled 537,031 and 544,706, respectively, as the exercise price was in excess of the market value.

*(b) Dividends*

*Common Stock*. The timing and amount of cash dividends paid on our common stock depends on the Company s earnings, capital requirements, financial condition and other relevant factors. Dividends on common stock from the Company depend substantially upon receipt of dividends from the Banks, which are the Company s predominant sources of income. On July 27, 2011, the Company s Board of Directors declared a dividend of $0.05 per share payable on August 26, 2011, to shareholders of record on August 12, 2011.

The FDIC and the DFI have the authority under their supervisory powers to prohibit the payment of dividends by Heritage Bank and Central Valley Bank to the Company. Additionally, current guidance from the Federal Reserve provides, among other things, that dividends per share on the Company s common stock generally should not exceed earnings per share, measured over the previous four fiscal quarters. Current regulations allow the Company and its subsidiary banks to pay dividends on their common stock if the Company s or Banks regulatory capital would not be reduced below the statutory capital requirements set by the Federal Reserve and the FDIC.

**NOTE 6. Share Based Payment**

Total stock-based compensation expense (excluding ESOP expense) for the six months ended June 30, 2011 and 2010 were as follows:

| | Six Months Ended June 30, | |
|---|---|---|
| | 2011 | 2010 |
| | (In thousands) | |
| Compensation expense recognized | $ 514 | $ 285 |
| Related tax benefit recognized | 151 | 70 |

As of June 30, 2011, the total unrecognized compensation expense related to non-vested stock awards was $1.5 million and the related weighted average period over which it is expected to be recognized is approximately 2.8 years.

The fair value of options granted during the six months ended June 30, 2010 was estimated on the date of grant using the Black-Scholes option pricing model based on the assumptions noted in the following table (there were no options granted during the six months ended June 30, 2011.) The expected term of share options was derived from historical data and represents the period of time that share options granted are expected to be outstanding. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. Expected volatility is based on historical volatility of Company shares. Expected dividend yield is based on dividends expected to be paid during the expected term of the share options.

| Six months ended | Weighted Average Risk Free Interest Rate | Expected Term in years | Expected Volatility | Expected Dividend Yield | Weighted Average Fair Value |
|---|---|---|---|---|---|
| June 30, 2010 | 2.45% | 6.21 | 32% | 2.72% | $ 3.84 |

**NOTE 7. Stock Option and Award Activity**

The following table summarizes stock option activity for the six months ended June 30, 2011.

| | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value (In thousands) |
|---|---|---|---|---|
| Outstanding at December 31, 2010 | 550,524 | $ 18.70 | | |
| Granted | | | | |
| Exercised | (50) | 11.35 | | |
| Forfeited or expired | (107,403) | 20.19 | | |
| Outstanding at June 30, 2011 | 443,071 | $ 18.34 | 3.9 | $ 156 |
| Exercisable at June 30, 2011 | 334,314 | $ 19.84 | 2.7 | $ 104 |

The total intrinsic value of options exercised during the six months ended June 30, 2011 was $0.

The following table summarizes restricted stock award activity for the six months ended June 30, 2011.

| | Shares | Weighted-Average Grant |
|---|---|---|

| | | Date Fair Value |
|---|---|---|
| Outstanding at December 31, 2010 | 118,304 | $ 18.28 |
| Granted | 78,403 | 14.85 |
| Vested | (22,149) | 21.84 |
| Forfeited | (1,740) | 16.64 |
| Outstanding at June 30, 2011 | 172,818 | $ 16.28 |

**NOTE 8. Investment Securities**

The amortized cost, gross unrealized gains and losses, and fair values of investment securities at the dates indicated were as follows:

| Securities Available for Sale | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| | | (In thousands) | | |
| **June 30, 2011** | | | | |
| U.S. Treasury and U.S. Government agencies | $ 40,596 | $ 359 | $ | $ 40,955 |
| Municipal securities | 24,999 | 519 | (20) | 25,498 |
| Corporate securities | 10,056 | 152 | | 10,208 |
| Mortgage backed securities and collateralized mortgage obligations: | | | | |
| U.S. Government agencies | 69,800 | 1,486 | (83) | 71,203 |
| Total | $ 145,451 | $ 2,516 | $ (103) | $ 147,864 |
| **December 31, 2010** | | | | |
| U.S. Treasury and U.S. Government agencies | $ 41,124 | $ 367 | $ (62) | $ 41,429 |
| Municipal securities | 20,237 | 169 | (193) | 20,213 |
| Corporate securities | 10,097 | 182 | (3) | 10,276 |
| Mortgage backed securities and collateralized mortgage obligations: | | | | |
| U.S. Government agencies | 52,394 | 1,034 | (171) | 53,257 |
| Total | $ 123,852 | $ 1,752 | $ (429) | $ 125,175 |

| Securities Held to Maturity | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| | | (In thousands) | | |
| **June 30, 2011** | | | | |
| U.S. Treasury and U.S. Government agencies | $ 1,827 | $ 159 | $ | $ 1,986 |
| Municipal securities | 3,672 | 157 | (2) | 3,827 |
| Mortgage backed securities and collateralized mortgage obligations: | | | | |
| U.S. Government agencies | 5,958 | 296 | | 6,254 |
| Private residential collateralized mortgage obligations | 1,718 | 204 | (91) | 1,831 |
| Total | $ 13,175 | $ 816 | $ (93) | $ 13,898 |
| **December 31, 2010** | | | | |
| U.S. Treasury and U.S. Government agencies | $ 1,858 | $ 93 | $ | $ 1,951 |
| Municipal securities | 3,410 | 100 | (19) | 3,491 |
| Mortgage backed securities and collateralized mortgage obligations: | | | | |
| U.S. Government agencies | 6,592 | 208 | | 6,800 |
| Private residential collateralized mortgage obligations | 1,908 | 250 | (110) | 2,048 |
| Total | $ 13,768 | $ 651 | $ (129) | $ 14,290 |

Available for sale and held to maturity investments with unrealized losses as of June 30, 2011, were as follows:

| | Less than 12 Months | 12 Months or Longer | Total |
|---|---|---|---|

| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
|---|---|---|---|---|---|---|
| | | | (In thousands) | | | |
| U.S. Treasury and U.S. Government agencies | $ | $ | $ | $ | $ | $ |
| Municipal securities | 4,133 | 22 | | | 4,133 | 22 |
| Mortgage backed securities and collateralized mortgage obligations: | | | | | | |
| U.S. Government agencies | 4,577 | 83 | 5 | | 4,582 | 83 |
| Private residential collateralized mortgage obligations | 271 | 3 | 721 | 88 | 992 | 91 |
| Total temporarily impaired securities | $ 8,981 | $ 108 | $ 726 | $ 88 | $ 9,707 | $ 196 |

Available for sale and held to maturity investments with unrealized losses as of December 31, 2010, were as follows:

| | Less than 12 Months | | 12 Months or Longer | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| | (In thousands) | | | | | |
| U.S. Treasury and U.S. Government agencies | $ 10,651 | $ 62 | $ | $ | $ 10,651 | $ 62 |
| Municipal securities | 13,575 | 212 | | | 13,575 | 212 |
| Corporate securities | 2,067 | 3 | | | 2,067 | 3 |
| Mortgage backed securities and collateralized mortgage obligations: | | | | | | |
| U.S. Government agencies | 10,968 | 171 | | | 10,968 | 171 |
| Private residential collateralized mortgage obligations | 681 | 7 | 736 | 103 | 1,417 | 110 |
| Total temporarily impaired securities | $ 37,942 | $ 455 | $ 736 | $ 103 | $ 38,678 | $ 558 |

The Company has evaluated these securities and has determined that the decline in their value is temporary. The unrealized losses are primarily due to unusually large pricing spreads in the market for mortgage-related securities. The fair value of the mortgage backed securities and the collateralized mortgage obligations is expected to recover as the securities approach their maturity date and/or as the pricing spreads narrow on mortgage-related securities. Because the Company does not intend to sell these securities nor does the Company consider it more likely than not that it will be required to sell these securities before the recovery of amortized cost basis, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at June 30, 2011.

The amortized cost and fair value of securities at June 30, 2011, by contractual maturity, are set forth below. Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

| Securities Available for Sale | Amortized Cost | Fair Value |
|---|---|---|
| | (In thousands) | |
| Due in one year or less | $ 25,512 | $ 25,711 |
| Due after one year through three years | 28,570 | 28,950 |
| Due after three years through five years | 1,982 | 1,995 |
| Due after five through ten years | 29,378 | 29,919 |
| Due after ten years | 60,009 | 61,289 |
| Totals | $ 145,451 | $ 147,864 |

| Securities Held to Maturity | Amortized Cost | Fair Value |
|---|---|---|
| | (In thousands) | |
| Due in one year or less | $ 95 | $ 95 |
| Due after one year through three years | 625 | 653 |
| Due after three years through five years | 1,328 | 1,415 |
| Due after five years through ten years | 3,016 | 3,215 |
| Due after ten years | 8,111 | 8,520 |
| Totals | $ 13,175 | $ 13,898 |

For the private residential collateralized mortgage obligations we estimated expected future cash flows of the securities by estimating the expected future cash flows of the underlying collateral and applying those collateral cash flows, together with any credit enhancements such as subordination interests owned by third parties, to the security. The expected future cash flows of the underlying collateral are determined using the remaining contractual cash flows adjusted for future expected credit losses (which considers current delinquencies and nonperforming assets, future expected default rates and collateral value by vintage and geographic region) and prepayments. The expected cash flows of the security

are then discounted at the interest rate used to recognize interest income on the security to arrive at a present value amount. For the six months ended June 30, 2011, four private residential collateralized mortgage obligations were determined to be other-than-temporarily impaired resulting in the Company recording $20,000 in impairments on private collateralized mortgage obligations not related to credit losses through other comprehensive income rather than through earnings and $45,000 in impairments related to credit losses through earnings. The average prepayment rate and discount interest rate used in the valuations of the present value were 6.0% and 7.67%, respectively.

The following table summarizes activity related to the amount of other-than-temporary impairments on held to maturity securities during the six months ended June 30, 2011:

| | Gross Other-Than-Temporary Impairments | Other-Than-Temporary Impairments Included in Other Comprehensive Loss | Net Other-Than-Temporary Impairments Included in Earnings |
|---|---|---|---|
| | | (In thousands) | |
| December 31, 2010 | $ 2,317 | $ 1,080 | $ 1,237 |
| Additions: | | | |
| Initial impairments | 7 | | 7 |
| Subsequent impairments | 57 | 20 | 37 |
| June 30, 2011 | $ 2,381 | $ 1,100 | $ 1,281 |

Details of private residential collateralized mortgage obligation securities received in 2008 from the redemption-in-kind of the AMF Ultra Short Mortgage Fund ( Fund ) as of June 30, 2011 were as follows:

| | | | | | | | | Current Ratings | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Type and Year of Issuance | Par Value | Amortized Cost | Fair Value (2) | Aggregate Unrealized Gain (loss) | Year-to-date Change in Unrealized Gain (loss) | Year-to-date Impairment Charge | Life-to-date Impairment Charge (1) | AAA | AA | A | BBB | Below Investment Grade |
| | | | | | (Dollars in thousands) | | | | | | | |
| Alt-A | 937 | 261 | 256 | (5) | (58) | 19 | 642 | 1% | | | 2% | 97% |
| Prime | 2,452 | 1,457 | 1,575 | 118 | (169) | 26 | 639 | 3% | 3% | 4% | 5% | 85% |
| Totals | $ 3,389 | $ 1,718 | $ 1,831 | $ 113 | $ (227) | $ 45 | $ 1,281 | 3% | 2% | 4% | 5% | 86% |

(1) Life-to-date impairment charge represents impairment charges recognized in earnings subsequent to redemption of the Fund.

(2) Level three valuation assumptions were used to determine the fair value of the held-to-maturity securities in the Fund.

**NOTE 9. Federal Home Loan Bank Stock**

The Banks are required to maintain an investment in the stock of the Federal Home Loan Bank ( FHLB ) of Seattle in an amount equal to the greater of $500,000 or 0.50% of residential mortgage loans and pass-through securities or an advance requirement to be confirmed on the date of the advance and 5.0% of the outstanding balance of mortgage loans sold to the FHLB of Seattle. At June 30, 2011 and December 31, 2010, the Company was required to maintain an investment in the stock of FHLB of Seattle of at least $1.2 million and $1.4 million, respectively. At June 30, 2011 and December 31, 2010, the Company had an investment in FHLB stock carried at a cost basis (par value) of $5.6 million.

The Company evaluated its investment in FHLB of Seattle stock for other-than-temporary impairment, consistent with its accounting policy. Based on the Company s evaluation of the underlying investment, including the long-term nature of the investment, the liquidity position of the FHLB of Seattle, the actions being taken by the FHLB of Seattle to address its regulatory situation and the Company s intent and ability to hold the investment for a period of time sufficient to recover the par value, the Company did not recognize an other-than-temporary impairment loss on its FHLB of Seattle stock. Even though the Company did not recognize an other-than-temporary impairment loss on its FHLB of Seattle stock during the six months ended June 30, 2011, and June 30, 2010, further deterioration in the FHLB of Seattle s financial position may result in future impairment losses.

**NOTE 10. Goodwill**

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

When required, the goodwill impairment test involves a two-step process. The first test for goodwill impairment is done by comparing the reporting unit s aggregate fair value to its carrying value. Absent other indicators of impairment, if the aggregate fair value exceeds the carrying value, goodwill is not considered impaired and no additional analysis is necessary. If the carrying value of the reporting unit were to exceed the aggregate fair value, a second test would be preformed 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.

The Company s annual impairment test was performed during the quarter ended December 31, 2010, and will be conducted during the quarter ending December 31, 2011. For the quarter ended June 30, 2011, the Company determined no triggering events had occurred and, therefore, did not conduct an interim impairment test of goodwill.

**NOTE 11. Fair Value Measurements**

Because broadly traded markets do not exist for most of the Company s financial instruments, the fair value calculations attempt to incorporate the effect of current market conditions at a specific time. These determinations are subjective in nature, involve uncertainties and matters of significant judgment and do not include tax ramifications; therefore, the results cannot be determined with precision, substantiated by comparison to independent markets and may not be realized in an actual sale or immediate settlement of the instruments. There may be inherent weaknesses in any calculation technique, and changes in the underlying assumptions used, including discount rates and estimates of future cash flows, could significantly affect the results. For all of these reasons, the aggregation of the fair value calculations presented herein do not represent, and should not be construed to represent, the underlying value of the Company.

*(a) Cash on Hand and in Banks, Interest Earning Deposits and Federal Funds Sold*

The fair value of financial instruments that are short-term or reprice frequently and that have little or no risk are considered to have a fair value equal to carrying value.

*(b) Investment Securities Available for Sale and Held to Maturity*

The fair value of all investment securities are based upon the assumptions market participants would use in pricing the security. Such assumptions include observable and unobservable inputs such as quoted market prices, dealer quotes and discounted cash flows.

*(c) Federal Home Loan Bank stock*

FHLB of Seattle stock is not publicly traded, however the recorded value of the stock holdings approximates the fair value, as the FHLB is required to pay par value upon re-acquiring this stock.

*(d) Loans Receivable and Loans Held for Sale*

Fair value is estimated using the Company s lending rates that would have been offered at June 30, 2011, and December 31, 2010, for loans, which mirror the attributes of the loans with similar rate structures and average maturities. Commercial loans and construction loans, which are variable rate and short-term are reflected with fair values equal to carrying value. Impaired loans are measured on a loan by loan basis by either the present value of expected future discounted cash flows, the loan s obtainable market price, or the market value (less selling costs) of the collateral if the loan is collateral dependent.

While these methodologies are permitted under U.S. Generally Accepted Accounting Principles or GAAP for this disclosure, the amounts derived are not intended to reflect an exit price of the asset.

*(e) Deposits*

For deposits with no contractual maturity, the fair value is equal to the carrying value. The fair value of fixed maturity deposits is based on discounted cash flows using the difference between the deposit rate and the rates currently offered by the Company for deposits of similar remaining maturities.

*(f) Securities Sold Under Agreement to Repurchase*

Securities sold under agreement to repurchase are short-term in nature, repricing on a daily basis. Fair value financial instruments that are short-term or reprice frequently and that have little or no risk are considered to have a fair value equal to carrying value.

*(g) Other Financial Instruments*

The majority of our commitments to extend credit, standby letters of credit and commitments to sell mortgage loans carry current market interest rates if converted to loans, as such, carrying value is assumed to equal fair value.

The table below presents the carrying value amount of the Company s financial instruments and their corresponding fair values. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by ASC 820-10, *Fair Value Measurements and Disclosures,* and generally produces a higher fair value.

| | June 30, 2011 | | December 31, 2010 | |
|---|---|---|---|---|
| | **Carrying Value** | **Fair Value** | **Carrying Value** | **Fair Value** |
| | (In thousands) | | | |
| **Financial Assets** | | | | |
| Cash on hand and in banks | $ 31,069 | $ 31,069 | $ 37,179 | $ 37,179 |
| Interest earning deposits | 86,323 | 86,323 | 129,822 | 129,822 |
| Federal funds sold | | | 1,990 | 1,990 |
| Investment securities available for sale | 147,864 | 147,864 | 125,175 | 125,175 |
| Investment securities held to maturity | 13,175 | 13,898 | 13,768 | 14,290 |
| Federal Home Loan Bank stock | 5,594 | 5,594 | 5,594 | 5,594 |
| Loans receivable and loans held for sale, net of allowance | 982,236 | 1,003,478 | 980,485 | 989,968 |
| **Financial Liabilities** | | | | |
| Deposits: | | | | |
| Savings, money market and demand | 754,530 | 754,530 | 733,335 | 733,335 |
| Time certificates | 353,190 | 354,946 | 402,941 | 404,676 |
| Total deposits | $ 1,107,720 | $ 1,109,476 | $ 1,136,276 | $ 1,138,011 |

| | | | | |
|---|---|---|---|---|
| Securities sold under agreement to repurchase | $ 17,272 | $ 17,272 | $ 19,027 | $ 19,027 |

We measure certain financial assets and financial liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1 Valuations for assets and liabilities traded in active exchange markets, or interest in open-end mutual funds that allow the Company to sell its ownership interest back to the fund at net asset value ( NAV ) on a daily basis. Valuations are obtained from readily available pricing sources for market transactions involving identical assets, liabilities, or funds.

Level 2 Valuations for assets and liabilities traded in less active dealer, or broker markets, such as quoted prices for similar assets or liabilities or quoted prices in markets that are not active. Level 2 includes U.S. Treasury, U.S. government and agency debt securities, and mortgage-backed securities. Valuations are usually obtained from third party pricing services for comparable assets or liabilities.

Level 3 Valuations for assets and liabilities that are derived from other valuation methodologies, such as option pricing models, discounted cash flow models and similar techniques, and not based on market exchange, dealer, or broker traded transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities.

The following table summarizes the balances of assets and liabilities measured at fair value on a recurring basis at June 30, 2011.

| | Total | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| | | (In thousands) | | |
| Investment Securities Available for Sale: | | | | |
| U.S. Treasury and U.S. Government agencies | $ 40,955 | $ | $ 40,955 | $ |
| Municipal securities | 25,498 | | 25,498 | |
| Corporate securities | 10,208 | | 10,208 | |
| Mortgage backed securities and collateralized mortgage obligations-residential: | | | | |
| U.S Government agencies | 71,203 | | 71,203 | |
| Total | $ 147,864 | $ | $ 147,864 | $ |

The Company may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis. These adjustments to fair value usually result from application of lower-of-cost-or-market accounting or write-downs of individual assets. For assets measured at fair value on a nonrecurring basis during the six months ended June 30, 2011 and year ended December 31, 2010 that were still held in the balance sheet at the end of such periods, the following tables provide the level of valuation assumptions used to determine each adjustment and the carrying value of the related assets at the dates indicated.

| | Fair Value at June 30, 2011 | | | | Six Months Ended June 30, 2011 |
|---|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 | Total Losses |
| | | | (In thousands) | | |
| Loans receivable (1) | $ 7,977 | $ | $ | $ 7,977 | $ 3,819 |
| Investment securities held to maturity (2): | | | | | |
| Mortgage back securities and collateralized mortgage obligations-residential: | | | | | |
| Private residential collateralized mortgage obligations | 118 | | | 118 | 45 |
| Other real estate owned (3) | 1,006 | | | 1,006 | 233 |
| Total | $ 9,101 | $ | $ | $ 9,101 | $ 4,097 |

(1) As of June 30, 2011, a specific reserve of $3.0 million was recorded on loans receivable identified as impaired. Impairment losses recorded were calculated based on the fair value of the collateral, less the costs to sell. Fair value of the loans collateral is determined by an appraisal or independent valuation, which is then adjusted for the cost related to liquidation of the collateral.

(2) Investment securities held to maturity with a carrying amount of $206,000 were written down to their fair value of $142,000 resulting in an impairment charge of $45,000 to non-interest expense for the six months ended June 30, 2011. Impairment losses recorded were determined using cash flow models. We estimated expected future cash flows of the securities by estimating the expected future cash flows of the underlying collateral and applying those collateral cash flows, together with any credit enhancements such as subordination interests owned by third parties, to the security. The expected future cash flows of the underlying collateral are determined using the remaining contractual cash flows adjusted for future expected credit losses (which considers current delinquencies and nonperforming assets, future expected default rates and collateral value by vintage and geographic region) and prepayments. The expected cash flows of the security are

then discounted at the interest rate used to recognize interest income on the security to arrive at a present value amount.

(3) Loans with a carrying amount of $1.2 million were written down to their fair value of $1.0 million when they were transferred to other real estate owned during the six months ended June 30, 2011. The resulting losses, to the extent they impacted the provision for loan losses for the six months ended June 30, 2011, are included in total losses for loans receivable for the six months ended June 30, 2011 shown above.

The following table summarizes the balances of assets and liabilities measured at fair value on a recurring basis at December 31, 2010.

| | Total | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| | | (In thousands) | | |
| Investment Securities Available for Sale: | | | | |
| U.S. Treasury and U.S. Government agencies | $ 41,429 | $ | $ 41,429 | $ |
| Municipal securities | 20,213 | | 20,213 | |
| Corporate securities | 10,276 | | 10,276 | |
| Mortgage backed securities and collateralized mortgage obligations-residential: | | | | |
| U.S Government agencies | 53,257 | | 53,257 | |
| Total | $ 125,175 | $ | $ 125,175 | $ |

The following table summarizes the balances of assets and liabilities measured at fair value on a nonrecurring basis at December 31, 2010, and the total losses resulting from these fair value adjustments for the year ended December 31, 2010.

| | Fair Value at December 31, 2010 | | | | Twelve Months Ended December 31, 2010 |
|---|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 | Total Losses |
| | | | (In thousands) | | |
| Loans receivable (1) | $ 13,486 | $ | $ | $ 13,486 | $ 6,118 |
| Investment securities held to maturity (2): | | | | | |
| Mortgage back securities and collateralized mortgage obligations-residential: | | | | | |
| Private residential collateralized mortgage obligations | 96 | | | 96 | 298 |
| Other real estate owned (3) | 3,030 | | | 3,030 | 264 |
| Total | $ 16,612 | $ | $ | $ 16,612 | $ 6,680 |

(1) At December 31, 2010, a specific reserve of $4.6 million was recorded on loans receivable identified as impaired. Impairment losses recorded were calculated based on the fair value of the collateral, less the costs to sell. Fair value of the loan s collateral is determined by an appraisal or independent valuation, which is then adjusted for the cost related to liquidation of the collateral.

(2) Investment securities held to maturity with a carrying amount of $394,000 were written down to their fair value of $76,000 resulting in an impairment charge of $298,000 to noninterest expense for the twelve months ended December 31, 2010. Impairment losses recorded were determined using cash flow models. We estimated expected future cash flows of the securities by estimating the expected future cash flows of the underlying collateral and applying those collateral cash flows, together with any credit enhancements such as subordination interests owned by third parties, to the security. The expected future cash flows of the underlying collateral are determined using the remaining contractual cash flows adjusted for future expected credit losses (which considers current delinquencies and nonperforming assets, future expected default rates and collateral value by vintage and geographic region) and prepayments. The expected cash flows of the security are then discounted at the interest rate used to recognize interest income on the security to arrive at a present value amount.

(3) Loans with a carrying amount of $4.4 million were written down to their fair value of $3.0 million when they were transferred to other real estate owned during the twelve months ended December 31, 2010. The resulting losses, to the extent they impacted the provision for loan losses for the twelve months ended December 31, 2010, are included in total losses for loans receivable for the twelve months ended December 31, 2010 shown above.

**ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion is intended to assist in understanding the financial condition and results of the Company as of and for the three and six months ended June 30, 2011. The information contained in this section should be read with the unaudited condensed consolidated financial statements and its accompanying notes, and the December 31, 2010 audited consolidated financial statements and its accompanying notes included in our Annual Report on Form 10-K for the year ended December 31, 2010.*

***Overview***

Heritage Financial Corporation is a bank holding company, which primarily engages in the business activities of our wholly owned subsidiaries: Heritage Bank and Central Valley Bank (collectively, the Banks ). We provide financial services to our local communities with an ongoing strategic focus in expanding our commercial lending relationships, market area and a continual focus on asset quality. At June 30, 2011, we had total assets of $1.34 billion and total stockholders equity of $205.7 million. The Company s business activities generally are limited to passive investment activities and oversight of its investment in the Banks. Accordingly, the information set forth in this report relates primarily to the Banks operations.

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 residential and commercial construction, multi-family and commercial real estate and consumer loans and originate for sale or investment purposes first mortgage loans on residential properties located in western and central Washington State and the greater Portland, Oregon area.

Our core profitability depends primarily on our net interest income after provision for loan losses. Net interest income is the difference between interest income, which is the income that we earn on interest-earning assets, comprised primarily of loans and investments, and interest expense, the amount we pay on our interest-bearing liabilities, which are primarily deposits and borrowings. The results of our operations may also be affected by local and general economic conditions. Changes in levels of interest rates affect our net interest income. Management strives to match the repricing characteristics of the interest earning assets and interest bearing liabilities to protect net interest income from changes in market interest rates and changes in the shape of the yield curve.

The provision for loan losses is dependent on changes in the loan portfolio and management s assessment of the collectability of the loan portfolio as well as prevailing economic and market conditions. The allowance for loan losses reflects the amount that the Company believes is appropriate to cover potential credit losses in its loan portfolio. Additionally, net income is affected by non-interest income and non-interest expenses. For the three and six months ended June 30, 2011, non-interest income consisted of service charges on deposits, merchant Visa income, gains on the sale of loans, change in the FDIC indemnification asset and other operating income. Non-interest expenses consist primarily of salaries and employee benefits, occupancy and equipment, data processing, and other expenses. Salaries and employee benefits consist primarily of the salaries and wages paid to our employees, payroll taxes, expenses for retirement and other employee benefits. Occupancy and equipment expenses, which are the fixed and variable costs of building and equipment, consist primarily of lease payments, taxes, depreciation charges, maintenance and costs of utilities.

Results of operations may also be affected significantly by general and local economic and competitive conditions, changes in market interest rates, governmental policies and actions of regulatory authorities.

Net interest income is affected by changes in the volume and mix of interest earning assets, interest earned on those assets, the volume and mix of interest bearing liabilities and interest paid on interest bearing liabilities. Other income and other expenses are impacted by growth of operations and growth in the number of loan and deposit accounts through both acquisitions and core banking business growth. Growth in operations affects other expenses primarily as a result of additional employees, branch facilities and marketing expense. Growth in the number of loan and deposit accounts affects other income, including service charges as well as other expenses such as data processing services, supplies, postage, telecommunications and other miscellaneous expenses.

***Earnings Summary***

Net income available to common shareholders was $0.11 per diluted common share for the three months ended June 30, 2011 compared to $0.05 per diluted common share for the three months ended June 30, 2010. Net income for the three months ended June 30, 2011 was $1.7 million compared to net income of $855,000 for the same period in 2010. The increase was the result of a $7.4 million increase in net interest income partially offset by a $374,000 increase in the provision for loan losses, a $1.3 million decrease in non-interest income and a $4.7 million increase in non-interest expense. Net income available to common shareholders was $0.16 per diluted common share for the six months ended June 30, 2011 compared to $0.08 per diluted common share for the six months ended June 30, 2010. Net income for the six months ended June 30, 2011 was $2.5 million compared to net income of $1.6 million for the same period in 2010. The increase was the result of a $12.3 million increase in net interest income and a $130,000 increase in non-interest income partially offset by a $997,000 increase in the provision for loan losses and a $10.4 million increase in non-interest expense. As a result of the increase in non-interest expense, the Company s efficiency ratio increased to 69.3% for the three months ended June 30, 2011 from 65.7% for the three months ended June 30, 2010 and increased to 70.4% for the six

months ended June 30, 2011 from 64.2% for the six months ended June 30, 2010. The efficiency ratio consists of non-interest expense divided by the sum of net interest income before provision for loan losses plus non-interest income.

***Net Interest Income***

Net interest income increased $7.4 million, or 68.6%, to $18.2 million for the three months ended June 30, 2011, compared with $10.8 million in the same period in 2010. Net interest income increased $12.3 million, or 57.5%, to $33.8 million for the six months ended June 30, 2011, compared with $21.4 million in the same period in 2010. The increase in net interest income for both the three and six months ended June 30, 2011 as a result of an increase in interest earning assets from the Cowlitz and Pierce Acquisitions and an increase in the net interest margin. Net interest income as a percentage of average earning assets (net interest margin) for the three months ended June 30, 2011, increased 133 basis points to 5.93% from 4.60% for the same period in 2010. Net interest income as a percentage of average earning assets (net interest margin) for the six months ended June 30, 2011, increased to 5.50% from 4.59% for the same period in 2010. The increase in net interest margin for the three and six months ended June 30, 2011, was primarily due to increased loan yields as a result of discount accretion on the acquired loan portfolios.

The following table provides relevant net interest income information for the dates indicated. The average 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 stated on a tax-equivalent basis.

| | For the Three Months Ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2011 | | | 2010 | | |
| | Average Balance | Interest Earned/ Paid | Average Yield/Rate | Average Balance | Interest Earned/ Paid | Average Yield/Rate |
| | (Dollars in thousands) | | | | | |
| **Interest Earning Assets:** | | | | | | |
| Loans | $ 972,608 | $ 18,829 | 7.77% | $ 733,233 | $ 11,903 | 6.51% |
| Taxable securities | 130,060 | 768 | 2.37 | 100,175 | 675 | 2.70 |
| Nontaxable securities | 23,914 | 199 | 3.34 | 7,458 | 78 | 4.20 |
| Interest earning deposits and Federal funds sold | 95,641 | 61 | 0.26 | 93,512 | 60 | 0.26 |
| FHLB stock | 5,594 | | | 3,566 | | |
| Total interest earning assets | $ 1,227,817 | $ 19,857 | 6.49 | $ 937,944 | $ 12,716 | 5.44 |
| Non-interest earning assets | 102,237 | | | 70,831 | | |
| Total assets | $ 1,330,054 | | | $ 1,008,775 | | |
| **Interest Bearing Liabilities:** | | | | | | |
| Certificates of deposit | $ 355,101 | $ 1,085 | 1.23 | $ 294,400 | $ 1,285 | 1.75 |
| Savings accounts | 102,945 | 104 | 0.41 | 83,726 | 124 | 0.59 |
| Interest bearing demand and money market accounts | 446,029 | 493 | 0.44 | 330,309 | 520 | 0.63 |
| Total interest bearing deposits | 904,075 | 1,682 | 0.75 | 708,435 | 1,929 | 1.09 |
| Securities sold under agreement to repurchase | 17,998 | 20 | 0.45 | 13,457 | 21 | 0.63 |
| Total interest bearing liabilities | $ 922,073 | $ 1,702 | 0.74% | $ 721,892 | $ 1,950 | 1.08% |
| Demand and other non-interest bearing deposits | 195,112 | | | 122,270 | | |
| Other non-interest bearing liabilities | 7,244 | | | 3,318 | | |
| Preferred stock | | | | 23,397 | | |
| Stockholders equity | 206,625 | | | 161,295 | | |
| Total liabilities and stockholders equity | $ 1,330,054 | | | $ 1,008,775 | | |
| Net interest income | | $ 18,155 | | | $ 10,766 | |
| Net interest spread | | | 5.75% | | | 4.35% |
| Net interest margin | | | 5.93% | | | 4.60% |
| Average interest earning assets to average interest bearing liabilities | | | 133.16% | | | 129.93% |

| | For the Six Months Ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2011 | | | 2010 | | |
| | Average Balance | Interest Earned/ Paid | Average Yield/Rate | Average Balance | Interest Earned/ Paid | Average Yield/Rate |
| | (Dollars in thousands) | | | | | |
| **Interest Earning Assets:** | | | | | | |
| Loans | $ 972,536 | $ 35,401 | 7.34% | $ 735,648 | $ 23,873 | 6.54% |
| Taxable securities | 127,223 | 1,431 | 2.27 | 98,014 | 1,420 | 2.92 |
| Nontaxable securities | 22,526 | 378 | 3.39 | 7,448 | 151 | 4.09 |
| Interest earning deposits and Federal funds sold | 108,602 | 141 | 0.26 | 96,006 | 120 | 0.25 |
| FHLB stock | 5,594 | | | 3,566 | | |
| Total interest earning assets | $ 1,236,481 | $ 37,351 | 6.09 | $ 940,682 | $ 25,564 | 5.48 |
| Non-interest earning assets | 104,710 | | | 70,111 | | |
| Total assets | $ 1,341,191 | | | $ 1,010,793 | | |
| **Interest Bearing Liabilities:** | | | | | | |
| Certificates of deposit | $ 365,633 | $ 2,310 | 1.27 | $ 296,125 | $ 2,771 | 1.89 |
| Savings accounts | 103,372 | 220 | 0.43 | 83,548 | 256 | 0.62 |
| Interest bearing demand and money market accounts | 444,195 | 1,027 | 0.47 | 331,077 | 1,065 | 0.65 |
| Total interest bearing deposits | 913,200 | 3,557 | 0.79 | 710,750 | 4,092 | 1.16 |
| Securities sold under agreement to repurchase | 19,242 | 42 | 0.44 | 12,282 | 41 | 0.67 |
| Total interest bearing liabilities | $ 932,442 | $ 3,599 | 0.78% | $ 723,032 | $ 4,133 | 1.15% |
| Demand and other non-interest bearing deposits | 195,471 | | | 123,442 | | |
| Other non-interest bearing liabilities | 8,334 | | | 3,635 | | |
| Preferred stock | | | | 23,503 | | |
| Stockholders equity | 204,944 | | | 160,684 | | |
| Total liabilities and stockholders equity | $ 1,341,191 | | | $ 1,010,793 | | |
| Net interest income | | $ 33,752 | | | $ 21,431 | |
| Net interest spread | | | 5.31% | | | 4.33% |
| Net interest margin | | | 5.50% | | | 4.59% |
| Average interest earning assets to average interest bearing liabilities | | | 132.61% | | | 130.10% |

Total interest income increased $7.1 million, or 56.2%, to $19.9 million for the three months ended June 30, 2011, from $12.7 million for the three months ended June 30, 2010. Total interest income increased $11.8 million, or 46.1%, to $37.4 million for the six months ended June 30, 2011, from $25.6 million for the six months ended June 30, 2010. The increases in interest income for the three and six months ended June 30, 2011 was due to a combination of higher balances of average interest earning assets and higher yields on interest earning assets. The balance of average interest earning assets (including nonaccrual loans) increased $289.9 million, or 30.9%, from $937.9 million for the three months ended June 30, 2010 to $1.23 billion for the three months ended June 30, 2011. The balance of average assets (including nonaccrual loans) increased $295.8 million, or 31.5%, from $1.0 billion for the six months ended June 30, 2010 to $1.34billion for the six months ended June 30, 2011. The increase in average interest earning assets for the three and six months ended June 30, 2011 was primarily due to the Cowlitz and Pierce Acquisitions. The yield on interest earning assets increased 105 basis points from 5.44% for the three months ended June 30, 2010 to 6.49% for the three months ended June 30, 2011 and increased 61 basis points from 5.48% for the six months ended June 30, 2010 to 6.09% for the six months ended June 30, 2011. The increase in the yield on earning assets for the three and six months ended June 30, 2011 reflects the increased loans yields due to discount accretion on the acquired loan portfolios. The effect of discount accretion on loan yields for the three and six months ended June 30, 2011 was approximately 1.32% and 0.87%, respectively. For the three months ended June 30, 2011 and June 30, 2010, originated nonaccruing loans reduced the yield earned on loans by approximately 16 basis points and 27 basis points, respectively. For the six months ended June 30, 2011 and June 30, 2010, originated nonaccruing loans reduced the yield earned on loans by approximately 30 basis points and 23 basis points, respectively. Originated nonaccrual loans totaled $23.8 million at June 30, 2011 as compared to $32.1 million at June 30, 2010.

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Total interest expense decreased by $248,000, or 12.7%, to $1.7 million for the three months ended June 30, 2011 from $1.9 million for the three months ended June 30, 2010. Total interest expense decreased by $534,000, or 12.9%, to $3.6 million for the six months ended June 30, 2011 from $4.1 million for the six months ended June 30, 2010. The decreases in interest expense was attributable to lower average rates paid on interest bearing liabilities partially offset by higher balances of interest bearing liabilities. The average rate paid on interest bearing liabilities decreased to 0.74% for the three months ended June 30, 2011 from 1.08% for the three months ended June 30, 2010 and the average rate paid on interest bearing liabilities decreased to 0.78% for the six months ended June 30, 2011 from 1.15% for the six months ended June 30, 2010. Total average interest bearing liabilities increased by $200.2 million, or 27.7%, to $922.1 million for the three months ended June 30, 2011 from $721.9 million for the three months ended June 30, 2010. Total average interest bearing liabilities increased by $209.4, or 29.0%, million to $932.4 million for the six months ended June 30, 2011 from $723.0 million for the six months ended June 30, 2010. The increases in average interest bearing liabilities were due primarily to Cowlitz and Pierce Acquisitions. Deposit interest expense decreased $247,000, or 12.8%, to $1.7 million for the three months ended June 30, 2011 compared to $1.9 million for the same quarter last year. Deposit interest expense decreased $535,000, or 13.1%, to $3.6 million for the six months ended June 30, 2011 compared to $4.1 million for the same period last year. The decrease in deposit interest expense for the three and six months ended June 30, 2011 is mostly a result of a 34 and 37 basis point decrease in the average cost of interest-bearing deposits, respectively, reflecting the relatively low interest rate environment.

***Provision for Loan Losses***

The provision for loan losses increased $374,000, or 11.9%, to $3.5 million for the three months ended June 30, 2011 from $3.2 million for the three months ended June 30, 2010. The provision for loan losses increased $997,000, or 14.5%, to $7.9 million for the six months ended June 30, 2011 from $6.9 million for the six months ended June 30, 2010. The provision for loan losses on originated loans decreased $1.2 million, or 36.7%, to $2.0 million for the three months ended June 30, 2011 from $3.2 million for the three months ended June 30, 2010. The provision for loan losses on originated loans decreased $2.3 million, or 33.5%, to $4.6 million for the six months ended June 30, 2011 from $6.9 million for the six months ended June 30, 2010. The Banks had net charge-offs of $1.4 million for the three months ended June 30, 2011 compared to $1.7 million for the three months ended June 30, 2010. The ratio of net charge-offs to average total originated loans outstanding was 0.18% for the three months ended June 30, 2011 and 0.22% for the three months ended June 30, 2010. The Banks had net charge-offs of $4.6 million for the six months ended June 30, 2011 compared to $6.8 million for the six months ended June 30, 2010. The ratio of net charge-offs to average total originated loans outstanding was 0.61% for the six months ended June 30, 2011 and 0.89% for the six months ended June 30, 2010.

The provision for loan losses on purchased loans for the three and six months ended June 30, 2011 totaled $1.5 million and $3.3 million, respectively. As of the acquisition date, purchased loans were recorded at their estimated fair value, incorporating our estimate of future expected cash flows until the ultimate resolution of these credits. To the extent actual or projected cash flows are less than originally estimated, additional provisions for loan losses on the purchased loan portfolios will be recognized. However, provisions on the purchased covered loans would be mostly offset by a corresponding increase in the FDIC indemnification asset recognized within non-interest income. To the extent actual or projected cash flows are more than originally estimated, the increase in cash flows is recognized prospectively in interest income. However, the increase in interest income would be offset by a corresponding decrease in the FDIC indemnification asset recognized within non-interest income prospectively.

The Banks have established comprehensive methodologies for determining the provisions for loan losses. On a quarterly basis the Banks perform an analysis taking into consideration pertinent factors underlying the quality of the loan portfolio. These factors include changes in the amount and composition of the loan portfolio, historical loss experience for various loan classes, changes in economic conditions, delinquency rates, a detailed analysis of individual loans on nonaccrual status, and other factors to determine the level of the allowance for loan losses. The allowance for loan losses on originated loans decreased slightly by $51,000 to $22.0 million at June 30, 2011 from $22.1 million at December 31, 2010. As of June 30, 2011, we had identified $29.0 million of impaired loans, including $10.5 million of restructured loans. Of those impaired loans, $12.0 million have no allowances for credit losses as their estimated collateral value is equal to or exceeds their carrying costs. The remaining $17.0 million have related allowances for credit losses totaling $3.0 million.

Based on the comprehensive methodology, management deemed the allowance for loan losses on originated loans of $22.0 million at June 30, 2011 (2.81% of total originated loans and 86.9% of nonperforming originated loans) appropriate to provide for probable losses based on an evaluation of known and inherent risks in the loan portfolio at that date. While the Banks believe they have established their existing allowances for loan losses in accordance with GAAP, there can be no assurance that regulators, in reviewing the Banks loan portfolios, will not request the Banks to increase significantly their allowance for loan losses. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is appropriate or that increased provisions will not be necessary should the quality of the loans deteriorate. Any material increase in the allowance for loan losses would adversely affect the Company s financial condition and results of operations.

***Non-interest Income***

Total non-interest income decreased $1.3 million, or 60.1%, to $853,000 for the three months ended June 30, 2011 compared to $2.1 million for the same period in 2010. Total non-interest income increased $130,000, or 3.1%, to $4.3 million for the six months ended June 30, 2011 compared to $4.2 million for the same period in 2010. The decrease for the three months ended June 30, 2011 was due substantially to the effects of the change in the FDIC indemnification asset offset by a $196,000 increase in service charges on deposits mostly due to deposits acquired through the Cowlitz and Pierce Acquisitions and a $297,000 increase in other income. The increase for the six months ended June 30, 2011 was due to substantially to a $409,000 increase in service charges on deposits mostly due to deposits acquired through the Cowlitz and Pierce Acquisitions and a $628,000 increase in other income, substantially offset by the effects of the change in the FDIC indemnification asset.

***Non-interest Expense***

Non-interest expense increased $4.7 million, or 55.5%, to $13.2 million during the quarter ended June 30, 2011 compared to $8.5 million for the quarter ended June 30, 2010 and increased $10.4 million, or 63.0%, to $26.8 million for the six months ended June 30, 2011 compared to $16.5 million for the six months ended June 30, 2010. The increase for the three months ended June 30, 2011 compared to the same period in the prior year was due to increased salaries and benefits expense in the amount of $2.9 million, increased occupancy and equipment expense of $729,000, increased data processing of $220,000, and increased state and local taxes expense of $213,000. The increase for the six months ended June 30, 2011 compared to the same period in the prior year was due to increased salaries and benefits expense in the amount of $5.5 million, increased occupancy and equipment expense of $1.5 million, increased data processing of $623,000, increased other real estate owned expense (including valuation adjustments) of $603,000, increase professional services of $422,000 and increased state and local taxes expense of $352,000. With the exception of expenses relating to other real estate owned, these increases were substantially due to the Cowlitz and Pierce Acquisitions.

The efficiency ratio for the quarter ended June 30, 2011 was 69.3% compared to 65.7% for the same period in the prior year. The efficiency ratio for the six months ended June 30, 2011 was 70.4% compared to 64.2% for the same period in the prior year. While growth strategies are being executed the Company expects to incur higher expenses as evidenced by the current efficiency ratio. Expenses are expected to be more in line with revenue when these growth strategies being producing long term results. The increase was mostly related to the increase in non-interest expense resulting from the Cowlitz and Pierce Acquisitions. The efficiency ratio consists of non-interest expense divided by the sum of net interest income before provision for loan losses plus non-interest income.

***Income Tax Expense (Benefit)***

The provision for income taxes increased by $201,000 to an expense of $624,000 for the three months ended June 30, 2011 from an expense of $423,000 for the three months ended June 30 2010. The provision for federal income taxes increased by $186,000 to an expense of $909,000 for the six months ended June 30, 2011 from an expense of $723,000 for the six months ended June 30 2010. The Company s effective tax rate was 27.0% for the three months ended June 30, 2011 compared to 33.1% for the same period in 2010. The Company s effective tax rate was 27.1% for the six months ended June 30, 2011 compared to 31.8% for the same period in 2010. The decrease in the Company s effective tax rate is due substantially to an increase in balances of tax exempt securities.

***Financial Condition Data***

Total assets decreased $29.0 million, or 2.1%, to $1.34 billion as of June 30, 2011 from the December 31, 2010 balance of $1.37 billion due primarily to a decrease in interest earning deposits partially offset by an increase in investment securities. For the same period, net loans, which exclude loans held for sale but are net of the allowance for loan losses increased $1.8 million, or 0.2%, to $981.6 million as of June 30, 2011 from $979.7 million at December 31, 2010 due substantially to increases in originated loans partially offset by decreases in purchased loans. Deposits decreased $28.6 million, or 2.5%, to $1.11 billion as of June 30, 2011 from the December 31, 2010 balance of $1.14 billion mostly due to a decrease in certificates of deposit acquired from Cowlitz and Pierce. Securities sold under agreement to repurchase decreased $1.8 million, or 9.2%, to $17.3 million as of June 30, 2011 from the December 31, 2010 balance of $19.0 million mostly due to decreases in customer balances.

Total stockholders equity increased by $3.4 million, or 1.7%, to $205.7 million as of June 30, 2011 from $202.3 million at December 31, 2010 as a result of net income of $2.5 million, a change in fair value of securities available for sale (net of tax) in the amount of $908,000, and stock compensation and earned ESOP in the amount of $433,000 partially offset by a common stock cash dividend of $470,000. The Company s capital position remains strong at 15.4% of total assets as of June 30, 2011, an increase from 14.8% at December 31, 2010.

***Lending Activities***

As indicated in the table below, total loans (not including loans held for sale) increased $5.1 million to $1.007 billion at June 30, 2011 from $1.002 billion at December 31, 2010. Total originated loans (not including loans held for sale) increased $40.5 million to $782.5 million at

June 30, 2011 from $742.0 million at December 31, 2010.

| | At June 30, 2011 | % of Total | At December 31, 2010 | % of Total |
|---|---|---|---|---|
| | | (Dollars in thousands) | | |
| Originated Loans: | | | | |
| Commercial business: | | | | |
| Commercial and industrial | $ 272,313 | 34.8% | $ 233,875 | 31.5% |
| Owner-occupied commercial real estate | 156,615 | 20.0 | 159,445 | 21.5 |
| Non-owner occupied commercial real estate | 219,154 | 28.0 | 221,718 | 29.9 |
| Total commercial business | 648,082 | 82.8 | 615,038 | 82.9 |
| One-to-four family residential mortgages | 38,704 | 5.0 | 38,850 | 5.3 |
| Real estate construction and land development: | | | | |
| One-to-four family residential | 23,845 | 3.0 | 28,989 | 3.9 |
| Multifamily residential and commercial properties | 42,043 | 5.4 | 28,411 | 3.8 |
| Total real estate construction and land development | 65,888 | 8.4 | 57,400 | 7.7 |
| Consumer | 31,447 | 4.0 | 32,054 | 4.3 |
| Gross originated loans receivable | 784,121 | 100.2 | 743,342 | 100.2 |
| Less: deferred loan fees | (1,624) | (0.2) | (1,323) | (0.2) |
| Total originated loans | 782,497 | 100.0% | 742,019 | 100.0% |
| Purchased covered loans | 120,120 | | 128,715 | |
| Purchased non-covered loans | 104,264 | | 131,049 | |
| Total loans receivable, net of deferred loan fees | $ 1,006,881 | | $ 1,001,783 | |

***Nonperforming Assets***

The following table describes our nonperforming assets for the dates indicated.

| | At June 30, 2011 | At December 31, 2010 |
|---|---|---|
| | (Dollars in thousands) | |
| Nonaccrual originated loans: | | |
| Commercial business | $ 11,566 | $ 10,841 |
| Real estate construction and land development | 12,123 | 15,642 |
| Consumer | 105 | |
| Total nonaccrual originated loans (1)(2) | 23,794 | 26,483 |
| Restructured originated loans: | | |
| Commercial business | 382 | 394 |
| Real estate construction and land development | 4,813 | |
| Total restructured originated loans | 5,195 | 394 |
| Total nonperforming originated loans | 28,989 | 26,877 |
| Other real estate owned | 1,911 | 3,030 |
| Total nonperforming originated assets | $ 30,900 | $ 29,907 |
| Accruing originated loans past due 90 days or more | $ 531 | $ 1,221 |
| Potential problem originated loans (3) | 47,311 | 56,088 |
| Allowance for loan losses on originated loans | 22,011 | 22,062 |
| Nonperforming originated loans to total originated loans (4) | 3.24% | 3.19% |
| Allowance for loan losses to total originated loans | 2.81% | 2.97% |
| Allowance for loan losses to nonperforming originated loans (4) | 86.93% | 93.16% |
| Nonperforming originated assets to total originated assets (4) | 2.44% | 2.41% |

(1) At June 30, 2011 and December 31, 2010, nonaccrual loans of $5.3 million and $8.7 million, respectively, were considered troubled debt restructurings.

(2) $3.7 million and $3.2 million of nonaccrual loans were guaranteed by government agencies at June 30, 2011 and December 31 2010, respectively.

(3) $4.8 million and $5.9 million of potential problem originated loans were guaranteed by government agencies at June 30, 2011 and December 31 2010, respectively.

(4) Excludes portions guaranteed by government agencies.

Nonperforming originated assets increased to $30.9 million, or 2.44% of total originated assets, at June 30, 2011 from $29.9 million, or 2.41% of total originated assets, at December 31, 2010 due to an increase in nonperforming originated loans which was partially offset by a decrease other real estate owned. During the six months ended June 30, 2011, there were $4.6 million in net charge-offs of which $1.7 million related to nonperforming commercial loans and $2.8 million related to nonperforming construction loans. In addition, nonperforming construction loan balances totaling $1.3 million were transferred to other real estate owned during the six months ended June 30, 2011. This increase in total nonperforming originated loans was due largely to a $4.8 million addition to nonperforming originated loans of a restructured commercial construction and land development loan. Potential problem originated loans as of June 30, 2011 and December 31, 2011 were $47.3 million and $56.1 million, respectively. Potential problem loans are those loans that are currently accruing interest and are not considered impaired, but which we are monitoring because the financial information of the borrower causes us concerns as to their ability to comply with their loan repayment terms. Loans that are past due 90 days or more and still accruing interest are both well secured and in the process of collection.

***Analysis of Allowance for Loan Losses***

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

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

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

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

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

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

| | Three Months Ended, | | Six Months Ended, | |
|---|---|---|---|---|
| | June 30, 2011 | June 30, 2010 | June 30, 2011 | June 30, 2010 |

| | | | | |
|---|---|---|---|---|
| Total loans outstanding at end of period (1) | $ 782,497 | $ 761,181 | $ 782,497 | $ 761,181 |
| Average total loans outstanding during period (1) | 771,923 | 758,791 | 765,893 | 761,832 |
| Allowance balance at beginning of period | 21,382 | 24,797 | 22,062 | 26,164 |
| Provision for loan losses | 1,995 | 3,150 | 4,590 | 6,900 |
| Charge offs: | | | | |
| Commercial | (1,237) | (103) | (2,465) | (3,082) |
| Real estate mortgages | | | (15) | |
| Real estate construction | (300) | (1,625) | (2,948) | (4,053) |
| Consumer | (15) | (8) | (118) | (38) |
| Total charge offs | (1,552) | (1,736) | (5,546) | (7,173) |
| Recoveries: | | | | |
| Commercial | 77 | 2 | 790 | 118 |
| Real estate mortgages | | | | |
| Real estate construction | 103 | 45 | 103 | 235 |
| Consumer | 6 | 10 | 12 | 24 |
| Total recoveries | 186 | 57 | 905 | 377 |
| Net charge offs | (1,366) | (1,679) | (4,641) | (6,796) |
| Allowance balance at end of period | $ 22,011 | $ 26,268 | $ 22,011 | $ 26,268 |
| Allowance for loan losses to total loans | 2.81% | 3.45% | 2.81% | 3.45% |
| Ratio of net charge offs during period to average total loans outstanding | (0.18)% | (0.22)% | (0.61)% | (0.89)% |

(1) Excludes loans held for sale.

The allowance for loan losses for originated loans at June 30, 2011 decreased $51,000 to $22.0 million from $22.1 million at December 31, 2010. The decrease was due to net charge-offs exceeding the provision for loan losses during the six months ended June 30, 2011 and a decrease in potential problem originated loans, partially offset by increases in originated loans receivable and nonperforming originated loans. Nonperforming originated loans to total originated loans increased to 3.24% at June 30, 2011 from 3.19% at December 31, 2010 and the allowance for loan losses to nonperforming originated loans decreased to 86.9% at June 30, 2011 from 93.2% at December 31, 2010. Potential problem originated loans decreased $8.8 million to $47.3 million at June 30, 2011 from $56.1 million at December 31, 2010. Based on management s assessment of loan quality and current economic conditions, the Company believes that its allowance for loan losses was appropriate to absorb the probable and inherent risks of loss in the loan portfolio at June 30, 2011.

***Liquidity and Capital Resources***

Our primary sources of funds are customer 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 prepayments are greatly influenced by the level of interest rates, economic conditions, and competition. In addition to customer deposits, management may utilize the use of brokered deposits on an as-needed basis.

As indicated in the table below, total deposits decreased slightly and were $1.1 billion at June 30, 2011 and December 31, 2010.

| | June 30, 2011 | % of Total | December 31, 2010 | % of Total |
|---|---|---|---|---|
| | (Dollars in thousands) | | | |
| Non-interest demand deposits | $ 193,815 | 17.5% | $ 194,583 | 17.1% |
| NOW accounts | 311,324 | 28.1 | 287,247 | 25.3 |
| Money market accounts | 148,401 | 13.4 | 150,953 | 13.3 |
| Savings accounts | 100,990 | 9.1 | 100,552 | 8.8 |
| Total non-maturity deposits | 754,530 | 68.1 | 733,335 | 64.5 |
| Certificate of deposit accounts | 353,190 | 31.9 | 402,941 | 35.5 |
| Total deposits | $ 1,107,720 | 100.0% | $ 1,136,276 | 100.0% |

Since December 31, 2010, non-maturity deposits (total deposits less certificate of deposit accounts) have increased $21.2 million to $754.5 million and certificate of deposit accounts have decreased $50.0 million to $353.2 million. As a result, the percentage of certificate of deposit accounts to total deposits decreased to 31.9% at June 30, 2011 from 35.5% at December 31, 2010. The decrease in certificate of deposit accounts was due primarily to a decrease in certificates of deposit accounts related to the Cowlitz and Pierce Acquisitions.

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 is utilizing repurchase agreements as a supplement to our funding sources. Our repurchase agreements are secured by available for sale investment securities. At June 30 2011, the Banks had securities sold under agreements to repurchase totaling $17.3 million, a decrease of $1.8 million from $19.0 million at December 31, 2010.

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 June 30, 2011, cash and cash equivalents totaled $117.4 million, or 8.8% of total assets and 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 $25.7 million, or 1.9% of total assets. At June 30, 2011, the Banks maintained an uncommitted credit facility with the FHLB of Seattle for $179.7 million and an uncommitted credit facility with the Federal Reserve Bank of San Francisco for $67.1 million. The Banks also maintain advance lines with Key Bank, US Bank and Pacific Coast Bankers Bank to purchase federal funds totaling $22.8 million as of June 30, 2011. There were no borrowings outstanding other than repurchase agreements as of June 30, 2011.

Stockholders equity at June 30, 2011was $205.7 million compared with $202.3 million at December 31, 2010. During the six months ended June 30, 2011, the Company realized net income of $2.5 million, recorded $908,000 in unrealized gains on securities available for sale (net of tax), realized the effects of exercising stock options, stock option compensation and earned ESOP and restricted stock shares totaling $433,000 and paid common stock dividends of $470,000.

***Capital Requirements***

The Company is a bank holding company under the supervision of the Federal Reserve Bank of San Francisco. Bank holding companies are subject to capital adequacy requirements of the Federal Reserve Board under the Bank Holding Company Act of 1956, as amended, and the regulations of the Federal Reserve Board. Heritage Bank and Central Valley Bank are federally insured institutions and thereby subject to the capital requirements established by the FDIC. The Federal Reserve Board capital requirements generally parallel the FDIC requirements. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company s financial statements and operations.

Pursuant to minimum capital requirements of the FDIC, Heritage Bank and Central Valley Bank are required to maintain a leverage ratio (capital to assets ratio) of 3% and risk-based capital ratios of Tier 1 capital and total capital (to total risk-weighted assets) of 4% and 8%, respectively. As of June 30, 2011 and December 31, 2010, Heritage Bank and Central Valley Bank were classified as well capitalized under applicable regulatory capital guidelines.

| | Minimum Requirements | | Well-Capitalized Requirements | | Actual | |
|---|---|---|---|---|---|---|
| | $ | % | $ | % | $ | % |
| | | | (Dollars in thousands) | | | |
| **As of June 30, 2011:** | | | | | | |
| The Company consolidated | | | | | | |
| Tier 1 leverage capital to average assets | $ 39,459 | 3.0% | $ 65,766 | 5.0% | $ 189,567 | 14.4% |
| Tier 1 capital to risk-weighted assets | 37,224 | 4.0 | 55,836 | 6.0 | 189,567 | 20.4 |
| Total capital to risk-weighted assets | 74,448 | 8.0 | 93,060 | 10.0 | 201,368 | 21.6 |
| Heritage Bank | | | | | | |
| Tier 1 leverage capital to average assets | 34,525 | 3.0 | 57,541 | 5.0 | 149,137 | 13.0 |
| Tier 1 capital to risk-weighted assets | 32,640 | 4.0 | 48,960 | 6.0 | 149,137 | 18.3 |
| Total capital to risk-weighted assets | 65,280 | 8.0 | 81,600 | 10.0 | 159,492 | 19.6 |
| Central Valley Bank | | | | | | |
| Tier 1 leverage capital to average assets | 4,916 | 3.0 | 8,193 | 5.0 | 17,035 | 10.4 |
| Tier 1 capital to risk-weighted assets | 4,571 | 4.0 | 6,856 | 6.0 | 17,035 | 14.9 |
| Total capital to risk-weighted assets | 9,141 | 8.0 | 11,427 | 10.0 | 18,478 | 16.2 |
| **As of December 31, 2010:** | | | | | | |
| The Company consolidated | | | | | | |
| Tier 1 leverage capital to average assets | $ 40,315 | 3% | $ 67,192 | 5% | $ 186,925 | 13.9% |
| Tier 1 capital to risk-weighted assets | 37,020 | 4 | 55,530 | 6 | 186,925 | 20.2 |
| Total capital to risk-weighted assets | 74,040 | 8 | 92,550 | 10 | 198,635 | 21.5 |
| Heritage Bank | | | | | | |
| Tier 1 leverage capital to average assets | 35,487 | 3 | 59,146 | 5 | 146,643 | 12.4 |
| Tier 1 capital to risk-weighted assets | 32,901 | 4 | 49,351 | 6 | 146,643 | 17.8 |
| Total capital to risk-weighted assets | 65,802 | 8 | 82,252 | 10 | 157,040 | 19.1 |
| Central Valley Bank | | | | | | |
| Tier 1 leverage capital to average assets | 4,841 | 3 | 8,068 | 5 | 15,925 | 9.9 |
| Tier 1 capital to risk-weighted assets | 4,100 | 4 | 6,150 | 6 | 15,925 | 15.5 |
| Total capital to risk-weighted assets | 8,200 | 8 | 10,249 | 10 | 17,220 | 16.8 |

Quarterly, the Company reviews the potential payment of cash dividends to its common shareholders. The timing and amount of cash dividends paid on our common stock depends on the Company s earnings, capital requirements, financial condition and other relevant factors. Dividends on common stock from the Company depend substantially upon receipt of dividends from the Banks, which are the Company s predominant sources of income. On July 27, 2011, the Company s Board of Directors declared a dividend of $0.05 per share payable on August 26, 2011, to shareholders of record on August 12, 2011.

**ITEM 3. Quantitative and Qualitative Disclosures About Market Risk**

Our results of operations are highly dependent upon our ability to manage interest rate risk. We consider interest rate risk to be a significant market risk that could have a material effect on our financial condition and results of operations. Interest rate risk is measured and assessed on a quarterly basis. In our opinion, there has not been a material change in our interest rate risk exposure since the information disclosed in our annual report for the year-ended at December 31, 2010.

We do not maintain a trading account for any class of financial instrument nor do we engage in hedging activities or purchase high-risk derivative instruments. Moreover, we have no material risk with foreign currency exchange rate risk or commodity price risk.

**ITEM 4. Controls and Procedures**

(a) *Evaluation of disclosure controls and procedures*. An evaluation of the Company s disclosure controls and procedure (as defined in Section 13a-15(e) or 15d-15(e) of the Securities Exchange Act of 1934 (the Act )) was carried out under the supervision and with the participation of the Company s Chief Executive Officer, Chief Financial Officer and the Company s Disclosure Committee as of the end of the period covered by this quarterly report. In designing and evaluating the Company s disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Based on their evaluation, the Company s Chief Executive Officer and Chief Financial Officer concluded that the Company s disclosure controls and procedures as of June 30, 2011 are effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Act is (i) accumulated and communicated to the Company s management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms.

(b) *Changes in internal control over financial reporting*. There have been no changes in the Company s internal control over financial reporting (as defined in Rule 13a-15(f) of the Act) that occurred during the quarter ended June 30, 2011, that have materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting. The Company does not expect that its internal control over financial reporting will prevent all error and all fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any control procedure also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

## PART II. OTHER INFORMATION

**Item 1. Legal Proceedings**

The Company is a party to certain legal proceedings incidental to its business. Management believes that the outcome of such currently pending proceedings, in the aggregate, will not have a material effect on our financial condition or results of operations.

**Item 1A. Risk Factors**

There have been no material changes to the risk factors set forth in Part I. Item 1A of the Company s Annual Report on Form 10-K for the year ended December 31, 2010.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. [Removed and Reserved]**

**Item 5. Other Information**

None

**Item 6. Exhibits**

| Exhibit No. | |
|---|---|
| 3.1 | Articles of Incorporation (1) |
| 3.2 | Bylaws of the Company (2) |
| 4.2 | Warrant for purchase (3) |
| 10.1 | 1998 Stock Option and Restricted Stock Award Plan (4) |
| 10.2 | 1997 Stock Option and Restricted Stock Award Plan (5) |
| 10.3 | 2002 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan (6) |
| 10.4 | 2006 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan (7) |
| 10.5 | Employment Agreement between the Company and Brian L. Vance, effective December 3, 2010 as amended and restated in February 2007 (8) |
| 10.6 | Employment Agreement between Central Valley Bank and D. Michael Broadhead, effective December 3, 2010 (8) |
| 10.7 | Letter of Understanding between Heritage Financial Corporation and Donald V. Rhodes dated August 18, 2009 (9) |
| 10.8 | Annual Incentive Compensation Plan (12) |
| 10.9 | 2010 Omnibus Equity Plan (11) |
| 14.0 | Code of Ethics and Conduct Policy (10) |
| 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 Financial Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101 | The following financial information from Heritage Financial Corporation s Quarterly Report on Form 10-Q for the quarter ended June 30, 2011 is formatted in XBRL: (i) the Unaudited Consolidated Condensed Statements of Income, (ii) the Unaudited Consolidated Condensed Balance Sheets, (iii) the Unaudited Consolidated Condensed Statements of Changes in Shareholders Equity, (iv) the Unaudited Consolidated Condensed Statements of Cash Flows, and (v) the Notes to Unaudited Consolidated Condensed Financial Statements, tagged as blocks of text(13) |

(1) Incorporated by reference to the Registration Statement on Form S-1 (Reg. No. 333-35573) declared effective on November 12, 1997; as amended, said Amendments being incorporated by reference to the Amendment to the Articles of Incorporation of Heritage Financial Corporation filed with the Current Reports on Form 8-K dated November 25, 2008 and May 14, 2010.
(2) Incorporated by reference to the Current Report on Form 8-K dated November 29, 2007.
(3) Incorporated by reference to the Current Report on Form 8-K dated November 25, 2008.
(4) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-71415).
(5) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-57513).
(6) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-88980; 333-88982; 333-88976).
(7) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-134473; 333-134474; 333-134475).
(8) Incorporated by reference to the Current Report on Form 8-K dated December 3, 2010.
(9) Incorporated by reference to the Current Report on Form 8-K dated August 20, 2009.
(10) 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.
(11) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 33-167146).
(12) Incorporated by reference to the Yearly Report on Form 10-K dated March 2, 2010.
(13) Submitted electronically herewith

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

HERITAGE FINANCIAL CORPORATION

Date: August 4, 2011

/s/ BRIAN L. VANCE
**Brian L. Vance**

**President and Chief Executive Officer**
**(Duly Authorized Officer)**

/s/ DONALD J. HINSON
**Donald J. Hinson**

**Senior Vice President and Chief Financial Officer**
**(Principal Financial and Accounting Officer)**

**EXHIBIT INDEX**

| Exhibit No. | Description of Exhibit |
| --- | --- |
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