

HERITAGE FINANCIAL CORP /WA/

Form 10-K

March 02, 2010

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2009

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

Commission File No. 0-29480

HERITAGE FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

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Washington
(State or other jurisdiction of
incorporation or organization)
201 Fifth Avenue SW, Olympia, Washington
(Address of principal executive offices)
(360) 943-1500

91-1857900
(IRS Employer
Identification No.)
98501
(Zip Code)

(Registrant's telephone number, including area code)

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

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

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

None

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer 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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant was \$64,245,035 and was based upon the last sales price as quoted on the NASDAQ Stock Market for June 30, 2009.

The Registrant had 11,064,893 shares of common stock outstanding as of February 10, 2010.

DOCUMENTS INCORPORATED BY REFERENCE

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Portions of the Registrant's definitive Proxy Statement for the 2010 Annual Meeting of Shareholders will be incorporated by reference into Part III of this Form 10-K.

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December 31, 2009

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PART I

ITEM 1. BUSINESS

General

Heritage Financial Corporation (Company) is a bank holding company incorporated in the State of Washington in August 1997. We were organized for the purpose of acquiring all of the capital stock of Heritage Savings Bank upon our reorganization from a mutual holding company form of organization to a stock holding company form of organization (Conversion).

We are primarily engaged in the business of planning, directing and coordinating the business activities of our wholly owned subsidiaries, Heritage Bank and Central Valley Bank (the Banks). Heritage Bank is a Washington-chartered commercial bank whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC) under the Deposit Insurance Fund (DIF). During 2004, Heritage Bank changed its charter from a savings bank to a commercial bank. Heritage Bank conducts business from its main office in Olympia, Washington and its thirteen branch offices located in Thurston, Pierce, Mason and south King counties in Washington. Central Valley Bank is a Washington-chartered commercial bank whose deposits are insured by the FDIC under the DIF. During 2005, Central Valley Bank changed its charter from a nationally-chartered commercial bank to a state-chartered commercial bank. Central Valley Bank conducts business from its main office in Toppenish, Washington, and its five branch offices located in Yakima and Kittitas counties in Washington. In June 2006, the Company completed the acquisition of Western Washington Bancorp (WWB) and its wholly owned subsidiary, Washington State Bank, N.A. Washington State Bank, N.A. was merged into Heritage Bank on the date of acquisition.

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.

In November 2008, the Company completed a sale to the U.S. Department of the Treasury of 24,000 shares of the Company s Fixed Rate Cumulative Perpetual Preferred Stock, Series A, (preferred shares), for an aggregate purchase price of \$24.0 million in cash, with a related warrant to purchase 276,074 shares of the Company s common stock with an exercise price of \$13.04 per share.

In addition, in September 2009, the Company completed the sale of 4.3 million shares of common stock in a public offering. The purchase price was \$11.50 per share and net proceeds from the sale totaled approximately \$46.6 million. As result of the common stock offering, the number of shares of our common stock underlying the above described warrant was reduced by 50% to 138,037 shares.

Market Areas

We offer financial services to meet the needs of the communities we serve through our community-oriented financial institutions. Headquartered in Olympia, Thurston County, Washington, we conduct business through Heritage Bank and Central Valley Bank. Heritage Bank has fourteen full service offices, with seven in Pierce County, five in Thurston County, one in Mason County and one in south King County. Heritage Bank has mortgage origination offices in Thurston County, Mason County, Pierce County and King County, which all operate within banking offices. The mortgage loan operations are performed in one office located in Thurston County. Central Valley Bank operates six full service offices, with five in Yakima County and one in Kittitas County.

Lending Activities

General. Our lending activities are conducted through Heritage Bank and Central Valley Bank. We offer residential and commercial construction, multi-family and commercial real estate, and consumer loans and

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originate for sale or investment purposes first mortgage loans on residential properties. Our focus is on commercial business lending with commercial business loans totaling to \$408.6 million, or 52.8% of total loans, as of December 31, 2009 and \$410.7 million, or 50.9% of total loans, as of December 31, 2008. We continue to provide real estate mortgages and real estate construction loans, both single and multifamily residential and commercial. Real estate mortgages totaled \$249.1 million, or 32.2% of total loans, at December 31, 2009, and \$248.2 million, or 30.6% of total loans, at December 31, 2008. Real estate construction loans totaled \$95.7 million, or 12.4% of total loans, at December 31, 2009, and \$130.7 million, or 16.1% of total loans, at December 31, 2008.

Our lending operations are guided by policies and guidelines that are reviewed and approved annually by our board of directors. These policies and guidelines address the types of loans, underwriting standards, structure and rate considerations, and compliance with laws, regulations and internal lending limits. We conduct post-approval reviews on selected loans and routinely engage external loan specialists to perform reviews of our loan portfolio to check for credit quality, proper documentation and compliance with laws and regulations.

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

| | 2009 | | 2008 | | At December 31, 2007 | | 2006 | | 2005 | |
|---|------------------------|------------|------------|------------|-------------------------|------------|-------------|------------|------------|------------|
| | Balance | % of Total | Balance | % of Total | Balance | % of Total | Balance (3) | % of Total | Balance | % of Total |
| | (Dollars in thousands) | | | | | | | | | |
| Commercial business(4) | \$ 408,622 | 52.8% | \$ 410,657 | 50.9% | \$ 388,483 | 49.8% | \$ 367,160 | 49.0% | \$ 334,133 | 51.2% |
| Real estate mortgages | | | | | | | | | | |
| One-to-four family residential(1) | 54,448 | 7.0 | 57,535 | 7.1 | 57,579 | 7.4 | 54,644 | 7.3 | 53,098 | 8.1 |
| Multi-family residential and commercial properties(4) | 194,613 | 25.2 | 190,706 | 23.5 | 196,637 | 25.2 | 199,652 | 26.6 | 190,463 | 29.2 |
| Total real estate mortgages | 249,061 | 32.2 | 248,242 | 30.6 | 254,217 | 32.6 | 254,297 | 33.9 | 243,561 | 37.3 |
| Real estate construction | | | | | | | | | | |
| One-to-four family residential | 46,060 | 6.0 | 71,159 | 8.8 | 82,165 | 10.6 | 85,635 | 11.4 | 42,245 | 6.5 |
| Multi-family residential and commercial properties | 49,665 | 6.4 | 59,572 | 7.3 | 40,342 | 5.2 | 32,037 | 4.3 | 21,355 | 3.3 |
| Total real estate construction(2) | 95,725 | 12.4 | 130,731 | 16.1 | 122,507 | 15.8 | 117,672 | 15.7 | 63,600 | 9.8 |
| Consumer | 21,261 | 2.8 | 21,255 | 2.6 | 16,641 | 2.1 | 12,976 | 1.7 | 12,855 | 2.0 |
| Gross loans | 774,669 | 100.2% | 810,884 | 100.2% | 781,847 | 100.3% | 752,104 | 100.3% | 654,149 | 100.3% |
| Less: deferred loan fees | (1,597) | (0.2) | (1,854) | (0.2) | (2,081) | (0.3) | (2,403) | (0.3) | (1,852) | (0.3) |
| Total loans receivable and loans held for sale | \$ 773,072 | 100.0% | \$ 809,030 | 100.0% | \$ 779,766 | 100.0% | \$ 749,701 | 100.0% | \$ 652,297 | 100.0% |

(1) Includes loans held for sale of \$825,000, \$304,000, \$447,000, \$0, and \$263,000 as of December 31, 2009, 2008, 2007, 2006, and 2005, respectively.

(2) Balances are net of undisbursed loan proceeds.

(3) The June 2006 acquisition of WWB included \$41.5 million in total loans.

(4) Certain loan balances previously categorized as commercial business have been reclassified as multi-family residential and commercial properties. The amounts reclassified were \$33.2 million, \$32.9 million, \$31.0 million, and \$25.7 million as of December 31, 2008, 2007, 2006, and 2005, respectively.

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The following table presents at December 31, 2009 (i) the aggregate contractual maturities of loans in the named categories of our loan portfolio and (ii) the aggregate amounts of fixed rate and variable or adjustable rate loans in the named categories that mature after one year.

| | Maturing | | | Total |
|-----------------------------------|-------------------|-------------------|-------------------|-------------------|
| | Within 1 year | 1-5 years | After 5 years | |
| (In thousands) | | | | |
| Commercial business | \$ 100,796 | \$ 113,086 | \$ 194,740 | \$ 408,622 |
| Real estate construction | 71,010 | 21,098 | 3,617 | 95,725 |
| Total | \$ 171,806 | \$ 134,184 | \$ 198,357 | \$ 504,347 |
| Fixed rate loans | | \$ 84,516 | \$ 181,753 | \$ 266,269 |
| Variable or adjustable rate loans | | 49,668 | 16,604 | 66,272 |
| Total | | \$ 134,184 | \$ 198,357 | \$ 332,541 |

Commercial Business Lending

We offer different types of commercial business loans to a variety of businesses. The types of commercial loans offered are business lines of credit, term equipment financing and term owner-occupied real estate loans. We also originate loans that are guaranteed by the Small Business Administration (SBA) and the Bank is a preferred lender of the SBA. Before extending credit to a business we look closely at the borrower's management ability, financial history, including cash flow of the borrower and all guarantors, and the liquidation value of the collateral. Emphasis is placed on having a comprehensive understanding of the borrower's global cash flow and performing necessary financial due diligence.

As of December 31, 2009, we had \$408.6 million, or 52.8% of our total loans receivable, in commercial business loans. The average loan size is approximately \$260,000 with loans generally in amounts of \$1.0 million or less.

See Risk Factors. The Company's loan portfolio is concentrated in loans with a higher risk of loss. Repayment of the Company's commercial business loans is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value.

Real Estate Lending

Single-Family Residential Real Estate Lending. The majority of our one-to four-family residential loans are secured by single-family residences located in our primary market areas. Our underwriting standards require that single-family portfolio loans generally are owner-occupied and do not exceed 80% of the lower of appraised value at origination or cost, of the underlying collateral. Terms typically range from 15 to 30 years. We generally sell most single-family loans in the secondary market. Management determines to what extent we will retain or sell these loans and other fixed rate mortgages in order to control the Bank's interest rate sensitivity position, growth and liquidity. See Management's Discussion and Analysis of Financial Condition and Results of Operations Asset/Liability Management.

Multifamily and Commercial Real Estate Lending. We originate multifamily and commercial real estate loans within our primary market areas. Owner-occupied commercial real estate loans are preferred. Our underwriting standards require that commercial and multifamily real estate loans not exceed 75% of the lower of appraised value at origination or cost, of the underlying collateral. Cash flow coverage to debt servicing requirements is generally a minimum of 1.10 times for multifamily loans and 1.15 times for commercial real estate loans. Cash flow coverage is calculated using an interest rate equal to the note rate plus 2%.

Multifamily and commercial real estate loans typically involve a greater degree of risk than single-family residential mortgage loans. Payments on loans secured by multifamily and commercial real estate properties are

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dependent on successful operation and management of the properties and repayment of these loans are affected by adverse conditions in the real estate market or the economy. We seek to minimize these risks by strictly scrutinizing the financial condition of the borrower, the quality and value of the collateral, and the management of the property securing the loan. We also generally obtain personal guarantees from the owners of the collateral after a thorough review of personal financial statements. In addition, we review our commercial real estate loan portfolio annually for performance of individual loans, and stress loans for potential changes in interest rates, occupancy, and collateral values.

See Risk Factors The Company's loan portfolio is concentrated in loans with a higher risk of loss. Repayment of the Company's income property loans, consisting of multi-family and commercial real estate loans, involve higher principal amounts than other loans and repayment of these loans may be dependent on factors outside its control or the control of its borrowers.

Construction Loans. We originate single-family residential construction loans for the construction of custom homes (where the home buyer is the borrower). We also provide financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. Because of the higher risks involved today in the residential construction industry, our lending to builders is limited to those who have demonstrated a favorable record of performance and who are building in markets that management understands. We further endeavor to limit our construction lending risk through adherence to strict underwriting guidelines and procedures. Speculative construction loans are short term in nature and priced with a variable rate of interest. We require builders to have tangible equity in each construction project, have prompt and thorough documentation of all draw requests and we inspect the project prior to paying any draw requests.

Origination and Sales of Residential Mortgage Loans

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

When we sell mortgage loans, we typically sell the servicing of the loans (i.e., collection of principal and interest payments). However, we serviced \$100,000, \$200,000, and \$300,000 in mortgage loans for others as of December 31, 2009, 2008, and 2007, respectively. We received fee income for servicing activities on mortgage loans of \$20,000, \$7,000, and \$2,000 for the years ended December 31, 2009, 2008 and 2007 respectively.

The following table presents summary information concerning our origination and sale of residential mortgage loans and the gains achieved on such activities.

| | Years ended December 31, | | | | |
|------------------------------|--------------------------|-----------|----------|----------|-----------|
| | 2009 | 2008 | 2007 | 2006 | 2005 |
| | (In thousands) | | | | |
| Residential mortgage loans: | | | | | |
| Originated | \$ 16,981 | \$ 16,177 | \$ 4,963 | \$ 8,593 | \$ 13,514 |
| Sold | 16,460 | 16,320 | 4,516 | 8,856 | 13,632 |
| Gains on sales of loans, net | \$ 288 | \$ 265 | \$ 64 | \$ 133 | \$ 277 |

Commitments and Contingent Liabilities

In the ordinary course of business, we enter into various types of transactions that include commitments to extend credit that are not included in our consolidated financial statements. We apply the same credit standards to

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these commitments as we use in all our lending activities and have included these commitments in our lending risk evaluations. Our exposure to credit loss under commitments to extend credit is represented by the amount of these commitments. At December 31, 2009, we had outstanding commitments to extend credit, including letters of credit, in the amount of \$173.6 million.

Delinquencies and Nonperforming Assets

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

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

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

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

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

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

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

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

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

| | 2009 | 2008 | At December 31, 2007 | 2006 | 2005 |
|--|------------------------|-----------|-------------------------|-----------|-----------|
| | (Dollars in thousands) | | | | |
| Nonaccrual loans: | | | | | |
| Commercial | \$ 7,266 | 1,176 | \$ 33 | \$ 2,801 | \$ 684 |
| Real estate mortgages | | | | | 67 |
| Real estate construction | 25,288 | 2,221 | 949 | | |
| Consumer | | | 39 | 6 | 85 |
| Total nonaccrual loans(1) | 32,554 | 3,397 | 1,021 | 2,807 | 836 |
| Restructured loans: | | | | | |
| Real estate mortgages | 425 | | | | |
| Total restructured loans | 425 | | | | |
| Total nonperforming loans | 32,979 | 3,397 | 1,021 | 2,807 | 836 |
| Other real estate owned | 704 | 2,031 | 169 | 225 | 371 |
| Total nonperforming assets | \$ 33,683 | \$ 5,428 | \$ 1,190 | \$ 3,032 | \$ 1,207 |
| Accruing loans past due 90 days or more | \$ 277 | \$ 664 | \$ 2,084 | \$ | \$ |
| Potential problem loans | \$ 45,848 | \$ 43,061 | \$ 22,023 | \$ 5,509 | \$ 9,882 |
| Allowance for loan losses | \$ 26,164 | \$ 15,423 | \$ 10,374 | \$ 10,105 | \$ 8,496 |
| Nonperforming loans to loans | 4.27% | 0.42% | 0.13% | 0.37% | 0.13% |
| Allowance for loan losses to total loans | 3.38% | 1.91% | 1.33% | 1.35% | 1.30% |
| Allowance for loan losses to nonperforming loans | 79.34% | 454.02% | 1,016.06% | 360.05% | 1,016.27% |
| Nonperforming assets to total assets | 3.32% | 0.57% | 0.13% | 0.36% | 0.16% |

(1) \$17.0 million of nonaccrual loans were considered troubled debt restructures at December 31, 2009. There were no nonaccrual loans considered troubled debt restructures at December 31, 2008, 2007, 2006 or 2005.

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

The increase in nonaccrual loans was primarily attributable to seven residential construction borrower relationships totaling approximately \$24.3 million and one commercial relationship totaling approximately \$3.0 million being placed on non-accrual status.

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At December 31, 2009, \$25.3 million, or 78%, of the total nonaccrual loans were real estate construction loans. Of this amount, \$21.3 million were residential acquisition and development loans. Of the remainder, \$1.9 million were single-family home construction loans, \$1.4 million were commercial construction loans and \$0.6 million were raw land loans.

At December 31, 2009, our largest lending relationship to one borrower had nonaccrual loans in the amount of \$14.6 million. The loans are to a builder/developer of single-family homes/lots in Pierce County, Washington. Pierce County has had a significant slowdown in home sales and this slowdown has affected the borrower's ability to sell lots and repay the loans as originally planned. Approximately 68% of total nonaccrual loans relate to borrowers in Pierce County.

Troubled Debt Restructures. Loans where the terms have been modified in order to grant a concession to a borrower that is experiencing financial difficulty are identified as a Troubled Debt Restructures (TDRs). TDRs are considered impaired and are reported as such.

Potential Problem Loans. Potential problem loans are those loans that are currently accruing interest and are not considered impaired, but which we are monitoring because the financial information of the borrower causes us concerns as to their ability to comply with their loan repayment terms.

Analysis of Allowance for Loan and Lease Losses

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

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

Historical loss experience in a number of homogeneous segments of the loan portfolio;

The impact of environmental factors, including:

Levels of and trends in delinquencies and impaired loans;

Levels and trends in charge-offs and recoveries;

Effects of changes in risk selection and underwriting standards, and other changes in lending policies, procedures and practices;

Experience, ability, and depth of lending management and other relevant staff;

National and local economic trends and conditions;

External factors such as competition, legal, and regulatory; and

Effects of changes in credit concentrations.

We calculate an adequate ALLL for the non-classified and classified performing loans in our loan portfolio by applying historical loss factors for homogeneous segments of the portfolio, adjusted for changes to the above-noted environmental factors. We may record specific provisions for

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impaired loans, including loans on non-accrual and TDR s, after a careful analysis of each loan s credit and collateral factors. Our analysis of an adequate 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

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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:

| | Years Ended December 31, | | | | |
|--|--------------------------|------------|------------|------------|------------|
| | 2009 | 2008 | 2007 | 2006 | 2005 |
| | (Dollars in thousands) | | | | |
| Total loans outstanding at end of period(1) | \$ 772,247 | \$ 808,726 | \$ 779,319 | \$ 749,701 | \$ 652,297 |
| Average total loans outstanding during period(1) | \$ 787,527 | \$ 795,752 | \$ 778,058 | \$ 690,287 | \$ 613,655 |
| Allowance balance at beginning of period | \$ 15,423 | \$ 10,374 | \$ 10,105 | \$ 8,496 | \$ 8,295 |
| Provision for loan losses | 19,390 | 7,420 | 810 | 720 | 810 |
| Allowance acquired through acquisition | | | | 749 | |
| Charge-offs: | | | | | |
| Commercial | (2,668) | (144) | (412) | (78) | (630) |
| Real estate mortgages | (189) | (280) | (67) | (3) | |
| Real estate construction | (5,774) | (1,818) | | | |
| Consumer | (192) | (165) | (94) | (83) | (61) |
| Total charge-offs | (8,823) | (2,407) | (573) | (164) | (691) |
| Recoveries: | | | | | |
| Commercial | 1 | 1 | 2 | 255 | 65 |
| Real estate mortgages | 1 | | 5 | 24 | 7 |
| Real estate construction | 50 | | | | |
| Consumer | 122 | 35 | 25 | 25 | 10 |
| Total recoveries | 174 | 36 | 32 | 304 | 82 |
| Net (charge-offs) recoveries | (8,649) | (2,371) | (541) | 140 | (609) |
| Allowance balance at end of period | \$ 26,164 | \$ 15,423 | \$ 10,374 | \$ 10,105 | \$ 8,496 |
| Ratio of net (charge-offs) recoveries during period to average total loans outstanding | (1.10)% | (0.30)% | (0.06)% | 0.02% | (0.10)% |

(1) Excludes loans held for sale

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

| 2009 | | 2008 | | At December 31, 2007 | | 2006 | | 2005 | |
|--------|---------------------------|--------|---------------------------|-------------------------|---------------------------|--------|---------------------------|--------|---------------------------|
| Amount | % of Total Loans(1) | Amount | % of Total Loans(1) | Amount(2) | % of Total Loans(1) | Amount | % of Total Loans(1) | Amount | % of Total Loans(1) |

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(Dollars in thousands)

| | | | | | | | | | | |
|--------------------------|-----------|--------|-----------|--------|-----------|--------|-----------|--------|----------|--------|
| Commercial | \$ 7,834 | 52.6% | \$ 2,785 | 50.7% | \$ 1,999 | 49.5% | \$ 7,276 | 48.7% | \$ 6,117 | 50.9% |
| Real estate construction | 12,480 | 12.4% | 6,587 | 16.1% | 3,839 | 15.8% | 585 | 15.7% | 494 | 9.8% |
| Real estate other | 5,456 | 32.2% | 5,797 | 30.6% | 4,231 | 32.6% | 2,106 | 33.9% | 1,770 | 37.3% |
| Consumer | 170 | 2.8% | 254 | 2.6% | 305 | 2.1% | 138 | 1.7% | 115 | 2.0% |
| Unallocated | 224 | 0.0% | | 0.0% | | 0.0% | | 0.0% | | 0.0% |
| Total loans | \$ 26,164 | 100.0% | \$ 15,423 | 100.0% | \$ 10,374 | 100.0% | \$ 10,105 | 100.0% | \$ 8,496 | 100.0% |

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- (1) Represents the total of all outstanding loans in each category as a percent of total loans outstanding.
- (2) The Company historically allocated its allowance for loan losses based on the percentages noted in (1) above, however, in 2008, management reclassified 2007 amounts to be consistent with the 2008 allowance for loan losses allocation method which, is based on qualitative and quantitative factors determined for each loan category.

Investment Activities

At December 31, 2009, our investment securities portfolio totaled \$104.4 million, which consisted of \$90.7 million of securities available for sale and \$13.6 million of securities held to maturity. This compares with a total portfolio of \$44.0 million at December 31, 2008, which was comprised of \$31.9 million of securities available for sale and \$12.1 million of securities held to maturity. The increase in the investment portfolio was substantially due to the \$46.6 million raised in our common stock offering completed in September 2009 as well as to the \$24.0 million raised in our sale of preferred stock to the U.S. Department of the Treasury. The proceeds of these equity transactions were invested in securities until it could be deployed into higher yielding loans. The composition of the two investment portfolios by type of security, at each respective date, is presented in Note 4 to the Notes to Consolidated Financial Statements.

At June 30, 2008, the Company recorded an other-than-temporary impairment charge of \$1.1 million related to its \$9.6 million investment in the AMF Ultra Short Mortgage Fund (the Fund). The net asset value of the Fund had declined primarily as a result of the uncertainty in spreads in the bond market for private label mortgage-related securities and credit downgrades to a small percentage of the underlying securities. In July 2008, the Company redeemed its 1,080,114 shares in the Fund for \$1.6 million in cash and securities with a fair value of \$7.9 million. This redemption resulted in a loss of \$96,000. The securities received, which were mortgage-backed securities and private residential collateralized mortgage obligations, were classified as held to maturity as the Company had the positive intent and ability to hold these securities until they matured. In December 2008, as a result of continued declines in market value and credit downgrades of specific securities acquired in the redemption, the Company recorded an additional impairment charge of \$668,000 on private residential collateralized mortgage obligations with a carrying value of \$856,000 and a fair value of \$188,000. In total during 2008, the Company recorded losses of \$1.9 million related to the Fund and the securities received in the redemption of the shares in the Fund.

In the second quarter of 2009, the Company adopted FASB ASC 320-10-65, *Recognition and Presentation of Other-Than-Temporary Impairments*, which provides for the bifurcation of other-than-temporary impairments into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. As a result of adopting FASB ASC 320-10-65, the Company recorded \$830,000 in impairments on private collateralized mortgage obligations not related to credit losses through other comprehensive income rather than through earnings and \$500,000 in impairments related to credit losses through earnings during the year ended December 31, 2009. The Company also reclassified \$229,000 from retained earnings to other comprehensive income related to impairment charges on private residential collateralized mortgage obligations at December 31, 2008 and March 31, 2009 that were not due to credit losses. The activity related to the amount of other-than-temporary impairments related to credit losses on held to maturity securities during the year ended December 31, 2009, is presented in Note 4 to the Notes to Consolidated Financial Statements.

Our investment policy is established by the Board of Directors and monitored by the Audit and Finance Committee of the Board of Directors. It is designed primarily to provide and maintain liquidity, generate a favorable return on investments without incurring undue interest rate and credit risk, and complements our Banks lending activities. The policy dictates the criteria for classifying securities as either available for sale or held to maturity. The policy permits investment in various types of liquid assets permissible under applicable regulations, which include U.S. Treasury obligations, U.S. Government agency obligations, some certificates of

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deposit of insured banks, mortgage backed and mortgage related securities, some corporate notes, municipal bonds, and federal funds. Investment in non-investment grade bonds and stripped mortgage backed securities are not permitted under the policy.

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

| | December 31, 2009 | | December 31, 2008 | | December 31, 2007 | |
|---|-------------------|------------------------------|---|------------------------------|-------------------|------------------------------|
| | Amortized Cost | % of Total Investments | Amortized Cost (Dollars in thousands) | % of Total Investments | Amortized Cost | % of Total Investments |
| U.S. Treasury and U.S Government agencies | \$ 22,986 | 25.5% | \$ 5,230 | 16.7% | \$ 11,529 | 31.8% |
| Municipal securities | 7,365 | 8.2% | 4,138 | 13.2% | 3,219 | 8.9% |
| Corporate securities | 10,060 | 11.2% | 4,007 | 12.7% | | |
| Mortgage backed securities and collateralized mortgage obligations: | | | | | | |
| U.S Government agencies | 49,645 | 55.1% | 18,006 | 57.4% | 10,449 | 28.9% |
| Equity securities | | | | | 11,003 | 30.4% |
| Total | \$ 90,056 | 100.0% | \$ 31,381 | 100.0% | \$ 36,200 | 100.0% |

The following table provides information regarding our investment securities available for sale, by contractual maturity, at December 31, 2009.

| | Less Than One Year | | One to Five Years | | Five to Ten Years | | Over Ten Years | |
|---|------------------------|---------------------------------|------------------------|---------------------------------|------------------------|---------------------------------|------------------------|---------------------------------|
| | (Dollars in thousands) | | (Dollars in thousands) | | (Dollars in thousands) | | (Dollars in thousands) | |
| | Fair Value | Weighted Average Yield(1) | Fair Value | Weighted Average Yield(1) | Fair Value | Weighted Average Yield(1) | Fair Value | Weighted Average Yield(1) |
| U.S. Treasury and U.S Government agencies | \$ | | \$ 22,959 | 1.35% | \$ | | \$ | |
| Municipal securities | 938 | 4.11% | 2,242 | 4.68% | 3,783 | 4.61% | 510 | 4.74% |
| Corporate securities | 2,029 | 1.81% | 8,147 | 2.16% | | | | |
| Mortgage backed securities and collateralized mortgage obligations: | | | | | | | | |
| U.S Government agencies | | | | | 7,344 | 3.10% | 42,784 | 3.52% |
| Total | \$ 2,967 | 2.53% | \$ 33,348 | 1.77% | \$ 11,127 | 3.61% | \$ 43,294 | 3.53% |

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

| | December 31, 2009 | | December 31, 2008 | | December 31, 2007 | |
|---|-------------------|------------------------------|---|------------------------------|-------------------|------------------------------|
| | Amortized Cost | % of Total Investments | Amortized Cost (Dollars in thousands) | % of Total Investments | Amortized Cost | % of Total Investments |
| U.S. Treasury and U.S Government agencies | \$ 1,443 | 10.6% | \$ 316 | 2.6% | \$ 855 | 22.0% |
| Municipal securities | 1,618 | 11.9% | 1,695 | 14.0% | 1,595 | 41.0% |
| Mortgage backed securities and collateralized mortgage obligations: | | | | | | |
| U.S Government agencies | 8,236 | 60.4% | 5,791 | 47.9% | 1,440 | 37.0% |
| Private residential collateralized mortgage obligations | 2,339 | 17.1% | 4,279 | 35.5% | | |

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| | | | | | | |
|-------|-----------|--------|-----------|--------|----------|--------|
| Total | \$ 13,636 | 100.0% | \$ 12,081 | 100.0% | \$ 3,890 | 100.0% |
|-------|-----------|--------|-----------|--------|----------|--------|

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The following table provides information regarding our investment securities held to maturity, by contractual maturity, at December 31, 2009.

| | One to Five Years | | Five to Ten Years (Dollars in thousands) | | Over Ten Years | |
|---|-------------------|---------------------------------|---|---------------------------------|----------------|---------------------------------|
| | Fair Value | Weighted Average Yield(1) | Fair Value | Weighted Average Yield(1) | Fair Value | Weighted Average Yield(1) |
| U.S. Treasury and U.S Government agencies | \$ 270 | 5.02% | \$ 481 | 3.80% | \$ 693 | 3.62% |
| Municipal securities | 1,229 | 5.39% | 482 | 5.68% | | |
| Mortgage backed securities and collateralized mortgage obligations: | | | | | | |
| U.S Government agencies | | | 137 | 7.37% | 8,352 | 4.34% |
| Private residential collateralized mortgage obligations | | | | | 2,001 | 4.44% |
| Total | \$ 1,499 | 5.32% | \$ 1,100 | 5.06% | \$ 11,046 | 4.31% |

(1) Taxable equivalent weighted average yield.

The Banks are required to maintain an investment in the stock of the Federal Home Loan Bank (FHLB) of Seattle in an amount equal to the greater of \$500,000 or 0.50% of residential mortgage loans and pass-through securities or an advance requirement to be confirmed on the date of the advance and 5.0% of the outstanding balance of mortgage loans sold to the FHLB of Seattle. At December 31, 2009 the Banks were required to maintain an investment in the stock of FHLB of Seattle of at least \$826,000. At December 31, 2009 the Banks had an investment in FHLB stock carried at a cost basis (par value) of \$3.6 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 year ended December 31, 2009, continued deterioration in the FHLB of Seattle's financial position may result in future impairment losses.

Deposit Activities and Other Sources of Funds

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

Borrowings may also be used on a short-term basis to compensate for reductions in other sources of funds (such as deposit inflows at less than projected levels). Borrowings may also be used on a longer-term basis to support expanded lending activities and match the maturity of repricing intervals of assets. In addition the Company began to utilize repurchase agreements as a supplement to other funding sources during the year ended December 31, 2009.

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During the year ended December 31 2009, non-maturity deposits (total deposits less certificate of deposit accounts) increased \$58.1 million, or 12.2%. As a result, the percentage of certificate of deposit accounts to total deposits decreased to 36.2% from 42.0% during the period. A significant reason for the change in mix of deposit accounts is attributable to developments with respect to public deposits. During the quarter ended March 31, 2009, the Banks were notified by the Washington Public Deposit Protection Commission (WPDPC) that the failure of a bank in Washington State had resulted in a shortfall in deposits held by Washington State municipalities. To prevent losses to public entities, Washington State now requires that all financial institutions that receive public deposits must pledge collateral to the WPDPC and participate in a collateral pool established to protect public deposits that are not covered by FDIC insurance or the assets of the failed bank. As a result, the Company was assessed \$184,000 for its share of the shortfall. Subsequent to the assessment, the WPDPC issued a resolution that all public depositors were required by June 30, 2009 to take all measures necessary to fully collateralize their uninsured public deposits at 100%. In order to comply with the WPDPC s resolution described above and reduce the Company s exposure to uninsured public deposits, the Company s total public deposit balances have been reduced to \$69.3 million at December 31, 2009 from \$132.1 million at December 31, 2008. Public certificate of deposit accounts have decreased \$89.5 million and other public deposit accounts have increased \$26.7 million from December 31, 2008 to December 31, 2009. To compensate for the loss of public deposits, the Company purchased \$22.6 million in brokered deposits with terms ranging from six to eighteen months during the year ended December 31, 2009.

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

Certificates of Deposit. We offer several types of CDs with maturities ranging from three months to five years, which require a minimum deposit of \$2,500. Negotiable CDs are offered in amounts of \$100,000 or more for terms of 30 days to 12 months.

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

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

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

Individual Retirement Accounts. Individual Retirement Accounts permit annual contributions regulated by law and pay interest at fixed rates. Maturities are available from one to five years.

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Deposit Activities. The following table provides the average balances outstanding and the weighted average interest rates for each major category of deposits for the years ended December 31:

| | 2009 | | 2008 | | 2007 | |
|---|--------------------|-------------------------|--|-------------------------|--------------------|-------------------------|
| | Average Balance | Average Rate Paid | Average Balance (Dollars in Thousands) | Average Rate Paid | Average Balance | Average Rate Paid |
| Interest bearing demand and money market accounts | \$ 310,860 | 0.89% | \$ 243,082 | 1.78% | \$ 216,641 | 2.56% |
| Savings | 85,541 | 0.98 | 92,648 | 1.70 | 82,526 | 1.93 |
| Certificates of deposit | 323,696 | 2.47 | 343,642 | 3.62 | 352,295 | 4.85 |
| Total interest bearing deposits | 720,097 | 1.61 | 679,372 | 2.70 | 651,462 | 3.72 |
| Non interest demand deposits | 120,107 | | 108,386 | | 103,790 | |
| Total deposits | \$ 840,204 | 1.38% | \$ 787,758 | 2.32% | \$ 755,252 | 3.21% |

The following table shows the amount and maturity of certificates of deposit of \$100,000 or more as of December 31, 2009 (dollars in thousands):

| | |
|---------------------------------------|------------|
| Remaining maturity: | |
| Three months or less | \$ 67,990 |
| Over three months through six months | 39,627 |
| Over six months through twelve months | 45,760 |
| Over twelve months | |
| Total | \$ 153,377 |

Borrowings. Deposits are the primary source of funds for our lending and investment activities and our general business purposes. We rely upon advances from the FHLB, to supplement our supply of lendable funds and meet deposit withdrawal requirements. The FHLB of Seattle serves as one of our secondary sources of liquidity. Advances from the FHLB of Seattle are typically secured by our first lien single family mortgage loans, multifamily mortgage loans, commercial real estate loans and stock issued by the FHLB, which is owned by us. At December 31, 2009, the Banks maintained an uncommitted credit facility with the FHLB of Seattle for \$169.1 million and an uncommitted credit facility with the Federal Reserve Bank of San Francisco for \$53.4 million, of which there were no advances or borrowings outstanding. The Banks also maintain advance lines with Key Bank, US Bank and Pacific Coast Bankers Bank to purchase federal funds up to \$22.8 million as of December 31, 2009. At December 31, 2009 we had securities sold under agreement to repurchase of \$10.4 million which were secured by available for sale investment securities.

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

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The following table is a summary of FHLB advances for the years ended December 31:

| | 2009 | 2008 | 2007 |
|---|------------------------|--------|-----------|
| | (Dollars in thousands) | | |
| Balance at period end | \$ | \$ | \$ 14,990 |
| Average balance during the period | | 6,223 | 24,296 |
| Maximum amount outstanding at any month end | | 17,100 | 47,751 |
| Average interest rate: | | | |
| During the period | | 2.91% | 5.55% |
| At period end | | | 4.35% |

There were no fed funds purchased for the years ended December 31, 2009, 2008 and 2007.

During 2006, the Company entered into a loan agreement with Key Bank in the amount of \$3,700,000. The terms of the loan included quarterly payments of \$345,000, interest at 6.8% and maturing July 2009. The loan was paid off during the year ended December 31, 2008.

Supervision and Regulation

We are subject to extensive Federal and Washington State legislation, regulation, and supervision. These laws and regulations are primarily intended to protect depositors, the FDIC and shareholders. The laws and regulations affecting banks and bank holding companies have changed significantly over recent years, and it is reasonable to expect that similar changes will continue in the future. Any change in applicable laws, regulations, or regulatory policies may have a material effect on our business, operations, and prospects. We cannot predict the nature or the extent of the effects on our business and earnings that any fiscal or monetary policies or new Federal or State legislation may have in the future.

The following information is qualified in its entirety by reference to the particular statutory and regulatory provisions described.

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

The Federal Reserve has a policy that a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, the Federal Reserve provides that bank holding companies should serve as a source of strength to its subsidiary banks by being prepared to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity, and should maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting its subsidiary banks. A bank holding company's failure to meet its obligation to serve as a source of strength to its subsidiary banks will generally be considered by the Federal Reserve to be an unsafe and unsound banking practice or a violation of the Federal Reserve's regulations or both. The Federal Deposit Insurance Act requires an undercapitalized bank to develop a capital restoration plan, approved by the FDIC, with a guaranty by each company having control of the bank, of the bank's compliance with the plan.

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

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

Bank regulations require bank holding companies and banks to maintain a minimum leverage ratio of core capital to adjusted quarterly average total assets of at least 3%. In addition, banking regulators have adopted risk-based capital guidelines under which risk percentages are assigned to various categories of assets and off-balance sheet items to calculate a risk-adjusted capital ratio. Tier 1 capital generally consists of common stockholders' equity (which does not include unrealized gains and losses on securities), less goodwill and certain identifiable intangible assets. Tier 2 capital includes Tier 1 capital plus the allowance for loan losses and subordinated debt, both subject to some limitations. Regulatory risk-based capital guidelines require Tier 1 capital of 4% of risk-adjusted assets and minimum total capital ratio (combined Tier 1 and Tier 2) of 8% of risk-adjusted assets.

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

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

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

Dividends paid by our subsidiaries provide substantially all of our cash flow. Applicable Federal and Washington State regulations restrict capital distributions by our Banks, including dividends. Such restrictions are tied to the institution's capital levels after giving effect to such distributions.

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

The Federal Reserve's risk-based guidelines for bank holding companies establish a two-tier capital framework. Tier 1 capital generally consists of common stockholders' equity, retained earnings, a limited amount of qualifying perpetual preferred stock, qualifying trust preferred securities and minority interests in the equity accounts of consolidated subsidiaries, less goodwill and certain intangibles. Tier 2 capital generally consists of certain hybrid capital instruments and perpetual debt, mandatory convertible debt securities and a limited amount of subordinated debt, qualifying preferred stock, loan loss allowance, and unrealized holding gains on certain equity securities. The sum of Tier 1 and Tier 2 capital represents qualifying total capital, at least 50% of which must consist of Tier 1 capital.

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Risk-based capital ratios are calculated by dividing Tier 1 and total capital by risk-weighted assets. Assets and off-balance sheet exposures are assigned to one of four categories of risk-weights, based primarily on relative credit risk. The minimum Tier 1 risk-based capital ratios under these guidelines at December 31, 2009 were 4% and 8%, respectively. At December 31, 2009, we had risk-based capital ratios of 19.4% and 20.7%, respectively.

The Federal Reserve's leverage capital guidelines establish a minimum leverage ratio determined by dividing Tier 1 capital by adjusted average total assets. The minimum leverage ratio is 3% for bank holding companies that meet certain specified criteria, including having the highest regulatory rating. All other bank holding companies generally are required to maintain a leverage ratio of at least 4%. At December 31, 2009, we had a leverage ratio of 14.4%.

Prompt Corrective Action. The Federal Deposit Insurance Corporation Improvement Act of 1991, among other things, identifies five capital categories for insured depository institutions (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) and requires the respective federal regulatory agencies to implement systems for prompt corrective action for insured depository institutions that do not meet minimum capital requirements within these categories. This Act imposes progressively more restrictive constraints on operations, management and capital distributions, depending on the category in which an institution is classified. Failure to meet the capital guidelines could also subject a banking institution to capital raising requirements. An undercapitalized bank must develop a capital restoration plan and its holding companies must guarantee the bank's compliance with the plan. The liability of a holding company under any such guarantee is limited to the lesser of five percent of the bank's assets at the time it became undercapitalized or the amount needed to comply with the plan. Furthermore, in the event of the bankruptcy of a holding company, such guarantee would take priority over the parent's general unsecured creditors. In addition, the Federal Deposit Insurance Corporation Improvement Act requires the various regulatory agencies to prescribe certain non-capital standards for safety and soundness relating generally to operations and management, asset quality and executive compensation, and permits regulatory action against a financial institution that does not meet these standards.

The various federal regulatory agencies have adopted substantially similar regulations that define the five capital categories identified by the Federal Deposit Insurance Corporation Improvement Act, using the total risk-based capital, Tier 1 risk-based capital and leverage capital ratios as the relevant capital measures. These regulations establish various degrees of corrective action to be taken when an institution is considered undercapitalized. Under the regulations, a well capitalized institution must have a Tier 1 risk-based capital ratio of at least 6%, a total risk-based capital ratio of at least 10% and a leverage ratio of at least 5% and not be subject to a capital directive or order. An institution is adequately capitalized if it has a Tier 1 risk-based capital ratio of at least 4%, a total risk-based capital ratio of at least 8% and a leverage ratio of at least 4% (3% in certain circumstances). An institution is undercapitalized if it has a Tier 1 risk-based capital ratio of less than 4%, a total risk-based capital ratio of less than 8% or a leverage ratio of less than 4% (3% in certain circumstances). An institution is significantly undercapitalized if it has a Tier 1 risk-based capital ratio of less than 3%, a total risk-based capital ratio of less than 6% or a leverage ratio of less than 3%. An institution is critically undercapitalized if its tangible equity is equal to or less than 2% of total assets. Generally, an institution may be reclassified in a lower capitalization category if it is determined that the institution is in an unsafe or unsound condition or engaged in an unsafe or unsound practice.

As of December 31, 2009, the Banks met the requirements to be classified as well-capitalized.

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

Deposit Insurance and Other FDIC Programs. Each of the Banks is a member of the Deposit Insurance Fund (DIF), which is administered by the FDIC. Deposits are insured up to the applicable limits by the FDIC,

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backed by the full faith and credit of the United States Government. Under new legislation, during the period from October 3, 2008 through December 31, 2013, the basic deposit insurance limit is \$250,000, instead of the \$100,000 limit in effect earlier.

The FDIC assesses deposit insurance premiums on each FDIC-insured institution quarterly based on annualized rates for one of four risk categories applied to its deposits subject to certain adjustments. Each institution is assigned to one of four risk categories based on its capital, supervisory ratings and other factors. Well capitalized institutions that are financially sound with only a few minor weaknesses are assigned to Risk Category I. Risk Categories II, III and IV present progressively greater risks to the DIF. Under FDIC's risk-based assessment rules, effective April 1, 2009, the initial base assessment rates prior to adjustments range from 12 to 16 basis points for Risk Category I, and are 22 basis points for Risk Category II, 32 basis points for Risk Category III, and 45 basis points for Risk Category IV. Initial base assessment rates are subject to adjustments based on an institution's unsecured debt, secured liabilities and brokered deposits, such that the total base assessment rates after adjustments range from 7 to 24 basis points for Risk Category I, 17 to 43 basis points for Risk Category II, 27 to 58 basis points for Risk Category III, and 40 to 77.5 basis points for Risk Category IV. Rates increase uniformly by three basis points effective January 1, 2011.

In addition to the regular quarterly assessments, due to losses and projected losses attributed to failed institutions, the FDIC imposed a special assessment of five basis points on the amount of each depository institution's assets reduced by the amount of its Tier 1 capital (not to exceed 10 basis points of its assessment base for regular quarterly premiums) as of June 30, 2009, which was collected on September 30, 2009.

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

FDIC estimates that the reserve ratio will reach the minimum reserve ratio of 1.15% by 2017 as required by statute.

In addition, all institutions with deposits insured by the FDIC are required to pay assessments to fund interest payments on bonds issued by the Financing Corporation, an agency of the Federal government established to fund the costs of failed thrifts in the 1980's. The assessment rate for 2009 is approximately 0.010% of insured deposits. These assessments will continue until the Financing Corporation bonds mature in 2017.

Following a systemic risk determination, the FDIC established its Temporary Liquidity Guarantee Program (TLGP) in October 2008. Under the interim rule for the TLGP, there are two parts to the program: the Debt Guarantee Program (DGP) and the Transaction Account Guarantee Program (TAGP). Eligible entities generally are participants unless they exercised opt out rights in timely fashion. We and our bank subsidiaries did not opt out of these programs.

For the DGP, eligible entities are generally US bank holding companies, savings and loan holding companies, and FDIC-insured institutions. Under the DGP, the FDIC guarantees certain senior unsecured debt of

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an eligible entity that is issued not later than October 31, 2009. The guarantee is effective through the earlier of the maturity date or June 30, 2012 (for debt issued before April 1, 2009) or December 31, 2012 (for debt issued on or after April 1, 2009). The DGP coverage limit is generally 125% of the eligible entity's eligible debt outstanding on September 30, 2008 and scheduled to mature on or before June 30, 2009, or for certain institutions, 2% of liabilities as of September 30, 2008. The nonrefundable DGP fee ranges from 50 to 100 basis points (annualized), depending on maturity, for covered debt outstanding during the period until the earlier of maturity or June 30, 2012, with various surcharges of 10 to 50 basis points applicable to debt with a maturity of one year or more issued on or after April 1, 2009. Generally, eligible debt of a participating entity becomes covered when and as issued until the coverage limit is reached, except that under some circumstances, participating entities can issue certain nonguaranteed debt. Various features of the DGP require applications, additional fees, and approvals. The FDIC has also established a limited, six-month emergency guarantee facility. Under this facility, participating entities can apply to issue FDIC-guaranteed debt during the period October 31, 2009 through April 30, 2010, to be guaranteed through December 31, 2012. For approved applicants, fees of at least 300 basis points will be assigned on a case-by-case basis.

For the TAGP, eligible entities are FDIC-insured institutions. Under the TAGP, the FDIC provides unlimited deposit insurance coverage for noninterest-bearing transaction accounts (typically business checking accounts), NOW accounts bearing interest at 0.5% or less, and certain funds swept into noninterest-bearing savings accounts. Other NOW accounts and money market deposit accounts are not covered. TAGP coverage lasts until December 31, 2009 and, unless the participant has opted out of the extension period, during the extension period of January 1, 2010 through June 30, 2010. Participating institutions pay fees of 10 basis points (annualized) on the balance of each covered account in excess of \$250,000 during the period through December 31, 2009. During the extension period, such fees are 15 basis points for institutions in Risk Category I, 20 basis points for those in Risk Category II and 25 basis points for those in Risk Categories III and IV (Risk Categories are those assigned for deposit insurance purposes).

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

Emergency Economic Stabilization Act. On October 3, 2008, the Emergency Economic Stabilization Act (EESA) was enacted in response to recent unprecedented market turmoil. EESA authorizes the Secretary of the Treasury to purchase up to \$700 billion in troubled assets from financial institutions under the Troubled Asset Relief Program (TARP). Troubled assets include residential or commercial mortgages and related instruments originated prior to March 14, 2008 and any other financial instrument that the Secretary determines, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, the purchase of which is necessary to promote financial stability. If the Secretary exercises his authority under TARP, EESA directs the Secretary of the Treasury to establish a program to guarantee troubled assets originated or issued prior to March 14, 2008. The Secretary is authorized to purchase up to \$250 million in troubled assets immediately and up to \$350 million upon certification by the President that such authority is needed. The Secretary's authority will be increased to \$700 million if the President submits a written report to Congress detailing the Secretary's plans to use such authority unless Congress passes a joint resolution disapproving such amount within 15 days after receipt of the report.

Institutions selling assets under TARP will be required to issue a warrant for common or preferred stock or senior debt to the Secretary. If the Secretary purchases troubled assets directly from an institution without a bidding process and acquires a meaningful equity or debt position in the institution as a result or acquires more than \$300 million in troubled assets from an institution regardless of method, the institution will be required to meet certain standards for executive compensation and corporate governance, including a prohibition against incentives to take unnecessary and excessive risks, recovery of bonuses paid to senior executives based on materially inaccurate earnings or other statements and a prohibition against agreements for the payment of golden parachutes. Institutions that sell more than \$300 million in assets under TARP auctions will not be

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entitled to a tax deduction for compensation in excess of \$500,000 paid to its chief executive or chief financial official or of any its other three most highly compensated officers. In addition, any severance paid to such officers for involuntary termination or termination in connection with a bankruptcy or receivership will be subject to the golden parachute rules under the Internal Revenue Code.

Pursuant to his authority under EESA, the Secretary of the Treasury has created the TARP Capital Purchase Plan (TARP CCP) under which the Treasury Department will invest up to \$250 billion in senior preferred stock of U.S. banks and savings associations or their holding companies. Qualifying financial institutions may issue senior preferred stock with a value equal to not less than 1% of risk-weighted assets and not more than the lesser of \$25 billion or 3% of risk-weighted assets. The senior preferred stock will pay dividends at the rate of 5% per annum until the fifth anniversary of the investment and thereafter at the rate of 9% per annum. The senior preferred stock may not be redeemed for three years except with the proceeds from an offering of common stock or preferred stock qualifying as Tier 1 capital in an amount equal to not less than 25% of the amount of the senior preferred. After three years, the senior preferred may be redeemed at any time in whole or in part by the financial institution. No dividends may be paid on common stock unless dividends have been paid on the senior preferred stock. Until the third anniversary of the issuance of the senior preferred, the consent of the U.S. Treasury will be required for any increase in the dividends on the common stock or for any stock repurchases unless the senior preferred has been redeemed in its entirety or the Treasury has transferred the senior preferred to third parties. The senior preferred will not have voting rights other than the right to vote as a class on the issuance of any preferred stock ranking senior, any change in its terms or any merger, exchange or similar transaction that would adversely affect its rights. The senior preferred will also have the right to elect two directors if dividends have not been paid for six periods. The senior preferred will be freely transferable and participating institutions will be required to file a shelf registration statement covering the senior preferred. The issuing institution must grant the Treasury piggyback registration rights. Prior to issuance, the financial institution and its senior executive officers must modify or terminate all benefit plans and arrangements to comply with EESA. Senior executives must also waive any claims against the Treasury Department.

In connection with the issuance of the senior preferred, participating institutions must issue to the Secretary immediately exercisable 10-year warrants to purchase common stock with an aggregate market price equal to 15% of the amount of senior preferred. The exercise price of the warrants will equal the market price of the common stock on the date of the investment. The Secretary may only exercise or transfer one-half of the warrants prior to the earlier of December 31, 2009 or the date the issuing financial institution has received proceeds equal to the senior preferred investment from one or more offerings of common or preferred stock qualifying as Tier 1 capital. The Secretary will not exercise voting rights with respect to any shares of common stock acquired through exercise of the warrants. The financial institution must file a shelf registration statement covering the warrants and underlying common stock as soon as practicable after issuance and grant piggyback registration rights. The number of warrants will be reduced by one-half if the financial institution raises capital equal to the amount of the senior preferred through one or more offerings of common stock or preferred stock qualifying as Tier 1 capital. If the financial institution does not have sufficient authorized shares of common stock available to satisfy the warrants or their issuance otherwise requires shareholder approval, the financial institution must call a meeting of shareholders for that purpose as soon as practicable after the date of investment. The exercise price of the warrants will be reduced by 15% for each six months that lapse before shareholder approval subject to a maximum reduction of 45%.

On November 21, 2008, the Company entered into a Letter Agreement and Securities Purchase Agreement (collectively, the Purchase Agreement) with the United States Department of the Treasury (Treasury) under the TARP-CPP, pursuant to which the Company sold (i) 24,000 shares of the Company s Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the Series A Preferred Stock) and (ii) a warrant (the Warrant) to purchase 276,074 shares of the Company s common stock for an aggregate purchase price of \$24.0 million in cash. Under the terms of the warrant, because the Company s September 22, 2009 offering of common stock was a qualified equity offering resulting in aggregate gross proceeds of at least \$24.0 million, the number of shares of our common stock underlying the warrant was reduced by 50% to 138,037 shares.

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The Series A Preferred Stock qualifies as Tier 1 capital and pays cumulative dividends at a rate of 5% per annum for the first five years, and 9% per annum thereafter. The Series A Preferred Stock may be redeemed by the Company after three years. Prior to the end of three years, the Series A Preferred Stock may be redeemed by the Company only with proceeds from the sale of qualifying equity securities of the Company (a Qualified Equity Offering).

Pursuant to the terms of the Purchase Agreement, the ability of the Company to declare or pay dividends or distributions on, or purchase, redeem or otherwise acquire for consideration, shares of its Common Stock is subject to restrictions, including a restriction against increasing regular quarterly cash dividends from the last quarterly cash dividend per share (\$0.14) declared on the Common Stock prior to December 12, 2008. The redemption, purchase or other acquisition of trust preferred securities of the Company or its affiliates also will be restricted. These restrictions will terminate on the earlier of (a) the third anniversary of the date of issuance of the Series A Preferred Stock and (b) the date on which the Series A Preferred Stock has been redeemed in whole or Treasury has transferred all of the Series A Preferred Stock to third parties. The restrictions described in this paragraph are set forth in the Purchase Agreement.

In addition, the ability of the Company to declare or pay dividends or distributions on, or repurchase, redeem or otherwise acquire for consideration, shares of its Common Stock is subject to restrictions in the event that the Company fails to declare and pay full dividends (or declare and set aside a sum sufficient for payment thereof) on its Series A Preferred Stock. The Purchase Agreement also subjects the Company to certain of the executive compensation limitations included in the Emergency Economic Stabilization Act of 2008 (the EESA).

Sarbanes-Oxley Act. On July 30, 2002, President George W. Bush signed into law the Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act implements a broad range of corporate governance and accounting measures for public companies designed to promote honesty and transparency in corporate America and better protect investors from the type of corporate wrongdoing that occurred in Enron, WorldCom, and similar companies. The Sarbanes-Oxley Act s principal legislation includes:

The creation of an independent accounting oversight board;

Auditor independence provisions that restrict non-audit services accountants may provide to their audit clients;

Additional corporate governance and responsibility measures, including the requirement that the chief executive officer and the chief financial officer certify financial statements and the expansion of powers of audit committees;

Expanded disclosure requirements, including accelerated reporting of stock transactions by insiders;

Mandatory disclosure by analysts of potential conflicts of interest; and

A range of enhanced penalties for fraud and other violations.

USA Patriot Act. On October 26, 2001, President George W. Bush signed into law the USA Patriot Act (Patriot Act). Title III of the Patriot Act concerns money laundering provisions that may affect many community banks. These provisions include:

The Secretary of the Treasury is authorized to impose special measures, such as recordkeeping or reporting, on domestic financial institutions that are a primary concern;

Financial institutions with private or correspondent accounts with non-U.S. citizens must establish policies and procedures to detect money laundering through those accounts;

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Financial institutions are barred from maintaining correspondent accounts for foreign shell banks (that is a bank that does not have a physical presence in any country);

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The Secretary of the Treasury is required to prescribe regulations to further encourage cooperation among financial institutions, regulators, and law enforcement agencies and officials to share information about terrorist acts and money laundering activities;

The Secretary of the Treasury is required to issue regulations to establish minimum procedures for financial institutions to use in verifying customer identity during the account-opening process;

Depository institutions are permitted to provide information to other institutions concerning the possible involvement in potentially unlawful activity by a current or former employee;

The Secretary of the Treasury is required to establish a secure website to receive suspicious activity reports and currency transaction reports, and provide institutions with alerts and other information regarding suspicious activity that warrant immediate attention; and

The federal bank regulators are required to consider the anti-money laundering record of each depository institution in evaluating certain applications including those under the Bank Merger Act.

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

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

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

Website Access to Company Reports

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

Code of Ethics

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

Competition

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

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

Employees

We had 222 full-time equivalent employees at December 31, 2009. We experienced an increase of five full-time equivalents during 2009. We believe that employees play a vital role in the success of a service company. Employees are provided with a variety of benefits such as medical, vision, dental and life insurance, a generous retirement plan, and paid vacations and sick leave. None of our employees are covered by a collective bargaining agreement.

Executive Officers

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

EXECUTIVE OFFICERS

| Name | Age | Position | Has Served Heritage, Heritage Bank or Central Valley Bank Since |
|----------------------|------------|---|--|
| Brian L. Vance | 55 | President and Chief Executive Officer of Heritage; President and Chief Executive Officer of Heritage Bank; Vice Chairman and Chief Executive Officer of Central Valley Bank | 1996 |
| Gregory D. Patjens | 60 | Executive Vice President, Heritage Bank | 1999 |
| Donald J. Hinson | 48 | Senior Vice President and Chief Financial Officer of Heritage, Heritage Bank and Central Valley Bank | 2005 |
| D. Michael Broadhead | 64 | President of Central Valley Bank | 1986 |
| David A. Spurling | 56 | Senior Vice President and Chief Credit Officer | 2001 |

Biographical Information

Brian L. Vance currently serves as President and Chief Executive Officer of Heritage and Heritage Bank, and Vice Chairman and Chief Executive Officer of Central Valley Bank. Mr. Vance joined Heritage in 1996 as its Executive Vice President and Chief Credit Officer. Effective October 1, 1998, Mr. Vance was appointed President and Chief Operating Officer of Heritage Bank and in March of 2003, he was named President and Chief Executive Officer of Heritage Bank. On October 1, 2006, Mr. Vance was appointed to his current position. Prior to joining Heritage Bank, Mr. Vance was employed for 24 years with West One Bank, a bank with offices in Idaho, Utah, Oregon and Washington. Prior to leaving West One, he was Senior Vice President and Regional Manager of Banking Operations for the south Puget Sound region.

Gregory D. Patjens joined Heritage Bank on March 16, 1999. Mr. Patjens was employed for over 25 years with Key Bank and its predecessor, Puget Sound National Bank in positions with responsibilities for a variety of administrative and bank operations functions. Prior to leaving Key Bank, Mr. Patjens was Senior Vice President for Key Services, National Client Services.

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Donald J. Hinson became the Senior Vice President and Chief Financial Officer of Heritage, Heritage Bank and Central Valley Bank in September 2007. Prior to that since August 2005, Mr. Hinson was Vice President and Controller at Heritage Bank. Prior to that, he served in the banking practice of local and national accounting firms.

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

David A. Spurling is Chief Credit Officer of Heritage Bank. Mr. Spurling attended the University of Washington where he received his Bachelor's degree in Business Administration in 1981 and his MBA in 1983. He began his banking career as a middle market lender at Seafirst Bank, followed by positions as a commercial lender at Bank of America in Small Business Banking and as a regional manager for Bank of America's government-guaranteed lending division. He joined Heritage Bank in 2001 as a commercial lender, followed by a role as a commercial team leader. He was promoted to the position of Chief Credit Officer in 2007.

ITEM 1A. RISK FACTORS

The following are certain risks that management believes are specific to our business. This should not be viewed as an all inclusive list or in any particular order.

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

Substantially all of our loans are to businesses and individuals in the state of Washington, and a continuing decline in the economies of our primary market areas of the south Puget Sound and Yakima Valley regions of Washington could have a material adverse effect on our business, financial condition, results of operations and prospects. In particular, the Puget Sound region has experienced substantial home price declines and increased foreclosures. A series of large Puget Sound-based businesses have implemented substantial employee layoffs and scaled back plans for future growth. Additionally, acquisitions and consolidations have resulted in substantial employee layoffs, along with a significant increase in office space vacancies in downtown Seattle. The Yakima Valley has likewise seen increased unemployment and a continued decline in housing prices.

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

loan delinquencies, problem assets and foreclosures may increase;

demand for our products and services may decline;

collateral for loans made may decline further in value, in turn reducing customers' borrowing power, reducing the value of assets and collateral associated with existing loans; and

low cost or non-interest bearing deposits may decrease.

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

Repayment of our commercial business loans is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value. We offer different types of commercial loans to a variety of businesses with an emphasis on real estate related industries and businesses in agricultural, healthcare, legal, and other professions. The types of commercial loans offered are business lines of credit, term equipment financing and term real estate loans. We also originate loans that are guaranteed by the Small Business Administration (SBA) and are a preferred lender of the SBA. Commercial business lending

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involves risks that are different from those associated with real estate lending. Real estate lending is generally considered to be collateral based lending with loan amounts based on predetermined loan to collateral values and liquidation of the underlying real estate collateral being viewed as the primary source of repayment in the event of borrower default. Our commercial business loans are primarily made based on the cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The borrower's cash flow may be unpredictable, and collateral securing these loans may fluctuate in value. Although commercial business loans are often collateralized by equipment, inventory, accounts receivable, or other business assets, the liquidation of collateral in the event of default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories may be obsolete or of limited use, among other things. Accordingly, the repayment of commercial business loans depends primarily on the cash flow and credit worthiness of the borrower and secondarily on the underlying collateral provided by the borrower. In addition, as part of our commercial business lending activities, we originate agricultural loans. Payments on agricultural loans are typically dependent on the profitable operation or management of the related farm property. The success of the farm may be affected by many factors outside the control of the borrower, including adverse weather conditions that prevent the planting of a crop or limit crop yields, declines in market prices for agricultural products and the impact of government regulations. In addition, many farms are dependent on a limited number of key individuals whose injury or death may significantly affect the successful operation of the farm. If the cash flow from a farming operation is diminished, the borrower's ability to repay the loan may be impaired.

Our income property loans, consisting of commercial and multi-family real estate loans, involve higher principal amounts than other loans and repayment of these loans may be dependent on factors outside our control or the control of our borrowers. We originate commercial and multi-family real estate loans for individuals and businesses for various purposes, which are secured by commercial properties. These loans typically involve higher principal amounts than other types of loans, and repayment is dependent upon income generated, or expected to be generated, by the property securing the loan in amounts sufficient to cover operating expenses and debt service, which may be adversely affected by changes in the economy or local market conditions. For example, if the cash flow from the borrower's project is reduced as a result of leases not being obtained or renewed, the borrower's ability to repay the loan may be impaired. Commercial and multifamily mortgage loans also expose a lender to greater credit risk than loans secured by residential real estate because the collateral securing these loans typically cannot be sold as easily as residential real estate. In addition, many of our commercial and multifamily real estate loans are not fully amortizing and contain large balloon payments upon maturity. Such balloon payments may require the borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment.

If we foreclose on a commercial and multi-family real estate loan, our holding period for the collateral typically is longer than for one-to-four family residential mortgage loans because there are fewer potential purchasers of the collateral. Additionally, commercial and multi-family real estate loans generally have relatively large balances to single borrowers or related groups of borrowers. Accordingly, if we make any errors in judgment in the collectability of our commercial and multi-family real estate loans, any resulting charge-offs may be larger on a per loan basis than those incurred with our residential or consumer loan portfolios.

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

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

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

cash flow of the borrower and/or the project being financed;

the changes and uncertainties as to the future value of the collateral, in the case of a collateralized loan;

the credit history of a particular borrower;

changes in economic and industry conditions; and

the duration of the loan.

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

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

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

current macroeconomic factors.

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

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

For the year ended December 31, 2009 we recorded a provision of \$19.4 million compared to \$7.4 million for the year ended December 31, 2008. We also recorded net loan charge-offs of \$8.6 million for the year ended December 31, 2009 compared to \$2.4 million for the year ended December 31, 2008. We are experiencing increasing loan delinquencies and credit losses. Generally, our non-performing loans and assets reflect operating difficulties of individual borrowers resulting from weakness in the local economy; however, more recently the deterioration in the general economy has become a significant contributing factor to the increased levels of delinquencies and non-performing loans. Slower sales and excess inventory in the housing market has been the primary cause of the increase in delinquencies and foreclosures for residential construction and land development loans. In addition, slowing housing sales have been a contributing factor to the increase in non-performing loans as well as the increase in delinquencies. At December 31, 2009 our total non-performing loans had increased to \$33.0 million or 4.3% of

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total loans compared to \$3.4 million or 0.4% of total loans at December 31, 2008. If current trends in the housing and real estate markets continue, we expect that it will continue to experience

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higher than normal delinquencies and credit losses. Moreover, if a prolonged recession occurs, we expect that it could severely impact economic conditions in our market areas and that we could experience significantly higher delinquencies and credit losses. As a result, we may be required to make further increases in our provision for loan losses and to charge off additional loans in the future, which could adversely affect our financial condition and results of operations, perhaps materially.

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

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

Further economic downturns may adversely affect our investment securities portfolio.

The deterioration in the credit markets created market volatility and illiquidity, resulting in significant declines in the market values of a broad range of investment products. We continue to monitor our investment portfolio for deteriorating collateral values and other-than-temporary impairments. Any other than temporary impairments would adversely affect our operating results.

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

Accounting standards require that we account for acquisitions using the purchase method of accounting. Under purchase accounting, if the purchase price of an acquired company exceeds the fair value of its net assets, the excess is carried on the acquirer's balance sheet as goodwill. In accordance with generally accepted accounting principles, our goodwill is evaluated for impairment on an annual basis or more frequently if events or circumstances indicate that a potential impairment exists. Such evaluation is based on a variety of factors, including the quoted price of our common stock, market prices of common stock of other banking organizations, common stock trading multiples, discounted cash flows, and data from comparable acquisitions. At December 31, 2009, we had goodwill with a carrying amount of \$13.0 million.

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

Fluctuating interest rates can adversely affect our profitability.

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

The FDIC has increased deposit insurance premiums to restore and maintain the federal deposit insurance fund, which has increased our costs.

During the second quarter of 2009, the FDIC increased deposit insurance assessment rates generally and imposed a special assessment of five basis points on each insured institution's total assets less Tier 1 capital. This

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special assessment was calculated based on the insured institution's assets at June 30, 2009, and was collected on September 30, 2009. Based on the assets of the Company's subsidiary banks as of June 30, 2009 subject to the FDIC assessment, the special assessments on the Company's subsidiary banks totaled approximately \$437,000. This special assessment is in addition to the regular quarterly risk-based assessment. In addition, during fourth quarter of 2009, the FDIC approved a final rule requiring institutions to prepay approximately three years of estimated insurance assessments. As a result, as of December 31, 2009, the Company had \$5.0 million in prepaid FDIC assessments.

The FDIC deposit insurance fund may suffer additional losses in the future due to bank failures, which may require us to pay additional deposit insurance premiums in order to restore the insurance fund's reserve ratio. Additional deposit insurance premiums will increase our costs and, if substantial, may materially affect our results of operations and financial condition.

We may grow through future acquisitions, which could, in some circumstances, adversely affect our profitability measures.

We may engage in selected acquisitions of financial institutions in the future, which may involve the issuance of additional common stock, including FDIC-assisted transactions. Any such acquisitions and related issuances of stock may have dilutive effect on earnings per share and the percentage ownership of current shareholders. There are risks associated with our acquisition strategy that could adversely impact our profitability. These risks include, among others, incorrectly assessing the asset quality of a particular institution being acquired, encountering greater than anticipated costs of incorporating acquired businesses into our company, and being unable to profitably deploy funds acquired in an acquisition. Furthermore, we cannot provide any assurance as to the extent to which we can continue to grow through acquisitions.

Decreased volumes and lower gains on sales and brokering of mortgage loans sold could adversely impact net income.

We originate and sell mortgage loans as well as broker mortgage loans. Changes in interest rates affect demand for the Company's loan products and the revenue realized on the sale of loans. A decrease in the volume of loans sold/brokered can decrease our revenues and net income.

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

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

Our growth or future losses may require us to raise additional capital in the future, but that capital may not be available when it is needed or the cost of that capital may be very high.

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. At some point we may need to raise additional capital to support continued internal growth and growth through acquisitions.

Our ability to raise additional capital, if needed, will depend on conditions in the capital markets at that time, which are outside our control, and on our financial condition and performance. Accordingly, we cannot

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make assurances of our ability to raise additional capital if needed, or if the terms will be acceptable to us. If we cannot raise additional capital when needed, our ability to further expand our operations through internal growth and acquisitions could be materially impaired and our financial condition and liquidity could be materially and adversely affected.

We operate in a highly regulated environment and may be adversely affected by changes in federal and state laws and regulations, including rules and policies applicable to participants in the U.S. Treasury's Capital Purchase Program.

We are subject to extensive regulation, supervision and examination by federal and state banking authorities. Any change in applicable regulations or laws could have a substantial impact on us and our operations. Additional legislation and regulations that could significantly affect the Company's powers, authority and operations may be enacted or adopted in the future, which could have a material adverse effect on our financial condition and results of operations. The rules and policies applicable to recipients of capital under the U.S. Treasury's Capital Purchase Program have been significantly revised and supplemented since the inception of that program, and continue to evolve. Further, our regulators have significant discretion and authority to prevent or remedy unsafe or unsound practices or violations of laws by financial institutions and holding companies in the performance of their supervisory and enforcement duties. The exercise of regulatory authority generally may have a negative impact, which may be material, on our results of operations and financial condition.

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

At December 31, 2009, we owned \$3.6 million of stock of the Federal Home Loan Bank of Seattle, or FHLB. As a condition of membership at the FHLB, we are required to purchase and hold a certain amount of FHLB stock. Our stock purchase requirement is based, in part, upon the outstanding principal balance of advances from the FHLB and is calculated in accordance with the Capital Plan of the FHLB. Our FHLB stock has a par value of \$100, is carried at cost, and is subject to impairment testing. The FHLB has announced that it had a risk-based capital deficiency under the regulations of the Federal Housing Finance Agency (the FHFA), its primary regulator, and that it would suspend future dividends and the repurchase and redemption of outstanding common stock. As a result, the FHLB has not paid a dividend since the fourth quarter of 2008. The FHLB has communicated that it believes the calculation of risk-based capital under the current rules of the FHFA significantly overstates the market risk of the FHLB's private-label mortgage-backed securities in the current market environment and that it has enough capital to cover the risks reflected in its balance sheet. As a result, we have not recorded an other-than-temporary impairment on our investment in FHLB stock. However, continued deterioration in the FHLB's financial position may result in impairment in the value of those securities. We will continue to monitor the financial condition of the FHLB as it relates to, among other things, the recoverability of our investment.

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

We may have opportunities to acquire the assets and liabilities of failed banks in FDIC-assisted transactions. Although these FDIC-assisted transactions typically provide for FDIC assistance to an acquiror to mitigate certain risks, such as sharing exposure to loan losses and providing indemnification against certain liabilities of the failed institution, we are (and would be in future transactions) subject to many of the same risks we would face in acquiring another bank in a negotiated transaction, including risks associated with maintaining customer relationships and failure to realize the anticipated acquisition benefits in the amounts and within the timeframes we expect. In addition, because these acquisitions are structured in a manner that would not allow us the time and access to information normally associated with preparing for and evaluating a negotiated acquisition, we may face additional risks in FDIC-assisted transactions, including additional strain on management resources, management of problem loans, problems related to integration of personnel and operating systems and impact to

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our capital resources requiring us to raise additional capital. We cannot give assurance that we will be successful in overcoming these risks or any other problems encountered in connection with FDIC-assisted transactions. Our inability to overcome these risks could have a material adverse effect on our business, financial condition and results of operations.

Our Series A Preferred Stock impacts net income available to our common shareholders and earnings per common share, and the Warrant we issued to the Treasury may be dilutive to holders of our common stock.

The dividends declared on our Series A Preferred Stock reduce the net income available to common shareholders and our earnings per common share. The Series A Preferred Stock will also receive preferential treatment in the event of liquidation, dissolution or winding up of Heritage. Additionally, the ownership interest of the existing holders of our common stock will be diluted to the extent the Warrant we issued to the Treasury in conjunction with the sale to the Treasury of the Series A Preferred Stock is exercised. The 138,037 shares of common stock underlying the Warrant represent approximately 1.2% of the shares of our common stock outstanding as of December 31, 2009 (including the shares issuable upon exercise of the Warrant in total shares outstanding). Although the Treasury has agreed not to vote any of the shares of common stock it receives upon exercise of the Warrant, a transferee of any portion of the Warrant or of any shares of common stock acquired upon exercise of the Warrant is not bound by this restriction.

If we are unable to redeem our Series A Preferred Stock after five years, the cost of this capital to us will increase substantially.

If we are unable to redeem our Series A Preferred Stock prior to February 15, 2014, the cost of this capital to us will increase substantially on that date, from 5.0% per annum (approximately \$1.2 million annually) to 9.0% per annum (approximately \$2.2 million annually). Depending on our financial condition at the time, this increase in the annual dividend rate on the Series A Preferred Stock could have a material negative effect on our liquidity.

There may be future sales of additional common stock or other dilution of our equity, which may adversely affect the market price of our common stock.

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

Our board of directors is authorized generally to cause us to issue additional common stock, as well as series of preferred stock, without any action on the part of our shareholders except as may be required under the listing requirements of the Nasdaq Stock Market. In addition, the board has the power, without shareholder approval, to set the terms of any such series of preferred stock that may be issued, including voting rights, dividend rights and preferences over the common stock with respect to dividends or upon the liquidation, dissolution or winding-up of our business and other terms. If we issue preferred stock in the future that has a preference over the common stock with respect to the payment of dividends or upon liquidation, dissolution or winding-up, or if we issue preferred stock with voting rights that dilute the voting power of the common stock, the rights of holders of the common stock or the market price of the common stock could be adversely affected.

ITEM 1B. UNRESOLVED STAFF COMMENTS

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

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ITEM 2. PROPERTIES

Our executive offices and the main office of Heritage Bank are located in approximately 22,000 square feet of the headquarters building and adjacent office space which are owned by Heritage Bank and located in downtown Olympia. At December 31, 2009, Heritage Bank had seven offices located in Tacoma and surrounding areas of Pierce County (all but two of which are owned), five offices located in Thurston County (all of which are owned with one office located on leased land), one office in south King County (which is leased) and one office in Mason County (which is owned). Central Valley Bank had six offices, five located in Yakima County and one in Kittitas County (all of which are owned with one on leased land).

ITEM 3. LEGAL PROCEEDINGS

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

ITEM 4. RESERVED

Table of Contents**PART II****ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock is traded on the NASDAQ Global Select Market under the symbol HFWA. At December 31, 2009, we had approximately 1,192 shareholders of record (not including the number of persons or entities holding stock in nominee or street name through various brokerage firms) and 11,057,972 outstanding shares of common stock. The last reported sales price on February 10, 2010 was \$14.15 per share. The following table provides sales information per share of our common stock as reported on the NASDAQ Global Select Market for the indicated quarters.

| | 2009 Quarter ended: | | | |
|------|---------------------|----------|--------------|-------------|
| | March 31 | June 30 | September 30 | December 31 |
| High | \$ 12.49 | \$ 13.00 | \$ 14.20 | \$ 14.20 |
| Low | \$ 8.55 | \$ 10.53 | \$ 10.51 | \$ 12.25 |

| | 2008 Quarter ended: | | | |
|------|---------------------|----------|--------------|-------------|
| | March 31 | June 30 | September 30 | December 31 |
| High | \$ 20.39 | \$ 19.00 | \$ 15.56 | \$ 15.00 |
| Low | \$ 16.75 | \$ 15.53 | \$ 9.01 | \$ 10.00 |

Quarterly, the Company reviews the potential payment of cash dividends to common shareholders. The timing and amount of cash dividends paid on our common stock depends on the Company's earnings, capital requirements, financial condition and other relevant factors. In this regard, in the second quarter of 2009, the Company's board of directors decided to suspend the quarterly common stock dividend after reviewing these factors and giving consideration to the current economic environment and to preserve our strong capital position.

The two most recent fiscal years quarterly cash dividends per common share are listed below:

| Declared | Cash Dividend per Share | Record Date | Paid |
|--------------------|-------------------------|------------------|-------------------|
| March 25, 2008 | \$0.210 | April 15, 2008 | April 30, 2008 |
| June 24, 2008 | \$0.210 | July 15, 2008 | July 30, 2008 |
| September 18, 2008 | \$0.140 | October 15, 2008 | October 31, 2008 |
| January 27, 2009 | \$0.100 | February 5, 2009 | February 20, 2009 |

The timing and amount of cash dividends paid on our common stock depends on our earnings, capital requirements, financial condition and other relevant factors. In this regard, in the second quarter of 2009, our Board decided to suspend our quarterly common stock dividend after reviewing these factors and giving consideration to the current economic environment. The primary source for dividends paid to our shareholders is dividends paid to us from Heritage Bank and Central Valley Bank. There are regulatory restrictions on the ability of our subsidiary banks to pay dividends. Under federal regulations, the dollar amount of dividends the banks may pay depends upon their capital position and recent net income. Generally, if a bank satisfies its regulatory capital requirements, it may make dividend payments up to the limits prescribed under state law and FDIC regulations. However, an institution that has converted to a stock form of ownership may not declare or pay a dividend on, or repurchase any of, its common stock if the effect thereof would cause the regulatory capital of the institution to be reduced below the amount required for the liquidation account which was established in connection with the conversion. Heritage Bank converted to a stock form of ownership and is therefore subject to the limitation described in the preceding sentence.

As a bank holding company, our ability to pay dividends is subject to the guidelines of the Federal Reserve Board regarding capital adequacy and dividends. The Federal Reserve Board's policy is that a bank holding

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

In addition to the legal and regulatory restrictions described above, certain contractual provisions limit our ability to pay dividends on our common stock. The securities purchase agreement between us and the Treasury, pursuant to which we issued our Series A Preferred Stock and Warrant as part of the TARP Capital Purchase Program provides that prior to the earlier of (i) November 21, 2011 and (ii) the date on which all of the shares of the Series A Preferred Stock have been redeemed by us or transferred by Treasury to third parties, we may not, without the consent of the Treasury, (a) pay a quarterly cash dividend on our common stock of more than \$0.14 per share or (b) subject to limited exceptions, redeem, repurchase or otherwise acquire shares of our common stock or preferred stock, other than the Series A Preferred Stock, or any trust preferred securities then outstanding. In addition, under the terms of the Series A Preferred Stock, we may not pay dividends on our common stock unless we are current in our dividend payments on the Series A Preferred Stock. Dividends on the Series A Preferred Stock are payable quarterly at a rate of 5% per annum for the first five years and a rate of 9% per annum thereafter if not redeemed prior to that time.

The Company does not currently have a stock repurchase plan in place and no stock was repurchased during the fourth quarter of 2009.

The Equity Compensation Plan information contained under Part III, Item 12 of this report is incorporated by reference herein.

Table of Contents**Stock Performance Graph**

The chart shown below depicts total return to stockholders during the period beginning December 31, 2004 and ending December 31, 2009. Total return includes appreciation or depreciation in market value of Heritage common stock as well as actual cash and stock dividends paid to common stockholders. Indices shown below, for comparison purposes only, are the Total Return Index for the NASDAQ Stock Market (U.S. Companies), which is a broad nationally recognized index of stock performance by publicly traded companies and the NASDAQ Bank Index, which is an index that contains securities of NASDAQ-listed companies classified according to the Industry Classification Benchmark as Banks. The chart assumes that the value of the investment in Heritage's common stock and each of the three indices was \$100 on December 31, 2004, and that all dividends were reinvested in Heritage common stock.

| Index | Period Ended | | | | | |
|--------------------------------|--------------|-----------|-----------|-----------|----------|----------|
| | 12/31/04 | 12/31/05 | 12/31/06 | 12/31/07 | 12/31/08 | 12/31/09 |
| Heritage Financial Corporation | \$ 100.00 | \$ 119.76 | \$ 125.44 | \$ 103.96 | \$ 66.78 | \$ 75.65 |
| NASDAQ Composite | 100.00 | 102.28 | 112.81 | 124.70 | 59.78 | 86.87 |
| NASDAQ Bank | 100.00 | 97.69 | 109.64 | 86.90 | 63.36 | 53.09 |

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

| | 2009 | For the years ended December 31, | | | 2005 |
|---|--------------|----------------------------------|------------|------------|------------|
| | | 2008 | 2007 | 2006 | |
| (Dollars in thousands, except per share amounts) | | | | | |
| Operations Data: | | | | | |
| Net interest income | \$ 41,696 | \$ 38,342 | \$ 36,621 | \$ 35,772 | \$ 33,881 |
| Provision for loan losses | 19,390 | 7,420 | 810 | 720 | 810 |
| Non-interest income | 8,667 | 8,824 | 8,572 | 7,954 | 6,630 |
| Non-interest expense | 30,895 | 30,419 | 28,288 | 27,082 | 24,183 |
| Federal income tax (benefit) expense | (503) | 2,976 | 5,387 | 5,377 | 5,042 |
| Net income | 581 | 6,351 | 10,708 | 10,547 | 10,476 |
| Net income (loss) applicable to common shareholders | (739) | 6,208 | 10,708 | 10,547 | 10,476 |
| Earnings (loss) per common share(1) | | | | | |
| Basic | (0.10) | 0.93 | 1.62 | 1.64 | 1.69 |
| Diluted | (0.10) | 0.93 | 1.60 | 1.59 | 1.64 |
| Dividend payout ratio to common shareholders(2) | (100.0)% | 59.5% | 51.5% | 49.1% | 42.0% |
| Performance Ratios: | | | | | |
| Net interest spread | 4.25% | 4.11% | 3.86% | 4.30% | 4.75% |
| Net interest margin(3) | 4.57% | 4.59% | 4.50% | 4.83% | 5.08% |
| Efficiency ratio(4) | 61.34% | 64.50% | 62.59% | 61.94% | 59.69% |
| Return on average assets | 0.06% | 0.71% | 1.23% | 1.33% | 1.46% |
| Return on average common equity | (0.72)% | 6.98% | 12.87% | 14.18% | 16.13% |
| At December 31, | | | | | |
| | 2009 | 2008 | 2007 | 2006 | 2005 |
| Balance Sheet Data: | | | | | |
| Total assets | \$ 1,014,859 | \$ 946,145 | \$ 886,055 | \$ 852,893 | \$ 751,152 |
| Loans receivable, net | 746,083 | 793,303 | 768,945 | 739,596 | 643,538 |
| Loans held for sale | 825 | 304 | 447 | | 263 |
| Deposits | 840,128 | 824,480 | 776,280 | 725,921 | 636,504 |
| Federal Home Loan Bank advances | | | 14,990 | 37,167 | 39,900 |
| Securities sold under agreement to repurchase | 10,440 | | | | |
| Stockholders' equity | 158,498 | 113,147 | 84,967 | 78,639 | 66,120 |
| Book value per common share | 12.21 | 13.40 | 12.79 | 11.99 | 10.57 |
| Equity to assets ratio | 15.62% | 11.96% | 9.59% | 9.22% | 8.80% |
| Asset Quality Ratios: | | | | | |
| Nonperforming loans to loans | 4.27% | 0.42% | 0.13% | 0.37% | 0.13% |
| Allowance for loan losses to loans | 3.38% | 1.91% | 1.33% | 1.35% | 1.30% |
| Allowance for loan losses to nonperforming loans | 79.33% | 454.02% | 1,016.06% | 360.05% | 1,016.27% |
| Nonperforming assets to total assets | 3.32% | 0.57% | 0.13% | 0.36% | 0.16% |
| Other Data: | | | | | |
| Number of banking offices | 20 | 20 | 20 | 20 | 18 |
| Number of full-time equivalent employees | 222 | 217 | 224 | 233 | 211 |

(1) Effective January 1, 2009, the Company adopted FASB ASC 03-6-1. Earnings per share data for the prior periods have been revised to reflect the retrospective adoption of the ASC.

(2) Dividend payout ratio is declared dividends per common share (excluding stock dividends) divided by basic earnings per common share.

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

(4) The efficiency ratio is recurring non-interest expense divided by the sum of net interest income and non-interest income.

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

The following discussion is intended to assist in understanding the financial condition and results of operations of the Company. The information contained in this section should be read with the December 31, 2009 audited consolidated financial statements and notes to those financial statements included in this Form 10-K.

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

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 and of our bank subsidiaries by the Federal Deposit Insurance Corporation, the Washington State Department of Financial Institutions, Division of Banks 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;

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 branch expansion strategy;

our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired or may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto;

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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 the other risks described elsewhere in this prospectus supplement, the accompanying prospectus and the incorporated documents; and

future legislative changes in the TARP Capital Purchase Program.

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

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

Critical Accounting Policies

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

The Company considers its most critical accounting estimates to be the allowance for loan losses, other than temporary impairments in the market value of investments and impairment of goodwill.

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

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

Historical loss experience in the portfolio;

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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;

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Experience, ability, and depth of lending management and other relevant staff;

National and local economic trends and conditions;

External factors such as competition, legal, and regulatory; and

Effects of changes in credit concentrations.

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

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

For additional information regarding the allowance for loan losses, its relation to the provision for loans losses, risk related to asset quality and lending activity, see Part I, Item 1 as well as the Management's Discussion and Analysis of Financial Condition and Results of Operations Provision for Loan Losses .

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

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

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

Overview

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

During the period from December 31, 2005 through December 31, 2009 our total assets have grown \$263.7 million, or 35.1%, with net loans growing \$102.5 million during the period. Our emphasis in growing our commercial business loan portfolio resulted in an increase in commercial loans of \$48.8 million, or 13.6%, since 2005. Overall loan increases have benefited from our emphasis in growing our lending in the Pierce County market.

Deposits increased \$15.6 million to \$840.1 million at December 31, 2009 from \$824.5 million at December 31, 2008. From December 31, 2008 to December 31, 2009, non-maturity deposits (total deposits less certificate of deposit accounts) increased \$58.1 million, or 12.2%. As a result, the percentage of certificate of deposit accounts to total deposits decreased to 36.2% at December 31, 2009 from 42.0% at December 31, 2008. A significant amount of the change in the mix of deposit accounts was a result of the Company reducing its public deposits. In order to comply with new public deposit collateral requirements and reduce the Company's exposure to uninsured public deposits, management implemented additional measures to manage public deposits. These measures included allowing some public certificate of deposit accounts to run-off and converting others to insured deposit accounts. As a result, total public deposit balances decreased \$63 million to \$69 million at December 31, 2009 from \$132 million at December 31, 2008. The Company's uninsured public deposit accounts (which are fully collateralized) declined to \$0.5 million at December 31, 2009 from \$125 million at December 31, 2008.

Equity has increased by \$92.4 million since December 31, 2005 due to a combination of earnings and issuances of common and preferred stock. During the period from December 31, 2005 through December 31, 2009, our annual net income increased through 2007 by 2.2% or \$232,000 and subsequently decreased in 2009 by 94.6% or \$10.1 million, mostly due to the increase in the allowance for loan losses and losses incurred from other than temporarily impaired securities.

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

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

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

| | Years Ended December 31, | | | | | | | | |
|---|--------------------------|--------------------------|------------------------|-------------------|--------------------------|------------------------|-------------------|--------------------------|------------------------|
| | 2009 | | | 2008 | | | 2007 | | |
| | Average Balance | Interest Earned/ Paid | Average Yield/ Rate | Average Balance | Interest Earned/ Paid | Average Yield/ Rate | Average Balance | Interest Earned/ Paid | Average Yield/ Rate |
| (Dollars in thousands) | | | | | | | | | |
| Interest Earning Assets: | | | | | | | | | |
| Loans | \$ 766,346 | \$ 50,567 | 6.60% | \$ 784,514 | \$ 54,919 | 7.00% | \$ 768,015 | \$ 60,409 | 7.87% |
| Taxable securities | 57,666 | 2,295 | 3.98 | 33,970 | 1,649 | 4.86 | 35,409 | 1,638 | 4.63 |
| Nontaxable securities | 7,421 | 244 | 3.29 | 5,528 | 197 | 3.56 | 4,823 | 177 | 3.67 |
| Interest earning deposits | 76,921 | 236 | 0.31 | 7,402 | 152 | 2.06 | 2,939 | 148 | 5.02 |
| Federal Home Loan Bank stock | 3,566 | | | 3,348 | 31 | 0.92 | 3,227 | 19 | 0.60 |
| Total interest earning assets | \$ 911,920 | \$ 53,342 | 5.85% | \$ 834,762 | \$ 56,948 | 6.82% | \$ 814,413 | \$ 62,391 | 7.66% |
| Non-interest earning assets | 66,279 | | | 58,812 | | | 58,254 | | |
| Total assets | \$ 978,199 | | | \$ 893,574 | | | \$ 872,667 | | |
| Interest Bearing Liabilities: | | | | | | | | | |
| Certificates of deposit | \$ 323,696 | \$ 7,988 | 2.47% | \$ 343,642 | \$ 12,423 | 3.62% | \$ 352,295 | \$ 17,082 | 4.85% |
| Savings accounts | 85,541 | 842 | 0.98 | 92,648 | 1,578 | 1.70 | 82,526 | 1,596 | 1.93 |
| Interest bearing demand and money market accounts | 310,860 | 2,769 | 0.89 | 243,082 | 4,320 | 1.78 | 216,641 | 5,553 | 2.56 |
| Total interest bearing deposits | 720,097 | 11,599 | 1.61 | 679,372 | 18,321 | 2.70 | 651,462 | 24,231 | 3.72 |
| FHLB advances and other borrowings | 1 | | 1.73 | 7,850 | 285 | 3.63 | 27,044 | 1,539 | 5.69 |
| Securities sold under agreement to repurchase | 6,206 | 46 | 0.75 | | | | | | |
| Total interest bearing liabilities | \$ 726,304 | \$ 11,645 | 1.60% | \$ 687,222 | \$ 18,606 | 2.71% | \$ 678,506 | \$ 25,770 | 3.80% |
| Demand and other non-interest bearing deposits | 120,107 | | | 108,386 | | | 103,790 | | |
| Other non-interest bearing liabilities | 5,321 | | | 6,372 | | | 7,196 | | |
| Preferred stock | 23,413 | | | 2,687 | | | | | |
| Stockholders equity | 126,467 | | | 91,594 | | | 83,175 | | |
| Total liabilities and stockholders equity | \$ 978,199 | | | \$ 893,574 | | | \$ 872,667 | | |
| Net interest income | | \$ 41,697 | | | \$ 38,342 | | | \$ 36,621 | |
| Net interest spread | | | 4.25% | | | 4.11% | | | 3.86% |
| Net interest margin | | | 4.57% | | | 4.59% | | | 4.50% |
| Average interest earning assets to average interest bearing liabilities | | | 125.56% | | | 121.47% | | | 120.03% |

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

| | Years Ended December 31, | | | | | |
|---|----------------------------|------------|------------|----------------------------|------------|------------|
| | 2009 Compared to 2008 | | | 2008 Compared to 2007 | | |
| | Increase (Decrease) Due to | | | Increase (Decrease) Due to | | |
| | Volume | Rate | Total | Volume | Rate | Total |
| | (In thousands) | | | | | |
| Interest Earning Assets: | | | | | | |
| Loans | \$ (1,199) | \$ (3,153) | \$ (4,352) | \$ 1,155 | \$ (6,645) | \$ (5,490) |
| Taxable securities | 944 | (297) | 647 | (70) | 81 | 11 |
| Nontaxable securities | 62 | (15) | 47 | 25 | (5) | 20 |
| Interest earning deposits | 213 | (130) | 83 | 91 | (87) | 4 |
| Federal Home Loan Bank stock | | (31) | (31) | 2 | 10 | 12 |
| Interest income | \$ 20 | \$ (3,626) | \$ (3,606) | \$ 1,203 | \$ (6,646) | \$ (5,443) |
| Interest bearing liabilities: | | | | | | |
| Certificates of deposit | \$ (492) | \$ (3,943) | \$ (4,435) | \$ (313) | \$ (4,346) | \$ (4,659) |
| Savings accounts | (70) | (666) | (736) | 172 | (190) | (18) |
| Interest bearing demand and money market accounts | 604 | (2,155) | (1,551) | 470 | (1,703) | (1,233) |
| Total interest bearing deposits | 42 | (6,764) | (6,722) | 329 | (6,239) | (5,910) |
| FHLB advances and other borrowings | (136) | (149) | (285) | (696) | (558) | (1,254) |
| Securities sold under agreement to repurchase | 46 | | 46 | | | |
| Interest expense | \$ (48) | \$ (6,913) | \$ (6,961) | \$ (367) | \$ (6,797) | \$ (7,164) |

Results of Operations for the Years Ended December 31, 2009 and 2008

Earnings Summary. Including preferred stock dividends, a net loss applicable to common shareholders of \$0.10 per diluted common share was recorded for the year ended December 31, 2009 compared to net income of \$0.93 per diluted common share for the year ended December 31, 2008. Net income for the year ended December 31, 2009 was \$581,000 compared to net income of \$6.4 million for the same period in 2008. The decrease was primarily the result of a \$12.0 million increase in the provision for loan losses partially offset by a \$3.4 million increase in net interest income. The Company's efficiency ratio improved to 61.3% for the year ended December 31, 2009 from 64.5% for the year ended December 31, 2008.

Net Interest Income. Net interest income increased \$3.4 million, or 8.8%, to \$41.7 million for the year ended December 31, 2009 compared with the previous year of \$38.3 million. The increase in net interest income resulted primarily from a decrease in interest expense due to lower cost of funds partially offset by a decrease in interest income. Net interest income as a percentage of average earning assets (net interest margin) for the year ended December 31, 2009 decreased 2 basis points to 4.57% from 4.59% for the previous year. Our net interest spread for the year ended December 31, 2009 increased to 4.25% from 4.11% for the prior year.

Total interest income decreased \$3.6 million, or 6.3%, to \$53.3 million for the year ended December 31, 2009 from \$56.9 million for the year ended December 31, 2008 as the yield on interest earning assets decreased to 5.85% for the year ended December 31, 2009 from 6.82% for the year ended December 31, 2008. Total average interest earning assets (including nonaccrual loans) increased by \$77.1 million to \$911.9 million for the year ended December 31, 2009 from \$834.8 million for the year ended December 31, 2008. Nonaccrual loans increased by \$29.2 million to \$32.6 million at December 31, 2009 from \$3.4 million at December 31, 2008.

Total interest expense decreased by \$7.0 million, or 37.4%, to \$11.6 million for the year ended December 31, 2009 from \$18.6 million for the year ended December 31, 2008 as the average rate paid on interest bearing

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liabilities decreased to 1.60% for the year ended December 31, 2009 from 2.71% for the year ended December 31, 2008. Total interest bearing liabilities increased by \$39.1 million to \$726.3 million at December 31, 2009 from \$687.2 at December 31, 2008.

Provision for Loan Losses. The provision for loan losses increased \$12.0 million, or 161.2%, to \$19.4 million for the year ended December 31, 2009 from \$7.4 million for the year ended December 31, 2008. The increased provision for loan losses was primarily the result of an increase in impaired loans, an increase in net charge-offs, an increase in the level of performing loans classified as substandard under the Banks' loan grading system, and uncertainties in the housing market in certain markets of the Pacific Northwest. The Banks had net charge-offs of \$8.6 million for the year ended December 31, 2009 compared to net charge-offs of \$2.4 million for the year ended December 31, 2008. The ratio of net charge-offs to average total loans outstanding was 1.10% for the year ended December 31, 2009 and 0.30% for the year ended December 31, 2008.

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 segments, 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 increased by \$10.6 million to \$26.2 million at December 31, 2009 from \$15.4 million at December 31, 2008. The increased level of the allowance for loan losses was primarily attributable to an increase in impaired loans, an increase in the level of performing loans classified as substandard under the Banks' grading system and uncertainties in the housing market and economy.

Based on the comprehensive methodology, management deemed the allowance for loan losses of \$26.2 million at December 31, 2009 (3.38% of total loans and 79.3% of nonperforming loans) adequate 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 allowance for loan losses in accordance with GAAP, there can be no assurance that regulators, in reviewing the Banks' loan portfolio, 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 adequate or that substantial increases will not be necessary should the quality of the loans deteriorate. Any material increase in the allowance for loan losses would adversely affect the Company's financial condition and results of operations. For additional information, see Item 1, Analysis of the Allowance for Loan and Lease Losses.

Non-interest Income. Total non-interest income decreased \$157,000, or 1.8%, for the year ended December 31, 2009 compared with the prior year. The decrease was due substantially to a decrease in income from mortgage banking operations in the amount of \$56,000 and a decrease in gains on Small Business Administration loan sales in the amount of \$36,000 due to decreased market demand and a decrease in rental income in the amount of \$141,000 offset by an increase in services charges on deposits due to increased deposits and a lower earnings credit rate in an amount of \$96,000.

The decrease in rental income was due primarily to the loss of a tenant formerly occupying office space at the Company's headquarters. The Company is currently occupying this office space and has no immediate plans to acquire tenants for the space.

Non-interest Expense. Non-interest expense increased \$476,000 or 1.6% to \$30.9 million during the year ended December 31, 2009 compared to \$30.4 million for the year ended December 31, 2008. The increase was due substantially to an assessment from the Washington Public Deposit Protection Commission (WPDPC) in the amount of \$184,000 due to uncollateralized public deposits of a failed bank, increased FDIC assessment rates and a special assessment resulting in an increase in FDIC assessments in the amount of \$1.2 million, and increased marketing expense in the amount of \$288,000 resulting primarily from costs associated with a checking

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account acquisition program, partially offset by a decrease in impairment losses on investment securities of \$1.4 million and a decrease in salaries and employee benefits in the amount of \$430,000. The decrease in salaries and employee benefits primarily resulted from a decrease of \$589,000 in incentive bonuses.

The \$1.9 million impairment loss on investment securities recorded during the year ended December 31, 2008 was the result of the redemption of investments in the AMF Ultra Short Mortgage Fund and subsequent other-than-temporary impairment charge on the private label mortgage securities received in the redemption. The \$500,000 net impairment loss on investment securities during the year ended December 31, 2009 was also due to the private label mortgage securities received in the redemption.

Effective June 30, 2009, the Company adopted FASB ASC 320-10-65, *Recognition and Presentation of Other-Than-Temporary Impairments*, which provides for the bifurcation of other-than-temporary impairments into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. As a result of adopting FASB ASC 320-10-65, the Company recorded \$830,000 in other-than-temporary impairments not related to credit losses through other comprehensive income rather than through non-interest expense and as discussed above, recorded \$500,000 in other-than-temporary impairments related to credit losses to non-interest expense during the year ended December 31, 2009.

The efficiency ratio for the year ended December 31, 2009 was 61.3% compared to 64.5% for the prior year. 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.

Federal Income Tax Expense (Benefit). The provision for federal income taxes decreased by \$3.5 million to a net benefit of \$503,000 for the year ended December 31, 2009 from an expense of \$3.0 million for the year ended December 31, 2008 primarily as a result of lower income before taxes.

Results of Operations for the Years Ended December 31, 2008 and 2007

Earnings Summary. Our net income was \$6.4 million or \$0.93 per diluted common share for the year ended December 31, 2008 compared to \$10.71 million or \$1.61 per diluted common share for the previous year. The 40.7% decrease in actual net income was mostly due to an increase in our allowance for loan losses of \$6.6 million and by losses totaling \$1.9 million (\$1.3 million net of tax) relating to the Company's investments in the AMF Ultra Short Mortgage Fund (the Fund). These losses resulted from an other-than-temporary impairment charge in the second quarter of 2008 totaling \$1.1 million (\$0.7 million net of tax), a subsequent third quarter loss on a redemption-in-kind totaling \$0.2 million (\$95,000 net of tax) in which fund shares were exchanged for a pro-rata share of cash and underlying securities in the fund, and a fourth quarter \$0.7 million (\$0.4 million net of tax) other-than-temporary impairment charge on eleven of the securities acquired with the redemption-in-kind. Continued deterioration of market conditions could result in additional impairment losses recognized within the investment portfolio.

Net Interest Income. Net interest income increased \$1.7 million to \$38.3 million for the year ended December 31, 2008 compared with the previous year of \$36.6 million. The increase in net interest income resulted primarily from an increase in average loans. Net interest income as a percentage of average earning assets (net interest margin) for the year ended December 31, 2008 increased to 4.59% from 4.50% for the previous year. The increase in net interest margin is due to the decrease in cost of funds exceeding the decrease in loan yields for the same period. Our net interest spread for the year ended December 31, 2008 increased to 4.11% from 3.86% for the prior year. The average rate of interest earning assets decreased to 6.82% for the year ended December 31, 2008 from 7.66% for the same period 2007 while the average cost of funds decreased to 2.71% for the year ended December 31, 2008 from 3.80% for the same period 2007. Overall, our net interest margin of 4.59% is above the median for West Coast publicly traded commercial banks of 4.02% as reported by D.A. Davidson and Companies for the period ended September 30, 2008.

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Provision for Loan Losses. During the year ended December 31, 2008, we provided \$7.4 million through operations compared to \$0.8 million for the year ended December 31, 2007. The increase in the loss loan reserves was mostly related to management's assessment of the increased risk in the construction loan portfolio and the current economic environment as well as increases in nonperforming assets to \$5.4 million for the year ended December 31, 2008 compared to \$1.2 million for the previous year. The nonperforming assets to total assets ratio was 0.57% at December 31, 2008, up from 0.13% at December 31, 2007. For the year ended December 31, 2008, we experienced net charge-offs of \$2.4 million compared to net charge-offs of \$0.5 million for the year ended December 31, 2007. The increase in net charge-offs was mostly related to one-to-four family residential construction loans due to continued deterioration in the local market. The increase in provision increased our allowance for loan losses as a percentage of total loans to 1.91% at December 31, 2008 from 1.33% at the end of 2007.

We consider the allowance for loan losses at December 31, 2008 adequate to cover loan losses based on our assessment of various factors affecting the loan portfolio, including the level of problem loans, business conditions, estimated collateral values, loss experience including those related to our courtesy overdraft programs, and credit concentrations. 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. See the previous discussion on the allowance for loan losses in Item 1 for further information about these factors.

Non-interest Income. Total non-interest income increased \$252,000, or 2.9%, for the year ended December 31, 2008 compared with the prior year. Loan sale gains increased \$371,000 from the prior year while brokered mortgage income decreased \$464,000 from the prior year. This change is due to a decrease in mortgage volumes resulting from lower mortgage loan demand compared to the prior year and higher volumes of SBA and conventional loan sales. Merchant visa income increased \$170,000, or 5.9%, due to increased business volumes. Service charges on deposits also increased by \$305,000, or 8.0%, due to our continued focus on growing our deposit relationships and a decrease in the earnings credit rate.

Non-interest Expense. Total non-interest expense increased \$2.1 million, or 7.5%, for the year ended December 31, 2008 compared to the prior year. The increase is mostly related to the result of the loss on impairment of the Fund. Salaries and employee benefits decreased \$75,000, mostly due to a decrease in full time employees. Merchant Visa expenses increased by \$158,000, or 6.8%. The increase was in line with the increase in business volumes as well as Merchant Visa income. Other operating expenses increased by \$161,000, or 5.3%, due to various increases in other expenses.

Federal Income Tax Expense. The provision for federal income taxes decreased by \$2.4 million to \$3.0 million for the year ended December 31, 2008 from \$5.4 million for the year ended December 31, 2007 primarily as a result of lower income before taxes.

Liquidity and Capital Resources

Our primary sources of funds are customer and local government deposits, loan principal and interest payments, loan sales, interest earned on and proceeds from sales and maturities of investment securities, and advances from the Federal Home Loan Bank (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.

We must maintain an adequate level of liquidity to ensure the availability of sufficient funds to fund loan originations and deposit withdrawals, satisfy other financial commitments, and fund operations. We generally maintain sufficient cash and short-term investments to meet short-term liquidity needs. At December 31, 2009, cash and cash equivalents totaled \$107.2 million, or 10.6% of total assets and investment securities classified as

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either available for sale or held to maturity with maturities of one year or less amounted to \$3.0 million, or 0.3% of total assets. At December 31, 2009, the Banks maintained an uncommitted credit facility with the FHLB of Seattle for \$169.1 million and an uncommitted credit facility with the Federal Reserve Bank of San Francisco for \$53.4 million, of which there were no borrowings outstanding as of December 31, 2009. 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 December 31, 2009. As of December 31, 2009, there were no overnight federal funds purchased.

During 2009 total assets grew \$68.7 million with interest earning deposits increasing \$58.0 million, investment securities increasing \$60.4 million and net loans decreasing by \$47.2 million over the prior year-end. This growth was funded primarily through a decrease in loans, increase in deposits and a common stock offering. Our strategy has been to acquire core deposits (which we define to include all deposits except public funds) from our retail accounts, acquire non-interest bearing demand deposits from our commercial customers, and use available borrowing capacity to fund growth in assets. We anticipate that we will continue to rely on the same sources of funds in the future and use those funds primarily to make loans and purchase investment securities.

Stockholders' equity at December 31, 2009 was \$158.5 million compared with \$113.1 million at December 31, 2008. During the year ended December 31, 2009, we declared common stock dividends of \$670,000, accrued preferred stock dividends of \$1.2 million, realized net income of \$581,000, recorded \$90,000 in unrealized gains on securities available for sale, net of tax, recorded \$526,000 in other than temporary impairment on securities held to maturity, net of tax, and realized the effects of exercising stock options, stock option compensation and earned ESOP and restricted stock shares totaling \$504,000. On September 22, 2009, the Company completed the sale of 4.3 million shares of common stock in a public offering. The shares were issued at \$11.50 per share and net proceeds from the sale totaled approximately \$46.6 million.

On November 21, 2008, the Company completed a sale to the Treasury of 24,000 shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series A, (preferred shares), for an aggregate purchase price of \$24.0 million in cash, with a related warrant to purchase 276,074 shares of the Company's common stock. The warrant has a ten-year term with an exercise price of \$13.04 per share, an allocated value of \$646,000 and a fair value of \$588,000. Under the terms of the warrant, because our offering of common stock was a qualified equity offering resulting in aggregate gross proceeds of at least \$24.0 million, the number of shares of our common stock underlying the warrant was reduced by 50% to 138,037 shares. The issuance of preferred stock significantly increased the Company's capital levels. The preferred stock pays a cumulative dividend of 5% per annum for the first five years and 9% per annum thereafter if not redeemed first.

We, and the Banks, are subject to various regulatory capital requirements. As of December 31, 2009, we, and the Banks were classified as well capitalized institutions under the criteria established by the Federal Deposit Insurance Act. Our initial public offering in January of 1998 significantly increased our capital to levels well in excess of regulatory requirements and our internal needs.

Quarterly, the Company reviews the potential payment of cash dividends to common shareholders. The timing and amount of cash dividends paid on our common stock depends on the Company's earnings, capital requirements, financial condition and other relevant factors. In this regard, in the second quarter of 2009, the Company's Board of Directors decided to suspend the quarterly common stock dividend after reviewing these factors and giving consideration to the current economic environment and to preserve our strong capital position.

Our capital levels are also modestly impacted by our 401(k) Employee Stock Ownership Plan and Trust (ESOP). The Employee Stock Ownership Plan (ESOP) purchased 2% of the common stock issued in a January 1998 stock offering and borrowed from the Company to fund the purchase of the Company's common stock. The loan to the ESOP will be repaid principally from the Banks' contributions to the ESOP. The Banks' contributions will be sufficient to service the debt over the 15 year loan term at the interest rate of 8.5%. As the debt is repaid, shares are released, and allocated to plan participants based on the proportion of debt service paid during the year. As shares are released, compensation expense is recorded equal to the then current market price.

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of the shares, our capital is increased, and the shares become outstanding for earnings per common share calculations. For the year ended December 31, 2009, the Company has allocated or committed to be released to the ESOP 9,258 earned shares and has 28,544 unearned, restricted shares remaining to be released. The fair value of unearned, restricted shares held by the ESOP trust was \$393,000 at December 31, 2009.

Contractual Obligations

The following table provides the amounts due under specified contractual obligations for the periods indicated as of December 31, 2009:

| | Less than 1 year | 1-3 years | 3-5 years | More than 5 years | Indeterminate maturity(1) | Total |
|--|---------------------|------------------|-----------------|-------------------------|------------------------------|-------------------|
| (In thousands) | | | | | | |
| Contractual payments by period: | | | | | | |
| Deposits | \$ 265,177 | \$ 33,322 | \$ 5,414 | \$ | \$ 536,215 | \$ 840,128 |
| Operating leases | 532 | 883 | 232 | 972 | | 2,619 |
| Purchase obligations(2) | 158 | | | | | 158 |
| Total contractual obligations | \$ 265,867 | \$ 34,205 | \$ 5,646 | \$ 972 | \$ 536,215 | \$ 842,905 |

(1) Represents interest bearing and non-interest bearing checking, money market and checking accounts.

(2) Represents agreements to purchase goods or services.

Asset/Liability Management

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

Our asset and liability management strategies have resulted in a positive 0-3 month gap of 14.52% and a positive 4-12 month gap of 9.72% as of December 31, 2009. These gaps measure the difference between the dollar amount of our interest earning assets and interest bearing liabilities that mature or reprice within the designated period (three months and 4-12 months) as a percentage of total interest earning assets, based on certain estimates and assumptions as discussed below. We believe that the implementation of our operating strategies has reduced the potential effects of changes in market interest rates on our results of operations. The positive gap for the 0-3 month period indicates that decreases in market interest rates may adversely affect our results over that period.

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The following table provides the estimated maturity or repricing and the resulting interest rate sensitivity gap of our interest earning assets and interest bearing liabilities at December 31, 2009 based upon estimates of expected mortgage prepayment rates and deposit run off rates consistent with national trends. We adjusted mortgage loan maturities for loans held for sale by reflecting these loans in the three-month category, which is consistent with their sale in the secondary mortgage market. The amounts in the table are derived from our internal data. We used certain assumptions in presenting this data so the amounts may not be consistent with other financial information prepared in accordance with generally accepted accounting principles. The amounts in the tables also could be significantly affected by external factors, such as changes in prepayment assumptions, early withdrawal of deposits, and competition.

| | Estimated Maturity or Repricing Within | | | | | Total |
|--|--|----------------|--|---------------|--------------------------|------------|
| | 0-3 months | 3-12 months | 1-5 years (Dollars in thousands) | 5-15 years | More than 15 years | |
| Interest Earnings Assets: | | | | | | |
| Loans | \$ 225,824 | \$ 85,979 | \$ 292,873 | \$ 144,513 | \$ 25,480 | \$ 774,669 |
| Investment securities | 7,080 | 9,864 | 62,590 | 19,969 | 4,869 | 104,372 |
| FHLB and Federal Reserve Stock | 3,566 | | | | | 3,566 |
| Interest earning deposits | 87,075 | 50 | | | | 87,125 |
| Total interest earning assets | \$ 323,545 | \$ 95,893 | \$ 355,463 | \$ 164,482 | \$ 30,349 | \$ 969,732 |
| Interest Bearing Liabilities: | | | | | | |
| Total interest bearing deposits | \$ 182,325 | \$ 142,443 | \$ 382,191 | \$ | \$ | \$ 706,959 |
| Total interest bearing liabilities | \$ 182,325 | \$ 142,443 | \$ 382,191 | \$ | \$ | \$ 706,959 |
| Rate sensitivity gap | \$ 141,220 | \$ (46,550) | \$ (26,728) | \$ 164,482 | \$ 30,349 | \$ 262,773 |
| Cumulative rate sensitivity gap: | | | | | | |
| Amount | 141,220 | 94,670 | 67,942 | 232,424 | 262,773 | |
| As a percentage of total interest earning assets | 14.56% | 9.76% | 7.01% | 23.97% | 27.10% | |

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

Impact of Inflation and Changing Prices

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

Table of Contents**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

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

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

The table below provides information about our financial instruments that are sensitive to changes in interest rates as of December 31, 2009. The table presents principal cash flows and related weighted average interest rates by expected maturity dates. The expected maturity is the contractual maturity or earlier call date of the instrument. The data in this table may not be consistent with the amounts in the preceding table, which represents amounts by the repricing date or maturity date (whichever occurs sooner) adjusted by estimates such as mortgage prepayments and deposit reduction or early withdrawal rates.

| | By Expected Maturity Date Year Ended December 31, | | | | | Total | Fair Value |
|--------------------------------|--|-----------|-----------|---------------|---------------|------------|---------------|
| | 2010 | 2011 | 2012 | 2013- 2014 | After 2014 | | |
| (Dollars in thousands) | | | | | | | |
| Investment Securities | | | | | | | |
| Amounts maturing: | | | | | | | |
| Fixed rate | \$ 2,967 | \$ 12,524 | \$ 20,202 | \$ 2,050 | \$ 65,778 | \$ 103,521 | |
| Weighted average interest rate | 2.43% | 1.20% | 2.06% | 4.04% | 4.69% | | |
| Adjustable Rate | | | | | 851 | 851 | |
| Weighted average interest rate | | | | | 3.26% | | |
| Totals | 2,967 | 12,524 | 20,202 | 2,050 | 66,629 | \$ 104,372 | \$ 104,381 |
| Loans | | | | | | | |
| Amounts maturing: | | | | | | | |
| Fixed rate | \$ 54,913 | \$ 40,675 | \$ 20,184 | \$ 48,180 | \$ 157,394 | \$ 321,346 | |
| Weighted average interest rate | 6.43% | 5.44% | 7.41% | 6.90% | 6.44% | | |
| Adjustable rate | 164,095 | 7,932 | 8,063 | 41,168 | 232,065 | 453,323 | |
| Weighted average interest rate | 5.65% | 6.53% | 6.65% | 6.47% | 6.74% | | |
| Totals | \$ 219,008 | \$ 48,607 | \$ 28,247 | \$ 89,348 | \$ 389,459 | \$ 774,669 | \$ 789,517 |
| Certificates of Deposit | | | | | | | |
| Amounts maturing: | | | | | | | |
| Fixed rate | \$ 265,177 | \$ 29,533 | \$ 3,790 | \$ 5,413 | \$ | \$ 303,913 | \$ 304,542 |
| Weighted average interest rate | 2.26% | 1.94% | 3.93% | 3.09% | | | |

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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

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

None

ITEM 9A. CONTROLS AND PROCEDURES

(i) Disclosure Controls and Procedures.

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

(ii) Internal Control Over Financial Reporting.

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

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

The Company's management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2009. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control - Integrated Framework*. Based on our assessment, we believe that, as of December 31, 2009, the Company's internal control over financial reporting is effective based on these criteria.

KPMG, an independent registered public accounting firm, has audited the effectiveness of our internal control over financial reporting as of December 31, 2009, which is included in this Item 9A.

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

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Heritage Financial Corporation:

We have audited Heritage Financial Corporation and subsidiaries (the Company) internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying *Management's Report on Internal Control over Financial Reporting*. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

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

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

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of financial condition of Heritage Financial Corporation and subsidiaries as of December 31, 2009 and 2008, and the related consolidated statements of operations, stockholders' equity and comprehensive income (loss), and cash flows for each of the years in the three-year period ended December 31, 2009, and our report dated March 2, 2010 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

Seattle, Washington

March 2, 2010

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(c) Changes in internal control over financial reporting.

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

ITEM 9B. OTHER INFORMATION.

None.

Table of Contents**PART III****ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

Information concerning directors of the registrant is incorporated by reference to the section entitled "Election of Directors" of our definitive proxy statement for the annual meeting of shareholders to be held May 5, 2010 ("Proxy Statement").

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

The required information with respect to compliance with Section 16(a) of the Exchange Act is incorporated by reference to the section entitled "Section 16(a) Beneficial Ownership Reporting Compliance" of the Proxy Statement.

Board of Directors has adopted a written Code of Ethics that applies to our directors, officers and employees. You may obtain a copy of the Code of Ethics free of charge by writing to: Kaylene M. Lahn, Secretary, Heritage Financial Corporation, Inc., 201 Fifth Avenue S.W., Olympia, Washington 98501, or by calling (360) 943-1500. In addition, our Code of Ethics is available on our website at www.hf-wa.com.

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

ITEM 11. EXECUTIVE COMPENSATION

Information concerning executive and director compensation and certain matters regarding participation in the Company's compensation committee required by this item is set forth under the headings "Executive Compensation", "Director Compensation", and "Compensation Committee Report" of the Proxy Statement, which is incorporated as part of this document by reference.

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

The following table summarizes the consolidated activity within the Company's stock option plans as of December 31, 2009, all of which were approved by shareholders.

| Plan Category | Number of securities to be issued upon exercise of outstanding options and awards | Weighted-average price of outstanding options | Number of securities remaining available for future issuance under equity compensation plans |
|--|---|---|--|
| Equity compensation plans, all of which are approved by security holders | 604,547 | \$ 19.34 | 536,951 |

For information concerning security ownership of certain beneficial owners and management, see "Security Ownership of Certain Beneficial Owners and Management" of the Proxy Statement, which is incorporated as part of this document by reference.

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ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

For information concerning certain relationships and related transactions, see Meetings and Committees of the Board of Directors and Corporate Governance Matters of the Proxy Statement, which is incorporated as part of this document by reference.

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

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

For information concerning principal accounting fees and services, see Audit Fees in the Proxy Statement, which is incorporated as part of this document by reference.

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

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

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

(3) *Exhibits*

**Exhibit
No.**

| | |
|-------|---|
| 3.1 | Articles of Incorporation(1) |
| 3.2 | Bylaws of the Company(2) |
| 4.1 | Form of Certificate for Preferred Stock(3) |
| 4.2 | Warrant for purchase(3) |
| 10.1 | 1998 Stock Option and Restricted Stock Award Plan(4) |
| 10.6 | 1997 Stock Option and Restricted Stock Award Plan(5) |
| 10.10 | 2002 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan(6) |
| 10.12 | 2006 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan(7) |
| 10.13 | Employment Agreement between the Company and Brian L. Vance, effective October 1, 2006 as amended and restated in February 2007(8) |
| 10.14 | Employment Agreement between Central Valley Bank and D. Michael Broadhead, effective April 1, 2007(8) |
| 10.16 | Severance Agreement between Heritage Bank and Gregory D. Patjens, effective April 1, 2007(8) |
| 10.17 | Severance Agreement between Heritage Bank and Donald J. Hinson, effective August 1, 2007(9) |
| 10.18 | Letter Agreement between Heritage Financial Corporation and the United States Department of the Treasury dated November 21, 2008 in connection with the Company's participation in the Troubled Asset Relief Program Capital Purchase Program, and related documents(3) |
| 10.19 | Letter of Understanding between Heritage Financial Corporation and Donald V. Rhodes dated August 18, 2009(10) |
| 10.20 | Annual Incentive Compensation Plan |
| 10.21 | Compensation Modification Agreements between Heritage Financial Corporation and Brian L. Vance, Donald V. Rhodes, Donald J. Hinson, D. Michael Broadhead, Gregory Patjens and Dave Spurling dated September 29, 2009(11) |
| 14.0 | Code of Ethics and Conduct Policy |
| 21.0 | Subsidiaries of the Company |
| 23.0 | Consent of Independent Registered Public Accounting Firm |
| 24.0 | Power of Attorney |

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Exhibit

- | No. | |
|------------|---|
| 31.1 | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 99.1 | Subsequent Year Certification of the Principal Executive Officer pursuant to Section 111(b) of the Emergency Economic Stabilization Act of 2008 |
| 99.2 | Subsequent Year Certification of the Principal Financial Officer pursuant to Section 111(b) of the Emergency Economic Stabilization Act of 2008 |
-
- (1) Incorporated by reference to the Registration Statement on Form S-1 (Reg. No. 333-35573) declared effective on November 12, 1997; as amended, said Amendment being incorporated by reference to the Amendment to the Articles of Incorporation of Heritage Financial Corporation filed with the Current Report on Form 8-K dated November 25, 2008.
 - (2) Incorporated by reference to the Current Report on Form 8-K dated November 29, 2007.
 - (3) Incorporated by reference to the Current Report on Form 8-K dated November 25, 2008.
 - (4) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-71415).
 - (5) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-57513).
 - (6) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-88980; 333-88982; 333-88976).
 - (7) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-134473; 333-134474; 333-134475).
 - (8) Incorporated by reference to the Quarterly Report on Form 10-Q dated May 1, 2007.
 - (9) Incorporated by reference to the Quarterly Report on Form 10-Q dated November 2, 2007.
 - (10) Incorporated by reference to the Current Report on Form 8-K dated August 20, 2009.
 - (11) Incorporated by reference to the Current Report on Form 8-K dated October 2, 2009.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 2nd day of March 2010.

HERITAGE FINANCIAL CORPORATION
(Registrant)

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

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on the 2nd day of March 2010.

Principal Executive Officer:

/s/ BRIAN L. VANCE

Brian L. Vance
President and Chief Executive Officer

Principal Financial Officer:

/s/ DONALD J. HINSON

Donald J. Hinson
Senior Vice President and Chief Financial Officer

Remaining Directors:

*Brian S. Charneski

*Gary B. Christensen

*John A. Clees

*Kimberly T. Ellwanger

*Peter N. Fluetsch

*Daryl D. Jensen

*Jeffrey S. Lyon

*Donald V. Rhodes

*Philip S. Weigand

*By */s/ BRIAN L. VANCE*

Brian L. Vance
Attorney-in-Fact

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2009, 2008, and 2007

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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|---|-------------|
| <u>Report of Independent Registered Public Accounting Firm</u> | F-2 |
| <u>Consolidated Statements of Financial Condition December 31, 2009 and December 31, 2008</u> | F-3 |
| <u>Consolidated Statements of Operations Years ended December 31, 2009, 2008, and 2007</u> | F-4 |
| <u>Consolidated Statements of Stockholders Equity and Comprehensive Income (Loss) Years ended December 31, 2009, 2008, and 2007</u> | F-5 |
| <u>Consolidated Statements of Cash Flows Years ended December 31, 2009, 2008, and 2007</u> | F-6 |
| <u>Notes to Consolidated Financial Statements</u> | F-7 |

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Heritage Financial Corporation:

We have audited the accompanying consolidated statements of financial condition of Heritage Financial Corporation and subsidiaries (the Company) as of December 31, 2009 and 2008, and the related consolidated statements of operations, stockholders' equity and comprehensive income (loss), and cash flows for each of the years in the three-year period ended December 31, 2009. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Heritage Financial Corporation and subsidiaries as of December 31, 2009 and 2008, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2009, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Heritage Financial Corporation and subsidiaries' internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 2, 2010 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ KPMG LLP

Seattle, Washington

March 2, 2010

Table of Contents**HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**

December 31, 2009 and 2008

(Dollars in thousands, except per share amounts)

| | 2009 | 2008 |
|--|--------------|------------|
| <u>ASSETS</u> | | |
| Cash on hand and in banks | \$ 20,106 | \$ 31,478 |
| Interest earning deposits | 87,125 | 29,156 |
| Investment securities available for sale | 90,736 | 31,922 |
| Investment securities held to maturity (market value of \$13,645 and \$11,079) | 13,636 | 12,081 |
| Loans held for sale | 825 | 304 |
| Loans receivable | 772,247 | 808,726 |
| Less: Allowance for loan losses | (26,164) | (15,423) |
| Loans receivable, net | 746,083 | 793,303 |
| Other real estate owned | 704 | 2,031 |
| Premises and equipment, at cost, net | 16,394 | 15,721 |
| Federal Home Loan Bank stock, at cost | 3,566 | 3,566 |
| Accrued interest receivable | 4,018 | 4,168 |
| Prepaid expenses and other assets | 9,175 | 4,453 |
| Deferred Federal income taxes, net | 9,133 | 4,526 |
| Intangible assets, net | 346 | 424 |
| Goodwill | 13,012 | 13,012 |
| Total assets | \$ 1,014,859 | \$ 946,145 |
| <u>LIABILITIES AND STOCKHOLDERS' EQUITY</u> | | |
| Deposits | \$ 840,128 | \$ 824,480 |
| Securities sold under agreement to repurchase | 10,440 | |
| Accrued expenses and other liabilities | 5,793 | 8,518 |
| Total liabilities | 856,361 | 832,998 |
| Stockholders' equity: | | |
| Preferred stock, no par value, 2,500,000 shares authorized; Series A (liquidation preference \$1,000 per share); 24,000 shares issued and outstanding at December 31, 2009 and December 31, 2008 | 23,487 | 23,367 |
| Common stock, no par, 15,000,000 shares authorized; 11,057,972 and 6,699,550 shares outstanding at December 31, 2009 and 2008, respectively | 73,534 | 26,546 |
| Unearned compensation ESOP and other | (270) | (358) |
| Retained earnings | 61,980 | 63,240 |
| Accumulated other comprehensive income (loss), net | (233) | 352 |
| Total stockholders' equity | 158,498 | 113,147 |
| Total liabilities and stockholders' equity | \$ 1,014,859 | \$ 946,145 |

See accompanying notes to consolidated financial statements.

Table of Contents**HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS**

For the years ended December 31, 2009, 2008 and 2007

(Dollars in thousands, except per share amounts)

| | 2009 | 2008 | 2007 |
|--|---------------|---------------|---------------|
| Interest income: | | | |
| Interest and fees on loans | \$ 50,567 | \$ 54,919 | \$ 60,409 |
| Taxable interest on investment securities | 2,295 | 1,649 | 1,638 |
| Nontaxable interest on investment securities | 244 | 197 | 177 |
| Interest on federal funds sold and interest earning deposits | 235 | 152 | 148 |
| Dividends on Federal Home Loan Bank stock | | 31 | 19 |
| Total interest income | 53,341 | 56,948 | 62,391 |
| Interest expense: | | | |
| Deposits | 11,598 | 18,321 | 24,231 |
| Other borrowings | 47 | 285 | 1,539 |
| Total interest expense | 11,645 | 18,606 | 25,770 |
| Net interest income | 41,696 | 38,342 | 36,621 |
| Provision for loan losses | 19,390 | 7,420 | 810 |
| Net interest income after provision for loan losses | 22,306 | 30,922 | 35,811 |
| Non-interest income: | | | |
| Gains on sales of loans, net | 422 | 435 | 64 |
| Brokered mortgage income | 156 | 212 | 676 |
| Service charges on deposits | 4,191 | 4,095 | 3,790 |
| Rental income | 144 | 285 | 324 |
| Merchant Visa income | 3,008 | 3,039 | 2,869 |
| Other income | 746 | 758 | 849 |
| Total non-interest income | 8,667 | 8,824 | 8,572 |
| Non-interest expense: | | | |
| Impairment loss on investment securities | 1,330 | 1,927 | |
| Less: Portion recorded as other comprehensive income | (830) | | |
| Impairment loss on investment securities, net | 500 | 1,927 | |
| Salaries and employee benefits | 14,259 | 14,689 | 14,764 |
| Occupancy and equipment | 3,928 | 3,855 | 4,098 |
| Data processing | 1,681 | 1,575 | 1,572 |
| Marketing | 990 | 702 | 500 |
| Merchant Visa | 2,500 | 2,466 | 2,308 |
| Professional services | 823 | 710 | 635 |
| State and local taxes | 967 | 930 | 989 |
| Federal deposit insurance | 1,616 | 426 | 111 |
| Other expense | 3,631 | 3,139 | 3,311 |

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| | | | |
|--|-----------|-----------|-----------|
| Total non-interest expense | 30,895 | 30,419 | 28,288 |
| Income before Federal income taxes | 78 | 9,327 | 16,095 |
| Federal income tax (benefit) expense | (503) | 2,976 | 5,387 |
| Net income | \$ 581 | \$ 6,351 | \$ 10,708 |
| Dividend accrued and discount accreted on preferred shares | 1,320 | 143 | |
| Net income (loss) applicable to common shareholders | \$ (739) | \$ 6,208 | \$ 10,708 |
| Basic (loss) earnings per common share | \$ (0.10) | \$ 0.93 | \$ 1.62 |
| Basic weighted average common shares outstanding | 7,831,614 | 6,598,647 | 6,558,448 |
| Diluted (loss) earnings per common share | \$ (0.10) | \$ 0.93 | \$ 1.60 |
| Diluted weighted average common shares outstanding | 7,831,614 | 6,647,420 | 6,670,422 |

See accompanying notes to consolidated financial statements.

Table of Contents**HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME (LOSS)**

For the years ended December 31, 2009, 2008 and 2007

(Dollars and shares in thousands)

| | Number of preferred stock shares | Preferred stock | Number of common shares | Common stock | Unearned Compensation- ESOP and restricted stock awards | Retained earnings | Accumulated other comprehensive income (loss), net | Total stock holders equity |
|---|---|--------------------|-------------------------------|-----------------|---|----------------------|--|-------------------------------------|
| Balance at December 31, 2006 | | \$ | 6,558 | \$ 24,053 | \$ (535) | \$ 55,647 | \$ (526) | \$ 78,639 |
| Restricted stock awards granted | | | 24 | | | | | |
| Restricted stock awards canceled | | | (5) | | | | | |
| Stock option compensation expense | | | | 288 | | | | 288 |
| Earned ESOP and restricted stock shares | | | 9 | 454 | 88 | | | 542 |
| Exercise of stock options (including tax benefits from nonqualified stock options) | | | 116 | 1,541 | | | | 1,541 |
| Stock repurchased | | | (59) | (1,351) | | | | (1,351) |
| Net income | | | | | | 10,708 | | 10,708 |
| Change in fair value of securities available for sale, net of reclassification adjustments | | | | | | | 175 | 175 |
| Cash dividends declared (\$.84/share cumulative) | | | | | | (5,575) | | (5,575) |
| Balance at December 31, 2007 | | \$ | 6,643 | \$ 24,985 | \$ (447) | \$ 60,780 | \$ (351) | \$ 84,967 |
| Restricted stock awards granted | | | 25 | | | | | |
| Restricted stock awards canceled | | | (1) | | | | | |
| Stock option compensation expense | | | | 178 | | | | 178 |
| Earned ESOP and restricted stock shares | | | 9 | 449 | 89 | | | 538 |
| Exercise of stock options (including tax benefits from nonqualified stock options) | | | 24 | 288 | | | | 288 |
| Warrant issued | | | | 646 | | | | 646 |
| Preferred stock, series A, issued | 24 | 23,354 | | | | | | 23,354 |
| Accretion of preferred stock | | 13 | | | | (13) | | |
| Net income | | | | | | 6,351 | | 6,351 |
| Change in fair value of securities available for sale, net of reclassification adjustments | | | | | | | 703 | 703 |
| Cash dividends accrued on preferred stock | | | | | | (130) | | (130) |
| Cash dividends declared on common stock (\$.56/share cumulative) | | | | | | (3,748) | | (3,748) |
| Balance at December 31, 2008 | 24 | \$ 23,367 | 6,700 | \$ 26,546 | \$ (358) | \$ 63,240 | \$ 352 | \$ 113,147 |
| Restricted stock awards canceled | | | (1) | | | | | |
| Restricted stock awards issued | | | 5 | | | | | |
| Stock option compensation expense | | | | 143 | | | | 143 |
| Exercise of stock options (including tax benefits from nonqualified stock options) | | | 4 | 39 | | | | 39 |
| Share based payment and earned ESOP | | | 9 | 318 | 88 | | | 406 |
| Tax benefit (provision) associated with share based payment and unallocated ESOP | | | | (84) | | | | (84) |
| Accretion of preferred stock | | 120 | | | | (120) | | |
| Net income | | | | | | 581 | | 581 |
| Change in fair value of securities available for sale, net of reclassification adjustments | | | | | | | 90 | 90 |
| Cumulative effect of adoption of FASB ASC 320-10-65 relating to impairment of debt securities, net of tax | | | | | | 149 | (149) | |

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| | | | | | | | | |
|---|-------|-----------|--------|-----------|----|---------|-----------|---------------------|
| Other-than-temporary impairment on securities held to maturity, net of tax | | | | | | | (540) | (540) |
| Accretion of other-than-temporary impairment on securities held to maturity, net of tax | | | | | | | 14 | 14 |
| Common stock issuance, net of expenses | 4,341 | 46,572 | | | | | | 46,572 |
| Cash dividends accrued on preferred stock | | | | | | (1,200) | | (1,200) |
| Cash dividends declared on common stock | | | | | | (670) | | (670) |
| Balance at December 31, 2009 | 24 | \$ 23,487 | 11,058 | \$ 73,534 | \$ | (270) | \$ 61,980 | \$ (233) \$ 158,498 |

| | Comprehensive Income | | |
|--|-----------------------------|-------------|-------------|
| | 2009 | 2008 | 2007 |
| Net income | \$ 581 | \$ 6,351 | \$ 10,708 |
| Change in fair value of securities available for sale, net of tax of \$45, \$378, and \$94 | 84 | 703 | 175 |
| Reclassification adjustment of net gain from sale of available for sale securities included in income, net of tax of \$3, \$0, \$0 | 5 | | |
| Cumulative effect of adoption of FASB ASC 320-10-65 relating to impairment of debt securities, net of tax of \$(80), \$0, \$0 | (149) | | |
| Other-than-temporary impairment on securities held-to-maturity, net of tax of \$(290), \$0, \$0 | (540) | | |
| Accretion of other-than-temporary impairment on securities held-to-maturity, net of tax of \$8, \$0, \$0 | 14 | | |
| Comprehensive income (loss) | \$ (5) | \$ 7,054 | \$ 10,883 |

See accompanying notes to consolidated financial statements.

Table of Contents**HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****For the years ended December 31, 2009, 2008 and 2007****(Dollars in thousands)**

| | 2009 | 2008 | 2007 |
|--|-------------|-------------|-------------|
| Cash flows from operating activities: | | | |
| Net income | \$ 581 | \$ 6,351 | \$ 10,708 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation, amortization and accretion | 1,140 | 1,163 | 1,538 |
| Deferred loan fees, net of amortization | (257) | (227) | (322) |
| Provision for loan losses | 19,390 | 7,420 | 810 |
| Net change in accrued interest receivable, prepaid expenses and other assets, accrued expenses and other liabilities | (7,397) | 525 | 545 |
| Recognition of compensation related to ESOP shares and restricted stock awards | 406 | 507 | 410 |
| Stock option compensation expense | 143 | 178 | 288 |
| Tax expense (benefit) realized from stock options exercised and dividends on restricted stock awards | 84 | (68) | (196) |
| Amortization of intangible assets | 78 | 78 | 78 |
| (Gain) loss on sale of premises and equipment | (1) | 1 | 2 |
| Loss on other real estate owned | 95 | 23 | 20 |
| (Gain) loss on sale of investment securities | (2) | 3 | |
| Loss on impairment of securities | 500 | 1,927 | |
| Gain on sale of loans | (422) | (435) | (64) |
| Origination of loans held for sale | (20,213) | (19,574) | (4,963) |
| Proceeds from sale of loans | 20,114 | 20,152 | 4,580 |
| Deferred Federal income tax benefit | (4,373) | (2,540) | (216) |
| Net cash provided by operating activities | 9,866 | 15,484 | 13,218 |
| Cash flows from investing activities: | | | |
| Net decrease (increase) in loans, net of principal payments | 25,274 | (34,294) | (30,017) |
| Proceeds from sales of other real estate owned | 4,045 | 858 | 285 |
| Maturities of investment securities available for sale | 12,239 | 14,594 | 9,856 |
| Proceeds from sales of investment securities available for sale | 752 | 3,694 | |
| Maturities of investment securities held to maturity | 2,689 | 1,489 | 463 |
| Purchase of investment securities available for sale | (71,961) | (22,587) | (6,088) |
| Purchase of investment securities held to maturity | (5,332) | (2,407) | (499) |
| Purchase of premises and equipment | (1,977) | (2,161) | (728) |
| Proceeds from sale of premises and equipment | 241 | 10 | 19 |
| Net cash used in investing activities | (34,030) | (41,143) | (26,709) |
| Cash flows from financing activities: | | | |
| Net increase in deposits | 15,648 | 48,200 | 50,359 |
| Net decrease in borrowed funds | | (14,990) | (22,402) |
| Net increase in securities sold under agreement to repurchase | 10,440 | | |
| Proceeds from issuance of preferred stock and warrants | | 24,000 | |
| Proceeds from common stock issuance, net of expenses | 46,572 | | |
| Repayments of long-term debt | | (1,951) | (1,195) |
| Cash dividends paid | (1,854) | (3,748) | (5,561) |
| Exercise of stock options | 39 | 251 | 1,477 |
| Tax expense (benefit) realized from stock options exercised and dividends on restricted stock awards | (84) | 68 | 196 |
| Repurchase of common stock | | | (1,351) |
| Net cash provided by financing activities | 70,761 | 51,830 | 21,523 |

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| | | | |
|---|------------|------------|-----------|
| Net increase in cash and cash equivalents | 46,597 | 26,171 | 8,032 |
| Cash and cash equivalents at beginning of year | 60,634 | 34,463 | 26,431 |
| Cash and cash equivalents at end of year | \$ 107,231 | \$ 60,634 | \$ 34,463 |
| Supplemental disclosures of cash flow information: | | | |
| Cash payments for: | | | |
| Interest expense | \$ 12,079 | \$ 19,527 | \$ 25,394 |
| Federal income taxes | 4,942 | 4,509 | 5,146 |
| Supplemental disclosures of noncash investing and financing activities: | | | |
| Loans transferred to other real estate owned | \$ (2,813) | \$ (2,743) | \$ (249) |
| Securities exchanged in redemption-in-kind transaction | | 7,857 | |

See accompanying notes to consolidated financial statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) Summary of Significant Accounting Policies

(a) Description of Business

Heritage Financial Corporation (the Company) is a bank holding company incorporated in the State of Washington in August 1997. The Company is primarily engaged in the business of planning, directing and coordinating the business activities of its wholly owned subsidiaries: Heritage Bank and Central Valley Bank (the Banks). Heritage Bank is a Washington-chartered commercial bank whose 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 thirteen branch offices located in Thurston, Pierce, Mason and south King counties in Washington. Central Valley Bank is a Washington-chartered commercial bank whose deposits are insured by the FDIC under the DIF. Central Valley Bank conducts business from its main office in Toppenish, Washington, and its five branch offices located in Yakima and Kittitas counties in Washington.

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.

(b) Basis of Presentation

The accounting and reporting policies of the Company and its subsidiaries conform to U.S. generally accepted accounting principles. In preparing the consolidated financial statements, management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of financial statements and the reported amounts of income and expense during the reporting periods. Material estimates that are particularly susceptible to significant change related to the determination of the allowance for loan losses, other than temporary impairments in the market value of investments and impairment of goodwill. Actual results could differ from these estimates.

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

(c) Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents includes cash on hand and in banks, interest bearing deposits, and federal funds sold.

The Company is required to maintain an average reserve balance with the Federal Reserve Bank in the form of cash. For the years ended December 31, 2009 and 2008, the Company maintained adequate levels of cash to meet the Federal Reserve Bank requirement.

(d) Investment Securities

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

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

A decline in the market value of any available for sale or held to maturity security below cost that is deemed to be other than temporary results in a reduction in carrying amount to fair value, a charge to earnings and an establishment of a new cost basis for the security. Unrealized investment securities losses are evaluated at least quarterly to determine whether such declines in value should be considered other than temporary and therefore may be subject to immediate loss recognition in income. Although these evaluations involve significant judgment, an unrealized loss in the fair value of a debt security is generally deemed to be temporary when the fair value of the security is below the carrying value primarily due to changes in interest rates, there has not been significant deterioration in the financial condition of the issuer, and the Company has the intent and ability to hold the security for a sufficient time to recover the carrying value. An unrealized loss in the value of an equity security is generally considered temporary when the fair value of the security is below the carrying value primarily due to current market conditions and not deterioration in the financial condition of the issuer, and the Company has the intent and ability to hold the security for a sufficient time to recover the carrying value. Other factors that may be considered in determining whether a decline in the value of either a debt or an equity security is other than temporary include ratings by recognized rating agencies; actions of commercial banks or other lenders relative to the continued extension of credit facilities to the issuer of the security; the financial condition, capital strength and near-term prospects of the issuer and recommendations of investment advisors or market analysts. Therefore continued deterioration of market conditions could result in additional impairment losses recognized within the investment portfolio.

(e) Loans Receivable and Loans Held for Sale

Loans are generally recorded at their outstanding principal balance adjusted for charge-offs, the allowance for loan losses and deferred fees and costs on originated loans. Interest on loans is calculated using the simple interest method based on the daily balance of the principal amount outstanding and is credited to income as earned.

The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the credit is well secured and in the process of collection. Credit card loans and other personal loans are typically charged-off no later than 180 days past due. In all cases, loans are placed on non-accrual or charged-off at an earlier date if collection of principal or interest is doubtful.

All interest accrued but not collected on loans that are placed on non-accrual or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans may be returned to accrual status when their full collection is reasonably assured and a period of sustained performance has occurred.

Discounts and premiums on purchased loans are amortized using the effective interest method over the remaining contractual lives, adjusted for actual prepayments. Mortgage loans held for sale are carried at the lower of amortized cost or market value determined on an aggregate basis. Any loan that management determines will not be held to maturity is classified as held for sale at the time of origination, purchase or securitization, or when such decision is made. Unrealized losses on such loans are included in income.

(f) Loan Fees

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

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(g) Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the losses inherent in the non-classified and classified loan portfolio by applying estimated loss factors to the credit exposure of outstanding loans. The estimated loss factors consider a number of elements including:

Historical loss experience in the portfolio;

Levels of and trends in delinquencies and impaired loans;

Levels and trends in charge-offs and recoveries;

Effects of changes in risk selection and underwriting standards, and other changes in lending policies, procedures and practices;

Experience, ability, and depth of lending management and other relevant staff;

National and local economic trends and conditions;

External factors such as competition, legal, and regulatory; and

Effects of changes in credit concentrations.

The calculation of an adequate allowance for the non-classified and classified portion of the loan portfolio is based on an appropriate percentage loss factor that is calculated based on the above-noted elements and trends. Additional specific provisions for each impaired loan may be made after a detailed analysis of that loan's credit and collateral factors.

The evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on further declines in local and national economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the Bank to make adjustments to the allowance based on their judgments about information available to them at the time of their examinations.

(h) Impaired Loans

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

market price, or the fair value of the collateral if the loan is collateral dependent.

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(i) Mortgage Banking Operations

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

Commitments to sell mortgage loans are made primarily during the period between the taking of the loan application and the closing of the mortgage loan. The timing of making these sale commitments is dependent upon the timing of the borrower's election to lock-in the mortgage interest rate and fees prior to loan closing. Most of these sale commitments are made on a best-efforts basis whereby the Banks are only obligated to sell the mortgage if the mortgage loan is approved and closed by the Banks. As a result, management believes that market risk is minimal.

(j) Other Real Estate and Other Assets Owned

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

(k) Premises and Equipment

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

(l) Goodwill

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

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

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Based on the results of the first test above, it was determined that no goodwill impairment charges were required for the year ended December 31, 2009. Even though there was no goodwill impairment at December 31, 2009, continued declines in the value of the Company's stock price or additional adverse changes in the operating environment of the financial services industry may result in a future impairment charge. For the years ended December 31, 2008 and 2007 no goodwill impairment was recorded.

(m) Intangible Assets

The intangible assets represent the core deposit intangible arising from the purchase of Western Washington Bancorp. The core deposit intangible is being amortized to non-interest expense on a straight-line basis over eight years. Amortization expense related to the core deposit intangible was \$78,000 for the year ended December 31, 2009.

(n) Federal Income Taxes

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

Effective January 1, 2007, the Company adopted FASB ASC 740, *Accounting for Uncertainties in Income Taxes*, and it did not have a significant impact on our financial position or results of operations. FASB ASC 740 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. As of December 31, 2009 and December 31, 2008, the Company had an insignificant amount of unrecognized tax benefits, none of which would affect our effective tax rate if recognized. The Company does not anticipate that the amount of unrecognized tax benefits will significantly increase or decrease in the next 12 months. The Company's policy is to recognize interest and penalties on unrecognized tax benefits in Federal income taxes in the Consolidated Statements of Operations. The amount of interest and penalties accrued for the year ended December 31, 2009 was immaterial. The Company and its subsidiaries file a United States consolidated tax return and the tax years subject to examination by the Internal Revenue Service are the years ended December 31, 2009, 2008, 2007 and 2006.

(o) Employee Stock Ownership Plan

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

(p) Share Based Payment

The Company maintains a number of stock-based incentive programs, which are discussed in more detail in Note 12.

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Total stock-based compensation expense (excluding ESOP expense) for the year ended December 31, 2009 and 2008 were as follows:

| | 2009 | 2008 |
|---------------------------------|----------------|--------|
| | (In thousands) | |
| Compensation expense recognized | \$ 441 | \$ 521 |
| Related tax benefit recognized | 124 | 141 |

As of December 31, 2009, the total unrecognized compensation expense related to non-vested stock awards was \$735,000 and the related weighted average period over which it is expected to be recognized is approximately 2.6 years.

The fair value of options granted during the years ended December 31, 2009, 2008 and 2007 is estimated on the date of grant using the Black-Scholes option pricing model based on the assumptions noted in the following table. The expected term of share options is 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.

| Grant period ended | Weighted Average Risk Free Interest Rate | Expected Term in Years | Expected Volatility | Expected Dividend Yield | Weighted Average Fair Value |
|--------------------|---|------------------------------|------------------------|-------------------------------|-----------------------------------|
| December 31, 2009 | 2.07% | 5.00 | 31% | 3.49% | \$ 2.33 |
| December 31, 2008 | 2.38% | 4.50 | 21% | 4.30% | \$ 2.38 |
| December 31, 2007 | 5.04% | 4.50 | 21% | 3.59% | \$ 4.04 |

(q) *Recently Issued Accounting Pronouncements*

In June 2008, the Financial Accounting Standards Board (FASB) issued FASB ASC 260-10, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities*. Under this topic, unvested share-based payment awards that contain nonforfeitable rights to dividends are considered to be a separate class of common stock and are included in the basic earnings per share calculation using the two-class method that is described in FASB ASC 260-10, *Earnings per Share (EPS)*. This pronouncement was effective for the Company as of January 1, 2009 and did not have a material effect on the EPS calculation.

In April 2009, the FASB issued three amendments to the fair value measurement, disclosure and other-than-temporary impairment standards:

FASB ASC 820-10-65, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*

FASB ASC 320-10-65, *Recognition and Presentation of Other-Than-Temporary Impairments*

FASB ASC 825-10-65, *Interim Disclosures about Fair Value of Financial Instruments*

FASB ASC 820-10-65, *Fair Value Measurements*, defines fair value as the price that would be received to sell the asset or transfer the liability in an orderly transaction between market participants at the measurement date under current market conditions. FASB ASC 820-10-65 provides additional guidance on determining when the volume and level of activity for the asset or liability has significantly decreased as well as guidance on identifying circumstances when a transaction may not be considered orderly. When the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability, further analysis of the information from that market is needed and significant adjustments to the related prices may be necessary to estimate fair value in accordance with FASB ASC 820-10.

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FASB ASC 320-10-65 clarifies the interaction of the factors that should be considered when determining whether a debt security is other-than-temporarily impaired. For debt securities, management must assess whether, (a) it has the intent to sell the security or (b) it is more likely than not that it will be required to sell the security prior to its anticipated recovery. These steps are done before assessing whether the entity will recover the cost basis of the investment. Previously, this assessment required management to assert it has both the intent and the ability to hold a security for a period of time sufficient to allow for an anticipated recovery in fair value to avoid recognizing an other-than-temporary impairment. This change does not affect the need to forecast recovery of the value of the security through either cash flows or market price.

In instances when a determination is made that an other-than-temporary impairment exists but the investor does not intend to sell the debt security and it is not more likely than not that it will be required to sell the debt security prior to its anticipated recovery, FASB ASC 320-10-65 changes the presentation and amount of the other-than-temporary impairment recognized in the income statement. The other-than-temporary impairment is separated into: (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income.

FASB ASC 825-10-65 requires disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements.

All three pronouncements discussed herein include substantial additional disclosure requirements. The three pronouncements were effective for the Company as of June 30, 2009. FASB ASC 820-10-65 did not have a material effect on the Company's financial statements. As a result of adopting FASB ASC 320-10-65, the Company recorded \$830,000 in impairments not related to credit losses through other comprehensive income rather than through earnings during the year ending December 31, 2009. For additional information of the cumulative effect of the adoption of FASB ASC 320-10-65 see Note 5 Investment Securities.

On June 30, 2009, the Company adopted FASB ASC 855-10, *Subsequent Events*. The ASC establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. Specifically, the ASC defines: (a) the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, (b) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and (c) the disclosures that an entity should make about events or transactions that occurred after the balance sheet date.

Table of Contents**(2) Loans Receivable and Loans Held for Sale**

Loans receivable and loans held for sale at December 31, 2009 and 2008 consisted of the following:

| | 2009 | 2008(1) |
|---|-------------------|-------------------|
| | (In thousands) | |
| Commercial business | \$ 408,622 | \$ 410,657 |
| Real estate mortgages: | | |
| One-to-four family residential | 54,448 | 57,535 |
| Five or more family residential and commercial properties | 194,613 | 190,706 |
| Total real estate mortgages | 249,061 | 248,242 |
| Real estate construction: | | |
| One-to-four family residential | 46,060 | 71,159 |
| Five or more family residential and commercial properties | 49,665 | 59,572 |
| Total real estate construction | 95,725 | 130,731 |
| Consumer | 21,261 | 21,255 |
| Gross Loans | 774,669 | 810,884 |
| Less: deferred loan fees | (1,597) | (1,854) |
| Total loans receivable and loans held for sale | \$ 773,072 | \$ 809,030 |

- (1) Certain loan balances totaling \$33.2 million previously categorized as commercial business have been reclassified as multi-family residential and commercial properties.

As of December 31, 2009 and 2008, the Company had loans to persons serving as Directors and Executive Officers, and entities related to such individuals, aggregating \$16.8 million and \$18.5 million, respectively. All loans were made on essentially the same terms and conditions as comparable transactions with other persons, and did not involve more than the normal risk of collectibility. As of December 31, 2009 and 2008, the Company did not have any borrowings from Directors or Executive Officers.

Potential problem loans as of December 31, 2009 and 2008 were \$45.8 million and \$43.1 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.

Accrued interest on loans receivable amounted to \$3.6 million and \$4.0 million as of December 31, 2009 and 2008, respectively.

At December 31, 2009 and 2008, the Company had \$33.0 million and \$3.4 million, respectively, of nonperforming loans, of which \$32.6 million and \$3.4 million, respectively, were nonaccruing. At December 31, 2009, the Company had \$17.4 million in restructured loans, of which \$0.4 million were accruing and \$17.0 million were nonaccruing. At December 31, 2008, there were no restructured loans. The annual average balance of impaired loans for the years ended December 31, 2009, 2008 and 2007 were \$25.9 million, \$5.1 million and \$1.2 million, respectively. The allowance for loan losses related to nonperforming loans at December 31, 2009 and 2008 totaled \$7.4 million and \$443,000, respectively. There was no interest recognized on impaired loans for the years ended December 31, 2009, 2008 and 2007.

Details of certain mortgage banking activities at December 31, 2009 and 2008 are as follows:

| | 2009 | 2008 |
|--|----------------|--------|
| | (In thousands) | |
| Loans held for sale at lower of cost or market | \$ 825 | \$ 304 |
| Loans serviced for others | 131 | 234 |

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| | | |
|---|--------|--------|
| Total loans sold | 16,460 | 16,321 |
| Commitments to sell mortgage loans | 217 | 4,652 |
| Commitments to fund mortgage loans (at interest rates approximating market rates) | | |
| Fixed rate | 185 | 219 |
| Variable or adjustable rate | | |

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Servicing fee income from mortgage loans serviced for others amounted to \$20,000, \$7,000 and \$2,000 for the years ended December 31, 2009, 2008 and 2007, respectively.

As of December 31, 2009, the Company had commitments of \$144.6 million in other commercial lines of credit, \$26.0 million in real estate commitments (both construction and lines of credit), and \$2.6 million in other commitments (including consumer credit lines and letters of credit).

(3) Allowance for Loan Losses

Activity in the allowance for loan losses is summarized as follows for the years ended December 31:

| | 2009 | 2008 | 2007 |
|--|----------------|-----------|-----------|
| | (In thousands) | | |
| Allowance balance at beginning of period | \$ 15,423 | \$ 10,374 | \$ 10,105 |
| Provision for loan losses | 19,390 | 7,420 | 810 |
| Charge offs: | | | |
| Commercial | (2,668) | (144) | (412) |
| Real estate mortgages | (189) | (280) | (67) |
| Real estate construction | (5,774) | (1,818) | |
| Consumer | (192) | (165) | (94) |
| Total charge offs | (8,823) | (2,407) | (573) |
| Recoveries: | | | |
| Commercial | 1 | 1 | 2 |
| Real estate mortgages | 1 | | 5 |
| Real estate construction | 50 | | |
| Consumer | 122 | 35 | 25 |
| Total recoveries | 174 | 36 | 32 |
| Net charge offs | (8,649) | (2,371) | (541) |
| Allowance balance at end of period | \$ 26,164 | \$ 15,423 | \$ 10,374 |

The allocation of the allowance for loan losses is summarized as follows for the years ended December 31:

| | 2009 | | 2008 | | 2007 | |
|--------------------------|------------------------|-------------------------------|-----------|-------------------------------|-----------|-------------------------------|
| | Amount | % of Total Loans (1) | Amount | % of Total Loans (1) | Amount | % of Total Loans (1) |
| | (Dollars in thousands) | | | | | |
| Commercial | \$ 7,834 | 52.6% | \$ 2,785 | 50.7% | \$ 1,999 | 49.5% |
| Real estate mortgage | 12,480 | 12.4% | 5,797 | 30.6% | 4,231 | 32.6% |
| Real estate construction | 5,456 | 32.2% | 6,587 | 16.1% | 3,839 | 15.8% |
| Consumer | 170 | 2.8% | 254 | 2.6% | 305 | 2.1% |
| Unallocated | 224 | 0.0% | | 0.0% | | 0.0% |
| Total allowance | \$ 26,164 | 100.0% | \$ 15,423 | 100.0% | \$ 10,374 | 100.0% |

- (1) Represents the total of all outstanding loans in each category as a percent of total loans outstanding.
- (2) The Company historically allocated its allowance for loan losses based on the percentages noted in (1) above, however, in the 2008, management reclassified 2007 amounts to be consistent with the 2008 allowance for loan losses allocation method which, is based on qualitative and quantitative factors determined for each loan category.

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Table of Contents**(4) Investment Securities**

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

Securities Available for Sale

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|------------------|
| (In thousands) | | | | |
| December 31, 2009 | | | | |
| U.S. Treasury and U.S. Government agencies | \$ 22,986 | \$ 52 | \$ (80) | \$ 22,958 |
| Municipal securities | 7,365 | 149 | (54) | 7,460 |
| Corporate securities | 10,060 | 127 | (11) | 10,176 |
| Mortgage backed securities and collateralized mortgage obligations: | | | | |
| U.S. Government agencies | 49,645 | 695 | (198) | 50,142 |
| Total | \$ 90,056 | \$ 1,023 | \$ (343) | \$ 90,736 |
| December 31, 2008 | | | | |
| U.S. Treasury and U.S. Government agencies | \$ 5,230 | \$ 109 | \$ | \$ 5,339 |
| Municipal securities | 4,138 | 75 | (7) | 4,206 |
| Corporate securities | 4,007 | 107 | (1) | 4,113 |
| Mortgage backed securities and collateralized mortgage obligations: | | | | |
| U.S. Government agencies | 18,006 | 369 | (111) | 18,264 |
| Total | \$ 31,381 | \$ 660 | \$ (119) | \$ 31,922 |

Securities Held to Maturity

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|------------------|
| (In thousands) | | | | |
| December 31, 2009 | | | | |
| U.S. Treasury and U.S. Government agencies | \$ 1,443 | \$ 15 | \$ (14) | \$ 1,444 |
| Municipal securities | 1,618 | 93 | | 1,711 |
| Mortgage backed securities and collateralized mortgage obligations: | | | | |
| U.S. Government agencies | 8,236 | 172 | (57) | 8,351 |
| Private residential collateralized mortgage obligations | 2,339 | 70 | (270) | 2,139 |
| Total | \$ 13,636 | \$ 350 | \$ (341) | \$ 13,645 |
| December 31, 2008 | | | | |
| U.S. Treasury and U.S. Government agencies | \$ 316 | \$ 5 | \$ | \$ 321 |
| Municipal securities | 1,695 | 56 | | 1,751 |
| Mortgage backed securities and collateralized mortgage obligations: | | | | |
| U.S. government agencies | 5,791 | 134 | (35) | 5,890 |
| Private residential collateralized mortgage obligations | 4,279 | 1 | (1,163) | 3,117 |

| | | | | |
|-------|-----------|--------|------------|-----------|
| Total | \$ 12,081 | \$ 196 | \$ (1,198) | \$ 11,079 |
|-------|-----------|--------|------------|-----------|

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Available for sale and held to maturity investments with unrealized losses as of December 31, 2009 are 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 | \$ 20,907 | \$ 80 | \$ 1,175 | \$ 14 | \$ 22,082 | \$ 94 |
| Municipal securities | 2,993 | 54 | | | 2,993 | 54 |
| Corporate securities | 1,982 | 11 | | | 1,982 | 11 |
| Mortgage backed securities and collateralized mortgage obligations: | | | | | | |
| U.S. Government agencies | 17,247 | 254 | 270 | 1 | 17,517 | 255 |
| Private residential collateralized mortgage obligations | 55 | 12 | 2,084 | 258 | 2,139 | 270 |
| Total temporarily impaired securities | \$ 43,184 | \$ 411 | \$ 3,529 | \$ 273 | \$ 46,713 | \$ 684 |

Available for sale and held to maturity investments with unrealized losses as of December 31, 2008 are 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) | | | | | |
| Municipal securities | \$ 404 | \$ 7 | \$ | \$ | \$ 404 | \$ 7 |
| Corporate securities | 1,000 | 1 | | | 1,000 | 1 |
| Mortgage backed securities and collateralized mortgage obligations: | | | | | | |
| U.S. Government agencies | 1,831 | 86 | 2,591 | 60 | 4,422 | 146 |
| Private residential collateralized mortgage obligations | 3,055 | 1,163 | | | 3,055 | 1,163 |
| Total temporarily impaired securities | \$ 6,290 | \$ 1,257 | \$ 2,591 | \$ 60 | \$ 8,881 | \$ 1,317 |

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 spreads in the market for mortgage-related products. 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. The Company has the ability and intent to hold the investments until recovery of the market value.

The amortized cost and fair value of securities at December 31, 2009, 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.

Table of Contents**Securities Available for Sale**

| | Amortized Cost | Fair Value |
|--|-------------------|---------------|
| | (In thousands) | |
| Due in one year or less | \$ 2,923 | \$ 2,967 |
| Due after one year through three years | 32,079 | 32,208 |
| Due after three years through five years | 1,096 | 1,140 |
| Due after five through ten years | 11,150 | 11,127 |
| Due after ten years | 42,808 | 43,294 |
| Totals | \$ 90,056 | \$ 90,736 |

Securities Held to Maturity

| | Amortized Cost | Fair Value |
|--|-------------------|---------------|
| | (In thousands) | |
| Due after one year through three years | 505 | 531 |
| Due after three years through five years | 909 | 968 |
| Due after five years through ten years | 1,068 | 1,100 |
| Due after ten years | 11,154 | 11,046 |
| Totals | \$ 13,636 | \$ 13,645 |

During the year ended December 31, 2009 there were \$752,000 in sales of investment securities available for sale resulting in a gain of \$2,000 and no sales of investment securities held to maturity. During the year ended December 31, 2008 there were \$1.5 million in sales of investment securities available for sale resulting in a loss of \$3,000 and no sales of investment securities held to maturity.

At June 30, 2008, the Company recorded an other-than-temporary impairment charge of \$1.1 million related to its \$9.6 million investment in the AMF Ultra Short Mortgage Fund (the Fund). The net asset value of the Fund had declined primarily as a result of the uncertainty in spreads in the bond market for private label mortgage-related securities and credit downgrades to a small percentage of the underlying securities. In July 2008, the Company redeemed its 1,080,114 shares in the Fund for \$1.6 million in cash and securities with a fair value of \$7.9 million. This redemption resulted in a loss of \$96,000. The securities received, which were mortgage-backed securities and private residential collateralized mortgage obligations, were classified as held to maturity as the Company had the positive intent and ability to hold these securities until they matured. In December 2008, due to continued declines in market value and credit downgrades of specific securities acquired in the redemption, the Company recorded an additional impairment charge of \$668,000 on private residential collateralized mortgage obligations with a carrying value of \$856,000 and a fair value of \$188,000. In total during 2008, the Company recorded losses of \$1.9 million related to the Fund and the securities received in the redemption of the shares in the Fund.

Effective June 30, 2009, the Company adopted FASB ASC 320-10-65, *Recognition and Presentation of Other-Than-Temporary Impairments*, which provides for the bifurcation of other-than-temporary impairments into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) or (b) the amount of the total other-than-temporary impairment related to all other factors. As a result of adopting FASB ASC 320-10-65, the Company recorded \$830,000 in impairments on private collateralized mortgage obligations not related to credit losses through other comprehensive income rather than through earnings and \$500,000 in impairments related to credit losses through earnings during the twelve months ended December 31, 2009. The Company also reclassified \$229,000 from retained earnings to other comprehensive income related to impairment charges on private residential collateralized mortgage obligations at December 31, 2008 and March 31, 2009 that were not due to credit losses.

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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. The average prepayment rate and discount interest rate used in the valuations of the present value as of December 31, 2009 were 6.0% and 6.4%, respectively.

The following table summarizes activity related to the amount of other-than-temporary impairments related to credit losses on held to maturity securities during the year ended December 31, 2009:

| | Gross Other- Than-Temporary Impairments | Other-Than- Temporary Impairments Included in Other Comprehensive Loss (In thousands) | Net Other- Than- Temporary Impairments Included in Earnings |
|---|---|--|--|
| December 31, 2008 | \$ 668 | \$ | \$ 668 |
| Impact of change in accounting principle(1) | | 229 | (229) |
| Additions: | | | |
| Initial impairments | 1,226 | 831 | 395 |
| Subsequent impairments | 105 | | 105 |
| December 31, 2009 | \$ 1,999 | \$ 1,060 | \$ 939 |

(1) Represents a reclassification to other comprehensive income of other-than-temporary impairments on securities which were previously recorded in earnings at December 31, 2008 and March 31, 2009.

Details of private residential collateralized mortgage obligation securities related to redemption of the Fund as of December 31, 2009 were as follows:

| Type and Year of Issuance | Par Value | Amortized Cost(1) | Fair Value | Year-to-date Change in | | Year-to-date Impairment Charge(1) | Year-to-date Impairment Charge(2) | Ratings | | | | Below Investment Grade |
|------------------------------|--------------|----------------------|---------------|---------------------------------|--------------------|---|---|---------|-----|-----|-----|------------------------------|
| | | | | Aggregate Unrealized Loss | Unrealized Loss | | | AAA | AA | A | BBB | |
| Alt-A | | | | | | | | | | | | |
| 2007 | \$ 602 | \$ 154 | \$ 147 | \$ (7) | \$ (235) | \$ 88 | \$ 116 | | | | | 100% |
| 2006 | 747 | 60 | 39 | (21) | (174) | 138 | 304 | | | | | 100% |
| 2005 | 162 | 87 | 81 | (6) | (22) | 19 | 19 | | | | | 100% |
| 2004 and earlier | 8 | 8 | 7 | (1) | | | | 36% | 64% | | | |
| Total Alt-A | 1,519 | 309 | 274 | (35) | (431) | 245 | 439 | 1% | 2% | | | 97% |
| Prime | | | | | | | | | | | | |
| 2008 | 70 | 67 | 57 | (10) | 1 | | | | | | | 100% |
| 2007 | 488 | 191 | 169 | (22) | (106) | 22 | 137 | | | | | 100% |
| 2006 | 1,175 | 763 | 779 | 16 | (292) | 104 | 118 | | | | | 100% |
| 2005 | 916 | 477 | 441 | (36) | (37) | 67 | 228 | 31% | | 18% | | 51% |
| 2004 and earlier | 693 | 532 | 419 | (113) | (89) | 11 | 11 | 19% | 21% | 13% | 39% | 8% |

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| | | | | | | | | | | | | |
|-------------|----------|----------|----------|----------|----------|--------|--------|-----|----|----|-----|-----|
| Total Prime | 3,342 | 2,030 | 1,865 | (165) | (523) | 204 | 494 | 16% | 6% | 8% | 10% | 60% |
| Totals | \$ 4,861 | \$ 2,339 | \$ 2,139 | \$ (200) | \$ (954) | \$ 449 | \$ 933 | 13% | 5% | 6% | 9% | 67% |

- (1) As a result of the cumulative effect adjustment of adopting FASB ASC 320-10-65, effective June 30, 2009, year-to-date impairment charges decreased \$46,000, life-to-date impairment charges decreased \$637,000 and amortized cost increased \$637,000.
- (2) Life-to-date impairment charge represents impairment charges recognized subsequent to redemption of the Fund.

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At December 31, 2009 and 2008, investment securities available for sale with fair values of \$21.2 million and \$23.7 million, respectively, were pledged to secure public deposits and for other purposes as required or permitted by law. At December 31, 2009 and 2008, investment securities held to maturity with amortized cost values of \$3.7 million and \$4.9 million, respectively, were pledged to secure public deposits and for other purposes as required or permitted by law.

There were no securities classified as trading at December 31, 2009 or 2008.

(5) Premises and Equipment

A summary of premises and equipment at December 31, 2009 and 2008 follows:

| | 2009 | 2008 |
|-------------------------------------|----------------|-----------|
| | (In thousands) | |
| Land | \$ 6,175 | \$ 4,719 |
| Buildings and building improvements | 20,163 | 20,522 |
| Furniture, fixtures and equipment | 12,439 | 11,798 |
| | 38,777 | 37,039 |
| Less accumulated depreciation | 22,383 | 21,318 |
| | \$ 16,394 | \$ 15,721 |

Total depreciation expense on premises and equipment was \$1.1 million, \$1.2 million and \$1.6 million for the years ended December 31, 2009, 2008 and 2007, respectively.

The Banks lease premises and equipment under operating leases. Rental expense of leased premises and equipment was \$640,000, \$661,000, and \$699,000 for the years ended December 31, 2009, 2008 and 2007, respectively, which is included in occupancy and equipment expense.

Minimum net rental commitments under noncancelable leases having an original or remaining term of more than one year for future years ending December 31 are as follows (in thousands):

| | |
|------------|----------|
| 2010 | \$ 532 |
| 2011 | 517 |
| 2012 | 366 |
| 2013 | 150 |
| 2014 | 82 |
| Thereafter | 972 |
| | \$ 2,619 |

Certain leases contain renewal options from five to ten years and escalation clauses based on increases in property taxes and other costs.

(6) Deposits

Deposits consisted of the following at December 31:

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| | 2009 | | 2008 | |
|---------------------------------|------------------------|---------|------------|---------|
| | Amount | Percent | Amount | Percent |
| | (Dollars in thousands) | | | |
| Non interest demand deposits | \$ 133,169 | 15.8% | \$ 115,551 | 14.0% |
| NOW accounts | 211,509 | 25.2 | 122,104 | 14.8 |
| Money market accounts | 113,332 | 13.5 | 141,716 | 17.2 |
| Savings accounts | 78,205 | 9.3 | 98,715 | 12.0 |
| Certificate of deposit accounts | 303,913 | 36.2 | 346,394 | 42.0 |
| | \$ 840,128 | 100.0% | \$ 824,480 | 100.0% |

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Accrued interest payable on deposits was \$266,000 and \$748,000 at December 31, 2009 and 2008, respectively and is included in accrued expenses and other liabilities in the consolidated statements of financial condition. Interest expense, by category, is as follows for the years ended December 31:

| | 2009 | 2008 | 2007 |
|---------------------------------|----------------|-----------|-----------|
| | (In thousands) | | |
| NOW accounts | \$ 1,470 | \$ 1,679 | \$ 1,957 |
| Money market accounts | 1,433 | 3,089 | 4,158 |
| Savings accounts | 707 | 1,130 | 1,035 |
| Certificate of deposit accounts | 7,988 | 12,423 | 17,081 |
| | \$ 11,598 | \$ 18,321 | \$ 24,231 |

Scheduled maturities of certificates of deposit for future years ending December 31 are as follows (in thousands):

| | |
|------|------------|
| 2010 | \$ 265,177 |
| 2011 | 29,533 |
| 2012 | 3,790 |
| 2013 | 1,680 |
| 2014 | 3,733 |
| | \$ 303,913 |

Certificates of deposit issued in denominations equal to or in excess of \$100,000 totaled \$153.4 million and \$211.6 million at December 31, 2009 and 2008, respectively.

(7) FHLB Advances and Stock

The Federal Home Loan Bank of Seattle (FHLB) functions as a bank association providing credit for member financial institutions. Advances are made pursuant to several different programs. Each credit program has its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based either on a fixed percentage of an institution's net worth or on the FHLB's assessment of the institution's creditworthiness. At December 31, 2009, the Banks maintained uncommitted credit facilities with the FHLB of Seattle for \$169.1 million. There were no FHLB borrowings outstanding as of December 31, 2009.

The Banks are required to maintain an investment in the stock of the Federal Home Loan Bank (FHLB) of Seattle in an amount equal to the greater of \$500,000 or 0.50% of residential mortgage loans and pass-through securities or an advance requirement to be confirmed on the date of the advance and 5.0% of the outstanding balance of mortgage loans sold to the FHLB of Seattle. At December 31, 2009, the Company was required to maintain an investment in the stock of FHLB of Seattle of at least \$826,000. The Banks maintained \$3.6 million in FHLB stock at December 31, 2009. The stock has no contractual maturity and amounts in excess of the required minimum for FHLB membership may be redeemed at par subject to certain restrictions.

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 twelve months ended December 31, 2009, continued deterioration in the FHLB of Seattle's financial position may result in future impairment losses.

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A summary of FHLB advances is summarized as follows:

| | 2009 | 2008 |
|--|------------------------|--------|
| | (Dollars in thousands) | |
| Balance at period end, due less than 12 months | \$ | \$ |
| Average balance | | 6,223 |
| Maximum amount outstanding at any month end | | 17,100 |
| Average interest rate: | | |
| During the period | | 2.91% |
| At period end | | |

Advances from the FHLB are collateralized by a blanket pledge on FHLB stock owned by the Company, deposits at the FHLB and all mortgages or deeds of trust securing such properties. In accordance with the pledge agreement, the Company must maintain unencumbered collateral in an amount equal to varying percentages ranging from 100% to 125% of outstanding advances depending on the type of collateral. At December 31, 2009, the Company was required to maintain \$169.1 million in collateral to meet the collateral requirements of the FHLB.

(8) Federal Funds Purchased

The Banks maintain advance lines to purchase federal funds totaling \$22.8 million. The lines generally mature annually or are reviewed annually. As of December 31, 2009, there were no overnight federal funds purchased.

(9) Borrowings

During 2006, the Company entered into a loan agreement with Key Bank in the amount of \$3.7 million. The terms of the loan include quarterly payments of \$345,000, interest at 6.8% and maturing July 2009. The loan was paid off during the year ending December 31, 2008.

During the year ended December 31, 2009 the Company began to utilize repurchase agreements as a supplement to funding sources. Repurchase agreements are secured by available for sale investment securities. At December 31, 2009 we had securities sold under agreement to repurchase of \$10.4 million.

The Company also maintains an uncommitted credit facility with the Federal Reserve Bank of San Francisco for \$53.4 million, of which there were no borrowings outstanding as of December 31, 2009 and 2008.

(10) Federal Income Taxes

Federal income tax expense (benefit) consisted of the following for the years ended December 31:

| | 2009 | 2008 | 2007 |
|----------|----------------|----------|----------|
| | (In thousands) | | |
| Current | \$ 3,790 | \$ 5,516 | \$ 5,603 |
| Deferred | (4,293) | (2,540) | (216) |
| | \$ (503) | \$ 2,976 | \$ 5,387 |

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Federal income tax expense differs from that computed by applying the Federal statutory income tax rate of 35% for the years ended December 31:

| | 2009 | 2008 (In thousands) | 2007 |
|--|----------|------------------------|----------|
| Income tax expense at Federal statutory rate | \$ 27 | \$ 3,264 | \$ 5,633 |
| Tax exempt interest | (311) | (294) | (283) |
| Other, net | (219) | 6 | 37 |
| | \$ (503) | \$ 2,976 | \$ 5,387 |

The following table presents major components of the deferred Federal income tax asset (liability) resulting from differences between financial reporting and tax bases for the years ended December 31:

| | 2009 (In thousands) | 2008 |
|--|------------------------|-----------------|
| Deferred tax assets: | | |
| Allowance for loan losses | \$ 9,229 | \$ 5,370 |
| Accrued compensation | 420 | 539 |
| Capital loss carryforward | 359 | 359 |
| Other than temporarily impaired securities | 409 | 234 |
| Unrealized loss on available for sale securities | 125 | |
| Other | 183 | |
| Total deferred tax assets | 10,725 | 6,502 |
| Deferred tax liabilities: | | |
| Deferred loan fees | (708) | (768) |
| Premises and equipment | (87) | (104) |
| FHLB stock | (797) | (797) |
| Unrealized gain on available for sale securities | | (189) |
| Other | | (118) |
| Total deferred tax liabilities | (1,592) | (1,976) |
| Deferred Federal income tax asset, net | \$ 9,133 | \$ 4,526 |

The Company has qualified under provisions of the Internal Revenue Code to compute federal income taxes after deductions of additions to the bad debt reserves. At December 31, 2009, the Company had a taxable temporary difference of approximately \$2.8 million that arose before 1988 (base-year amount). In accordance with Statement of Financial Accounting Standards No. 109, a deferred tax liability has not been recognized for the temporary difference. Management does not expect this temporary difference to reverse in the foreseeable future.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management expects to realize the benefits of these deductible differences. The Company has a capital loss carryforward in the amount of \$1.0 million that will expire in 2013. A tax planning strategy has been developed that will enable the Company to deduct the capital loss carryforward prior to expiration.

Table of Contents**(11) Stockholders Equity***(a) Preferred Stock and Warrants*

On November 21, 2008, the Company completed a sale to the U.S. Department of the Treasury (Treasury) of 24,000 shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series A, (preferred shares), for an aggregate purchase price of \$24.0 million in cash, with a related warrant to purchase 276,074 shares of the Company's common stock. Under the terms of the warrants, because of our recent offering of common stock, described below, was a qualified equity offering resulting in aggregate gross proceeds of at least \$24.0 million, the number of shares of our common stock underlying the warrant was reduced by 50% to 138,037 shares.

The preferred shares pay a cumulative dividend of 5.0% per annum for the first five years and 9.0% per annum thereafter, if not redeemed within the first five years. The preferred securities can be redeemed at their liquidation preference (which is \$1,000 per share), plus all accrued and unpaid dividends. The discount on preferred shares will be accreted over a five-year term. If the preferred shares are redeemed during any period prior to the end of five years the unaccreted portion will be accreted during that period. During 2008 the preferred shares were authorized by the Board of Directors for issuance.

The warrant has a ten-year term with an exercise price of \$13.04 per share, an allocated value of \$646,000 and a fair value of \$588,000. The allocated value is the percent of the fair value of the warrant in relation to the total purchase price of the preferred shares and warrant. The fair value of the warrant was estimated on the date of issue using the Black-Scholes model based on the assumptions noted in the following table. The expected term of the warrant is ten years and represents the period of time that warrant is 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. The expected volatility is based on historical volatility of Company shares. The expected dividend yield is based on dividends expected to be paid during the expected term of the share options.

| Period ended | Weighted Average Risk Free Interest Rate | Expected Term in Years | Expected Volatility | Expected Dividend Yield | Weighted Average Fair Value |
|---------------------|---|---------------------------------------|--------------------------------|--|--|
| December 31, 2008 | 3.20% | 10.00 | 27% | 4.29% | \$ 2.13 |

(b) Common Stock

On September 22, 2009, the Company completed the sale of 4.3 million shares of common stock in a public offering. The purchase price was \$11.50 per share and net proceeds from the sale totaled approximately \$46.6 million.

Table of Contents*(c) Earnings Per Common Share*

The following table illustrates the reconciliation of weighted average shares used for earnings per common share computations for the years ended December 31:

| | 2009 | 2008 (Dollars in thousands) | 2007 |
|---|-----------|--------------------------------|-----------|
| Net income (loss): | | | |
| Net income (loss) | \$ 581 | \$ 6,351 | \$ 10,708 |
| Dividends accrued and discount accreted on preferred shares | (1,320) | (143) | |
| Net income (loss) available to common shareholders | \$ (739) | \$ 6,208 | \$ 10,708 |
| Dividends and undistributed earnings allocated to participating securities(1) | (7) | (50) | (55) |
| Earnings (loss) allocated to common shareholders | \$ (746) | \$ 6,158 | \$ 10,653 |
| Basic: | | | |
| Weighted average common shares outstanding | 7,908,412 | 6,684,709 | 6,618,611 |
| Less: restricted stock awards | (76,798) | (86,062) | (60,163) |
| Total basic weighted average common shares outstanding | 7,831,614 | 6,598,647 | 6,558,448 |
| Diluted: | | | |
| Basic weighted average common shares outstanding | 7,831,614 | 6,598,647 | 6,558,448 |
| Incremental shares from stock options, restricted stock awards and common stock warrant | | 48,773 | 111,974 |
| Weighted average shares common outstanding | 7,831,614 | 6,647,420 | 6,670,422 |

(1) Effective January 1, 2009, the Company adopted FASB ASC 03-6-1, which clarifies that unvested stock-based compensation awards containing nonforfeitable rights to dividend equivalents are considered participating securities and therefore are included in the two-class method calculation of earnings per share. The Company grants restricted stock to certain employees under its stock-based compensation programs. Recipients receive cash dividends during the vesting periods of these awards. Since these dividends are nonforfeitable, the unvested awards are considered participating securities and will have earnings allocated to them. Earnings per share data for the prior periods have been revised to reflect the retrospective adoption of the ASC.

Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. For the year ended December 31, 2009, the Company recognized a net loss applicable to common shareholders and therefore all shares outstanding related to options and warrants to acquire common stock and all outstanding restricted stock awards were anti-dilutive and have been excluded from the calculation of diluted earnings per share. For the year ended December 31, 2009 and 2008, anti-dilutive shares outstanding related to options to acquire common stock totaled 514,357 and 458,488, respectively, as the exercise price was in excess of the market value.

(d) Stock Repurchase Program

The Company does not currently have a stock repurchase plan in place and no stock was repurchased during the year ended December 31, 2009.

(e) Restrictions on Dividends

Dividends from the Company depend, in part, upon receipt of dividends from its subsidiary banks because the Company currently has no source of income other than dividends from Heritage Bank and Central Valley Bank.

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The FDIC and the Washington State Department of Financial Institutions (DFI) have the authority under their supervisory powers to prohibit the payment of dividends by Heritage Bank and Central Valley Bank to the Company. For a period of three years after the November 21, 2008 closing date of the Securities Purchase Agreement between the Company and the United States Department of the Treasury (Treasury) the Company cannot, without the consent of the Treasury, declare or pay regular quarterly cash dividends of more than the amount of the October 31, 2008 dividend per common share paid of \$0.14. Other than the specific restrictions mentioned above, current regulations allow the Company and its subsidiary banks to pay dividends on their common stock if the Company s or Bank s regulatory capital would not be reduced below the statutory capital requirements set by the Federal Reserve and the FDIC.

(12) Stock Option and Award Plans

Stock options generally vest ratably over three years and expire five years after they become exercisable which amounts to an average term of seven years. Restricted stock awards issued have a five-year cliff vesting. The Company issues new shares to satisfy share option exercises and restricted stock awards.

The following table summarizes stock option activity for the years ended December 31, 2009, 2008 and 2007.

| | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value (In thousands) |
|----------------------------------|-----------|---------------------------------|---|--|
| Outstanding at December 31, 2006 | 638,461 | \$ 18.78 | | |
| Granted | 17,550 | 23.40 | | |
| Exercised | (115,868) | 12.76 | | |
| Forfeited or expired | (21,485) | 22.07 | | |
| Outstanding at December 31, 2007 | 518,658 | \$ 20.15 | | |
| Granted | 17,550 | 19.99 | | |
| Exercised | (23,459) | 10.72 | | |
| Forfeited or expired | (1,120) | 20.21 | | |
| Outstanding at December 31, 2008 | 511,629 | \$ 20.58 | | |
| Granted | 100,735 | 11.35 | | |
| Exercised | (4,089) | 10.13 | | |
| Forfeited or expired | (69,433) | 17.39 | | |
| Outstanding at December 31, 2009 | 538,842 | \$ 19.34 | 2.82 | \$ 293 |
| Exercisable at December 31, 2009 | 421,197 | \$ 21.16 | 1.92 | \$ 50 |

The total intrinsic value of options exercised during the years ended December 31, 2009, 2008 and 2007, was \$4,000, \$172,000 and \$1.3 million, respectively. The total fair value of options vested during the years ended December 31, 2009, 2008 and 2007, was \$23,000, \$121,000 and \$1.1 million respectively.

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The following table summarizes restricted stock award activity for the years ended December 31, 2009, 2008 and 2007.

| | Shares | Weighted-Average Grant Date Fair Value |
|----------------------------------|----------|--|
| Outstanding at December 31, 2006 | 79,475 | \$ 17.99 |
| Granted | 23,505 | 23.40 |
| Vested | (31,685) | 11.74 |
| Forfeited | (5,350) | 21.84 |
| Outstanding at December 31, 2007 | 65,945 | \$ 22.62 |
| Granted | 24,495 | 19.85 |
| Vested | (1,245) | 27.71 |
| Forfeited | (635) | 22.76 |
| Outstanding at December 31, 2008 | 88,560 | \$ 21.87 |
| Granted | 5,000 | 13.55 |
| Vested | (26,250) | 20.11 |
| Forfeited | (1,605) | 23.75 |
| Outstanding at December 31, 2009 | 65,705 | \$ 21.90 |

(13) Regulatory Capital Requirements

The Company is a bank holding company under the supervision of the Federal Reserve Bank. Bank holding companies are subject to capital adequacy requirements of the Federal Reserve under the Bank Holding Company Act of 1956, as amended, and the regulations of the Federal Reserve. Heritage Bank and Central Valley Bank are federally insured institutions and thereby subject to the capital requirements established by the Federal Deposit Insurance Corporation (FDIC). The Federal Reserve 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.

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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 December 31, 2009 and December 31, 2008, Heritage Bank and Central Valley Bank were both classified as well capitalized institutions under the criteria established by the FDIC Act. There are no conditions or events since that notification that management believes have changed the Bank's classification as a well capitalized institution.

| | Minimum Requirements | | Well-Capitalized Requirements | | Actual | |
|---|----------------------|----|-------------------------------|----|------------|-------|
| | \$ | % | \$ | % | \$ | % |
| (Dollars in thousands) | | | | | | |
| As of December 31, 2009: | | | | | | |
| The Company consolidated | | | | | | |
| Tier 1 leverage capital to average assets | \$ 30,276 | 3% | \$ 50,460 | 5% | \$ 145,354 | 14.6% |
| Tier 1 capital to risk-weighted assets | 29,956 | 4 | 44,933 | 6 | 145,354 | 19.4 |
| Total capital to risk-weighted assets | 59,911 | 8 | 74,889 | 10 | 154,923 | 20.7 |
| Heritage Bank | | | | | | |
| Tier 1 leverage capital to average assets | 25,709 | 3 | 42,848 | 5 | 100,751 | 11.8 |
| Tier 1 capital to risk-weighted assets | 25,851 | 4 | 38,776 | 6 | 100,751 | 15.6 |
| Total capital to risk-weighted assets | 51,701 | 8 | 64,627 | 10 | 109,024 | 16.9 |
| Central Valley Bank | | | | | | |
| Tier 1 leverage capital to average assets | 4,545 | 3 | 7,575 | 5 | 13,762 | 9.1 |
| Tier 1 capital to risk-weighted assets | 4,075 | 4 | 6,113 | 6 | 13,762 | 13.5 |
| Total capital to risk-weighted assets | 8,151 | 8 | 10,188 | 10 | 15,048 | 14.8 |
| As of December 31, 2008: | | | | | | |
| The Company consolidated | | | | | | |
| Tier 1 leverage capital to average assets | \$ 27,027 | 3% | \$ 45,044 | 5% | \$ 99,359 | 11.0% |
| Tier 1 capital to risk-weighted assets | 31,861 | 4 | 47,791 | 6 | 99,359 | 12.5 |
| Total capital to risk-weighted assets | 63,722 | 8 | 79,652 | 10 | 109,383 | 13.7 |
| Heritage Bank | | | | | | |
| Tier 1 leverage capital to average assets | 22,909 | 3 | 38,182 | 5 | 66,834 | 8.8 |
| Tier 1 capital to risk-weighted assets | 27,585 | 4 | 41,377 | 6 | 66,834 | 9.7 |
| Total capital to risk-weighted assets | 55,170 | 8 | 68,962 | 10 | 75,523 | 11.0 |
| Central Valley Bank | | | | | | |
| Tier 1 leverage capital to average assets | 4,102 | 3 | 6,837 | 5 | 12,681 | 9.3 |
| Tier 1 capital to risk-weighted assets | 4,250 | 4 | 6,375 | 6 | 12,681 | 11.9 |
| Total capital to risk-weighted assets | 8,499 | 8 | 10,624 | 10 | 14,008 | 13.2 |

(14) Employee Benefit Plans

Effective October 1, 1999 the Company combined three retirement plans, a money purchase pension plan, a 401k plan, and an employee stock ownership plan (ESOP) at Heritage Bank, and the 401(k) plan at Central Valley Bank into one plan called the Heritage Financial Corporation 401(k) Employee Stock Ownership Plan (KSOP). Effective April 1, 2002 the Company added three investment funds to the plan as well as changed the eligibility requirements to the plan. At this same time the Company approved an amendment of the plan to reflect certain provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Effective July 1, 2008, the Company restated the plan to incorporate previously approved plan amendments, restate the Plan to formally comply with EGTRRA and to incorporate certain provisions of the Pension Protection Act of 2006. At this time certain plan eligibility, administration and contribution provisions were changed.

The profit sharing portion of the KSOP is a defined contribution retirement plan. The plan provides a contribution to all eligible participants upon completion of one year of service, the attainment of 18 years of age, and employment on the last day of the year. It is the Company's policy to fund plan costs as accrued. Employee vesting occurs over a period of six years, at which time they become fully vested.

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The KSOP also maintains the Company's salary savings 401(k) plan for its employees. All persons employed as of July 1, 1984 automatically participate in the plan. All employees hired after that date who are at least 18 years of age may participate in the plan the first of the month following thirty days of service. Employees who participate may contribute a portion of their salary, which is matched by the employer at 50% up to certain specified limits. Employee vesting in employer portions occurs over a period of six years for those contributions made after January 1, 2003. Employer contributions for the years ended December 31, 2009, 2008 and 2007 were \$237,000, \$309,000 and \$270,000, respectively.

The third portion of the KSOP is the employee stock ownership plan (ESOP). Heritage Bank established for eligible employees the ESOP and related trust effective July 1, 1994, which became active upon the former mutual holding company's conversion to a stock-based holding company in January 1995. The plan provides a contribution to all eligible participants upon completion of one year of service, the attainment of 18 years of age, and employment on the last day of the year. The ESOP is funded by employer contributions in cash or common stock. Employee vesting occurs over a period of six years.

In January 1998, the ESOP borrowed \$1.3 million from the Company to purchase additional common stock of the Company. The loan will be repaid principally from the subsidiary bank's contributions to the ESOP over a period of fifteen years. The interest rate on the loan is 8.5% per annum. ESOP compensation expense was \$113,000, \$145,000 and \$215,000 for the years ended December 31, 2009, 2008 and 2007, respectively.

For the year ended December 31, 2009, the Company has allocated or committed to be released to the ESOP 9,258 earned shares and has 28,544 unearned, restricted shares remaining to be released. The fair value of unearned, restricted shares held by the ESOP trust was \$393,000 at December 31, 2009.

(a) Severance Agreements

The Company has entered into contracts with certain senior officers that provide benefits under certain conditions following termination without cause, and/or following a change of control of the Company.

(15) Fair Value of Financial Instruments

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 and Interest Earning Deposits

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.

Table of Contents*(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

For most loans, fair value is estimated using the Company's lending rates that would have been offered on December 31, 2009 and 2008 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 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

The fair value of securities sold under agreement to repurchase are estimated based on discounting the future cash flows using the market rate currently offered.

(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:

| | December 31, 2009 | | December 31, 2008 | |
|--|-------------------|------------|-------------------|------------|
| | Book Value | Fair Value | Book Value | Fair Value |
| | (In thousands) | | | |
| Financial Assets | | | | |
| Cash on hand and in banks | \$ 20,106 | \$ 20,106 | \$ 31,478 | \$ 31,478 |
| Interest earning deposits | 87,125 | 87,125 | 29,156 | 29,156 |
| Investment securities available for sale | 90,736 | 90,736 | 31,922 | 31,922 |
| Investment securities held to maturity | 13,636 | 13,645 | 12,081 | 11,079 |
| Federal Home Loan Bank stock | 3,566 | 3,566 | 3,566 | 3,566 |
| Loans receivable and loans held for sale, net of allowance | 746,908 | 761,756 | 793,607 | 815,831 |
| Financial Liabilities | | | | |
| Deposits: | | | | |
| Savings, money market and demand | \$ 536,215 | \$ 536,215 | \$ 478,086 | \$ 478,086 |
| Time certificates | 303,913 | 304,542 | 346,394 | 348,139 |
| Total deposits | 840,128 | 840,757 | 824,480 | 826,225 |
| Securities sold under agreement to repurchase | 10,440 | 10,440 | | |

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We measure the 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 December 31, 2009.

| | Total | Level 1 | Level 2 | Level 3 |
|--|----------------|---------|-----------|---------|
| | (In thousands) | | | |
| Investment securities available for sale | \$ 90,736 | \$ | \$ 90,736 | \$ |

The following table summarizes the balances of assets and liabilities measured at fair value on a nonrecurring basis at December 31, 2009, and the total losses resulting from these fair value adjustments for the year ended December 31, 2009.

| | Fair Value at December 31, 2009 | | | | Twelve Months Ended December 31, 2009 |
|---|---------------------------------|---------|---------|-----------|---------------------------------------|
| | Total | Level 1 | Level 2 | Level 3 | Total Losses |
| | (In thousands) | | | | |
| Loans receivable(1) | \$ 12,758 | \$ | \$ | \$ 12,758 | \$ 15,904 |
| Investment securities held to maturity(2) | 1,078 | | | 1,078 | 500 |
| Other real estate owned(3) | 704 | | | 704 | 126 |
| Total | \$ 12,722 | \$ | \$ | \$ 12,722 | \$ 16,414 |

- (1) The loss on loans receivable disclosed above represents the amount of the specific reserve accrued during the period applicable to loans held at period end, and is included in the provision for loan losses. At December 31, 2009, a specific reserve of \$7.4 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 appraisals 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 \$2.4 million were written down to their fair value of \$1.1 million resulting in an impairment charge of \$500,000 to non-interest expense for the year ended December 31, 2009. 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

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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) Other real estate owned with a carrying amount of \$830,000 were written down to their fair value of \$704,000, resulting in impairment charge \$126,000 to non-interest expense. Impairment losses recorded were calculated based on the fair value of the collateral, less the costs to sell. The fair value of the collateral is generally based on estimated market prices from independently prepared appraisals or negotiated sales prices with potential buyers. When a current appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, such valuation inputs result in a fair value measurement that is categorized as a Level 3 measurement. The other real estate owned losses shown above are write-downs based on either an accepted purchase offer by an independent third party received after foreclosure or lowered listing prices based on management's expectation of local market conditions.

The following table summarizes the balances of assets and liabilities measured at fair value on a recurring basis at December 31, 2008.

| | Total | Level 1 | Level 2 | Level 3 |
|--|------------------------|---------|-----------|---------|
| | (Dollars in thousands) | | | |
| Investment securities available for sale | \$ 31,922 | \$ | \$ 31,922 | \$ |

The following table summarizes the balances of assets and liabilities measured at fair value on a nonrecurring basis at December 31, 2008, and the total losses resulting from these fair value adjustments for the twelve months ended December 31, 2008.

| | Fair Value at December 31, 2008 | | | | Twelve Months Ended December 31, 2008(1) |
|---|---------------------------------|-----------|-----------|-----------------|--|
| | Total | Level 1 | Level 2 | Level 3 | Total Losses |
| | (Dollars in thousands) | | | | |
| Loans Receivable(2) | \$ 3,232 | \$ | \$ | \$ 3,232 | \$ |
| Investment securities available for sale(3) | | | | | 1,259 |
| Investment securities held to maturity(4) | 188 | | | 188 | 668 |
| Other real estate owned(5) | 2,031 | | | 2,031 | 18 |
| Total | \$ 5,451 | \$ | \$ | \$ 5,451 | \$ 1,945 |

- (1) The losses represent charge offs to noninterest expense.
- (2) Loans receivable with a carrying amount of \$3,675 were identified as being impaired and a specific reserve of \$443 was recognized on these loans to reduce their carrying values to their fair value of \$3,232. Impairment losses recorded were calculated based on the fair value of the collateral, less the costs to sell.
- (3) Investment securities available for sale with a carrying amount of \$9,620 were written down to their fair value of \$8,508, resulting in an impairment charge of \$1,112 to noninterest expense. Subsequently, the related securities were redeemed for cash and securities valuing \$8,361, resulting in an additional loss of \$147. Impairment losses recorded were determined using cash flow models and dealer quotes.
- (4) Investment securities held to maturity with a carrying amount of \$856 were written down to their fair value of \$188, resulting in an impairment charge of \$668 to noninterest expense. Impairment losses recorded were determined using cash flow models.
- (5) Other real estate owned with a carrying amount of \$2,049 were written down to their fair value of \$2,031, resulting in impairment charge \$18 to noninterest expense. Impairment losses recorded were calculated based on the fair value of the collateral, less the costs to sell.

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(16) Contingencies

The Company is involved in numerous business transactions, which, in some cases, depend on regulatory determination as to compliance with rules and regulations. Also, the Company has certain litigation and negotiations in progress. All such matters are attributable to activities arising from normal operations. In the opinion of management, after review with legal counsel, the eventual outcome of the aforementioned matters is unlikely to have a materially adverse effect on the Company's consolidated financial statements or its financial position.

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Table of Contents**(17) Heritage Financial Corporation (Parent Company Only)**

Following is the condensed financial statements of the Parent Company.

HERITAGE FINANCIAL CORPORATION**(PARENT COMPANY ONLY)****Condensed Statements of Financial Condition**

| | December 31, | |
|--|-----------------------|-------------|
| | 2009 | 2008 |
| | (In thousands) | |
| <u>ASSETS</u> | | |
| Cash and interest earning deposits | \$ 29,893 | \$ 18,803 |
| Loans receivable ESOP | 423 | 537 |
| Investment in subsidiary banks | 127,662 | 93,327 |
| Other assets | 746 | 652 |
| | \$ 158,724 | \$ 113,319 |
| <u>LIABILITIES AND STOCKHOLDERS' EQUITY</u> | | |
| Other liabilities | 226 | 172 |
| Total stockholders' equity | 158,498 | 113,147 |
| | \$ 158,724 | \$ 113,319 |

HERITAGE FINANCIAL CORPORATION**(PARENT COMPANY ONLY)****Condensed Statements of Operations**

| | Years Ended December 31, | | |
|--|---------------------------------|--------------|---------------|
| | 2009 | 2008 | 2007 |
| | (In thousands) | | |
| Interest income: | | | |
| Interest earning deposits | \$ 163 | \$ 33 | \$ 7 |
| ESOP loan | 42 | 51 | 59 |
| Other income: | | | |
| Dividends from subsidiaries | 750 | 6,350 | 7,390 |
| Equity in undistributed income of subsidiaries | 773 | 1,087 | 4,372 |
| Total income | 1,728 | 7,521 | 11,828 |
| Interest expense | | 96 | 190 |
| Other expenses | 1,608 | 1,581 | 1,361 |
| Total expense | 1,608 | 1,677 | 1,551 |
| Income before Federal income taxes | 120 | 5,844 | 10,277 |
| Benefit for Federal income taxes | (461) | (507) | (431) |

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| | | | |
|--|----------|----------|-----------|
| Net income | \$ 581 | \$ 6,351 | \$ 10,708 |
| Dividend accrued and discount accreted on preferred shares | 1,320 | 143 | |
| Net income (loss) applicable to common shareholders | \$ (739) | \$ 6,208 | \$ 10,708 |

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Table of Contents**HERITAGE FINANCIAL CORPORATION****(PARENT COMPANY ONLY)****Condensed Statements of Cash Flows**

| | Years Ended December 31, | | |
|---|--------------------------|------------------|----------------|
| | 2009 | 2008 | 2007 |
| | (In thousands) | | |
| Cash flows from operating activities: | | | |
| Net income | \$ 581 | \$ 6,351 | \$ 10,708 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Equity in undistributed income of subsidiaries | (1,674) | (7,437) | (11,762) |
| Dividends from subsidiaries | 750 | 6,350 | 7,390 |
| Recognition of compensation related to ESOP shares and restricted stock awards | 406 | 507 | 410 |
| Stock option compensation expense | 143 | 178 | 288 |
| Net change in other assets and liabilities | 13 | (1,564) | 443 |
| Net cash provided by operating activities | 219 | 4,385 | 7,477 |
| Cash flows from investing activities: | | | |
| ESOP loan principal repayments | 114 | 106 | 97 |
| Investment in subsidiaries | (34,000) | (5,000) | |
| Net cash (used in) provided by investing activities | (33,886) | (4,894) | 97 |
| Cash flows from financing activities: | | | |
| Net decrease in short-term borrowed funds | | (1,951) | (225) |
| Proceeds from issuance of preferred stock and warrant | | 24,000 | |
| Repayments of long-term debt | | | (1,195) |
| Proceeds from common stock issuance, net of estimated expenses | 46,572 | | |
| Cash dividends paid | (1,854) | (3,748) | (5,561) |
| Exercise of stock options | 39 | 251 | 1,477 |
| Stock repurchase | | | (1,351) |
| Net cash provided by (used) in financing activities | 44,757 | 18,552 | (6,855) |
| Net increase in cash and cash equivalents | 11,090 | 18,043 | 719 |
| Cash and cash equivalents at beginning of year | 18,803 | 760 | 41 |
| Cash and cash equivalents at end of year | \$ 29,893 | \$ 18,803 | \$ 760 |

Table of Contents**(18) Selected Quarterly Financial Data (Unaudited)**

Results of operations on a quarterly basis were as follows:

| | Year Ended December 31, 2009 | | | |
|---|------------------------------|-------------------|------------------|-------------------|
| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
| | (Dollars in thousands) | | | |
| Interest income | \$ 13,441 | \$ 13,309 | \$ 13,304 | \$ 13,287 |
| Interest expense | 3,363 | 2,974 | 2,775 | 2,533 |
| Net interest income | 10,078 | 10,335 | 10,529 | 10,754 |
| Provision for loan losses | 5,250 | 4,540 | 4,650 | 4,950 |
| Net interest income after provision for loan losses | 4,828 | 5,795 | 5,879 | 5,804 |
| Non-interest income | 2,037 | 2,272 | 2,105 | 2,253 |
| Non-interest expense | 7,880 | 8,026 | 7,612 | 7,377 |
| (Loss) income before provision for income taxes | (1,015) | 41 | 372 | 680 |
| Federal income tax expense (benefit) | (421) | (50) | 60 | (92) |
| Net (loss) income | \$ (594) | \$ 91 | \$ 312 | \$ 772 |
| Net (loss) income available to common shareholders | \$ (923) | \$ (239) | \$ (18) | \$ 441 |
| Basic (loss) earnings per common share | \$ (0.14) | \$ (0.04) | \$ (0.00) | \$ 0.04 |
| Diluted (loss) earnings per common share | (0.14) | (0.04) | (0.00) | 0.04 |
| Cash dividends declared on common stock | 0.10 | | | |
| | Year Ended December 31, 2008 | | | |
| | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
| | (Dollars in thousands) | | | |
| Interest income | \$ 14,701 | \$ 13,976 | \$ 14,193 | \$ 14,078 |
| Interest expense | 5,637 | 4,587 | 4,337 | 4,045 |
| Net interest income | 9,064 | 9,389 | 9,856 | 10,033 |
| Provision for loan losses | 360 | 710 | 1,760 | 4,590 |
| Net interest income after provision for loan losses | 8,704 | 8,679 | 8,096 | 5,443 |
| Non-interest income | 2,246 | 2,274 | 2,251 | 2,053 |
| Non-interest expense | 6,970 | 8,286 | 7,260 | 7,903 |
| Income before provision for income taxes | 3,980 | 2,667 | 3,087 | (407) |
| Federal income tax expense | 1,320 | 863 | 1,006 | (213) |
| Net income (loss) | \$ 2,660 | \$ 1,804 | \$ 2,081 | \$ (194) |
| Net income (loss) available to common shareholders | \$ 2,660 | \$ 1,804 | \$ 2,081 | \$ (337) |
| Basic earnings (loss) per common share | \$ 0.40 | \$ 0.27 | \$ 0.31 | \$ (0.05) |
| Diluted earnings (loss) per common share | 0.40 | 0.27 | 0.31 | (0.05) |
| Cash dividends declared on common stock | 0.21 | 0.21 | 0.14 | |

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INDEX TO EXHIBITS

| Exhibit No. | |
|--------------------|---|
| 3.1 | Articles of Incorporation(1) |
| 3.2 | Bylaws of the Company(2) |
| 4.1 | Form of Certificate for Preferred Stock(3) |
| 4.2 | Warrant for purchase(3) |
| 10.1 | 1998 Stock Option and Restricted Stock Award Plan(4) |
| 10.6 | 1997 Stock Option and Restricted Stock Award Plan(5) |
| 10.10 | 2002 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan(6) |
| 10.12 | 2006 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan(7) |
| 10.13 | Employment Agreement between the Company and Brian L. Vance, effective October 1, 2006 as amended and restated in February 2007(8) |
| 10.14 | Employment Agreement between Central Valley Bank and D. Michael Broadhead, effective April 1, 2007(8) |
| 10.16 | Severance Agreement between Heritage Bank and Gregory D. Patjens, effective April 1, 2007(8) |
| 10.17 | Severance Agreement between Heritage Bank and Donald J. Hinson, effective August 1, 2007(9) |
| 10.18 | Letter Agreement between Heritage Financial Corporation and the United States Department of the Treasury dated November 21, 2008 in connection with the Company's participation in the Troubled Asset Relief Program Capital Purchase Program, and related documents(3) |
| 10.19 | Letter of Understanding between Heritage Financial Corporation and Donald V. Rhodes dated August 18, 2009(10) |
| 10.20 | Annual Incentive Compensation Plan |
| 10.21 | Compensation Modification Agreements between Heritage Financial Corporation and Brian L. Vance, Donald V. Rhodes, Donald J. Hinson, D. Michael Broadhead, Gregory Patjens and Dave Spurling dated September 29, 2009(11) |
| 14.0 | Code of Ethics and Conduct Policy |
| 21.0 | Subsidiaries of the Company |
| 23.0 | Consent of Independent Registered Public Accounting Firm |
| 24.0 | Power of Attorney |
| 31.1 | Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Principal Financial Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 99.1 | Subsequent Year Certification of the Principal Executive Officer pursuant to Section 111(b) of the Emergency Economic Stabilization Act of 2008 |
| 99.2 | Subsequent Year Certification of the Principal Financial Officer pursuant to Section 111(b) of the Emergency Economic Stabilization Act of 2008 |

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

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EXHIBIT INDEX

Exhibit

| No. | Description of Exhibit |
|------------|---|
| 10.20 | Annual Incentive Compensation Plan |
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