HERITAGE FINANCIAL CORP /WA/
Form 10-Q
November 05, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2014

OR

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

Commission File Number 0-29480

HERITAGE FINANCIAL CORPORATION
(Exact name of registrant as specified in its charter)

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

(360) 943-1500
(Registrant’s telephone number, including area code)

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

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

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

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

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

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

As of October 30, 2014 there were 30,255,743 shares of the registrant's common stock, no par value per share, outstanding.

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FORWARD LOOKING STATEMENTS:

“Safe Harbor” statement under the Private Securities Litigation Reform Act of 1995: This Quarterly Report on Form 10-Q ("Form 10-Q") contains forward-looking statements that are subject to risks and uncertainties, including, but not limited to: our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired, including those from the Cowlitz Bank, Pierce Commercial Bank, Northwest Commercial Bank, Valley Community Bancshares and Washington Banking Company transactions described in this Form 10-Q, or may in the future acquire, into our operations and our ability to realize related revenue synergies and cost savings within expected time frames or at all, and any goodwill charges related thereto and costs or difficulties relating to integration matters, including but not limited to customer and employee retention, which might be greater than expected; the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be effected by deterioration in the housing and commercial real estate markets, which may lead to increased losses and non-performing assets in our loan portfolio, and may result in our allowance for loan losses no longer being adequate to cover actual losses, and require us to increase our allowance for loan losses; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; risks related to acquiring assets in or entering markets in which we have not previously operated and may not be familiar; fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas; results of examinations of us by the Board of Governors of the Federal Reserve System ("Federal Reserve") and of our bank subsidiary by the Federal Deposit Insurance Corporation ("FDIC"), the Washington State Department of Financial Institutions, Division of Banks ("Division") or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our allowance for loan losses, write-down assets, or change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules including as a result of Basel III; our ability to control operating costs and expenses; the impact of the Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and the implementing regulations; further increases in premiums for deposit insurance; the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our Condensed Consolidated Statements of Financial Condition; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges; failure or security breach of computer systems on which we depend; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our expansion strategy of pursuing acquisitions and de novo branching; increased competitive pressures among financial service companies; changes in consumer spending, borrowing and savings habits; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board ("FASB"), including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; and other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and other risks detailed from time to time in our filings with the Securities and Exchange Commission ("SEC") including our Annual Report on Form 10-K for the year ended December 31, 2013.
The Company cautions readers not to place undue reliance on any forward-looking statements. Moreover, you should treat these statements as speaking only as of the date they are made and based only on information then actually known to the Company. The Company does not undertake and specifically disclaims any obligation to revise any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the

date of such statements. These risks could cause our actual results for future periods to differ materially from those expressed in any forward-looking statements by, or on behalf of, us, and could negatively affect the Company's operating results and stock price performance.

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

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS
HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
September 30, 2014 and December 31, 2013
(Dollars in thousands)
(Unaudited)

	September 30, 2014	December 31, 2013
ASSETS		
Cash on hand and in banks	$64,609	$40,162
Interest earning deposits	145,541	90,238
Cash and cash equivalents	210,150	130,400
Other interest earning deposits	13,129	15,662
Investment securities available for sale, at fair value	682,651	163,134
Investment securities held to maturity (fair value of $39,029 and $36,340, respectively)	38,213	36,154
Loans held for sale	4,641	—
Noncovered loans receivable, net	2,064,050	1,168,166
Allowance for loan losses for noncovered loans	(22,220)	(22,657)
Noncovered loans receivable, net of allowance for loan losses	2,041,830	1,145,509
Covered loans receivable, net	138,833	63,754
Allowance for loan losses for covered loans	(6,122)	(6,167)
Covered loans receivable, net of allowance for loan losses	132,711	57,587
Total loans receivable, net	2,174,541	1,203,096
FDIC indemnification asset	5,138	4,382
Other real estate owned ($2,784 and $182 covered by FDIC shared-loss agreements, respectively)	6,872	4,559
Premises and equipment, net	65,787	34,348
Federal Home Loan Bank stock, at cost	12,363	5,741
Bank owned life insurance	32,760	—
Accrued interest receivable	9,987	5,462
Prepaid expenses and other assets	64,616	25,120
Other intangible assets, net	11,561	1,615
Goodwill	118,911	29,365
Total assets	$3,451,320	$1,659,038
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits	$2,903,069	$1,399,189
Junior subordinated debentures	19,027	—
Securities sold under agreement to repurchase	35,390	29,420
Accrued expenses and other liabilities	42,183	14,667
Total liabilities	2,999,669	1,443,276
Stockholders’ equity:		
Preferred stock, no par value, 2,500,000 shares authorized; no shares issued and outstanding at September 30, 2014 and December 31, 2013	—	—
Common stock, no par value, 50,000,000 shares authorized; 30,252,114 and 16,210,747 shares issued and outstanding at September 30, 2014 and December	365,006	138,659

31, 2013, respectively		
Retained earnings	86,699	78,265
Accumulated other comprehensive loss, net	(54)	(1,162)
Total stockholders’ equity	451,651	215,762
Total liabilities and stockholders’ equity	$3,451,320	$1,659,038

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
For the Three and Nine Months Ended September 30, 2014 and 2013
(Dollars in thousands, except per share amounts)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
INTEREST INCOME:				
Interest and fees on loans	$31,841	$17,505	$75,738	$50,252
Taxable interest on investment securities	2,212	518	4,663	1,296
Nontaxable interest on investment securities	855	428	1,928	1,108
Interest and dividends on other interest earning assets	123	82	338	220
Total interest income	35,031	18,533	82,667	52,876
INTEREST EXPENSE:				
Deposits	1,534	939	3,685	2,786
Junior subordinated debentures	171	—	285	—
Other borrowings	19	13	52	32
Total interest expense	1,724	952	4,022	2,818
Net interest income	33,307	17,581	78,645	50,058
Provision for loan losses for noncovered loans	567	875	916	1,584
Provision for loan losses for covered loans	27	203	827	1,660
Total provision for loan losses	594	1,078	1,743	3,244
Net interest income after provision for loan losses	32,713	16,503	76,902	46,814
NONINTEREST INCOME:				
Bargain purchase gain on bank acquisition	—	—	—	399
Service charges and other fees	3,524	1,609	7,700	4,395
Merchant Visa income, net	278	259	839	642
Change in FDIC indemnification asset	(647)	(350)	(575)	(336)
(Loss) gain on sale of investment securities, net	(13)	—	254	—
Gain on sale of loans, net	742	—	975	142
Other income	1,599	1,064	3,377	1,980
Total noninterest income	5,483	2,582	12,570	7,222
NONINTEREST EXPENSE:				
Compensation and employee benefits	15,579	8,014	36,369	23,220
Occupancy and equipment	3,978	2,190	9,412	6,105
Data processing	1,978	953	6,977	2,809
Marketing	841	477	1,843	1,189
Professional services	1,113	862	5,173	2,532
State and local taxes	576	292	1,378	876
Impairment loss on investment securities, net	—	—	45	26
Federal deposit insurance premium	403	237	1,115	744
Other real estate owned, net	650	(162)	915	(260)
Amortization of intangible assets	603	157	1,248	386
Other expense	2,642	1,265	5,661	3,383
Total noninterest expense	28,363	14,285	70,136	41,010
Income before income taxes	9,833	4,800	19,336	13,026
Income tax expense	2,765	1,510	5,577	4,161

Net income	$7,068	$3,290	$13,759	$8,865
Basic earnings per common share	$0.23	$0.20	$0.57	$0.57
Diluted earnings per common share	$0.23	$0.20	$0.57	$0.57
Dividends declared per common share	$0.09	$0.18	$0.25	$0.34

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the Three and Nine Months Ended September 30, 2014 and 2013
(Dollars in thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	$7,068	$3,290	$13,759	$8,865
Change in fair value of securities available for sale, net of tax of $(744), $(100), $663 and $(1,332), respectively	(1,384)	(185)	1,231	(2,474)
Reclassification adjustment of net loss (gain) from sale of available for sale securities included in income, net of tax of $4, $0, $(89) and $0, respectively	8	—	(166)	—
Accretion of other-than-temporary impairment on securities held to maturity, net of tax of $9, $7, $27 and $26, respectively	13	12	43	48
Other comprehensive income (loss)	(1,363)	(173)	1,108	(2,426)
Comprehensive income	$5,705	$3,117	$14,867	$6,439

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
For the Nine Months Ended September 30, 2014 and 2013
(In thousands, except per share amounts)
(Unaudited)

	Number of common shares	Common stock	Retained earnings	Accumulated other comprehensive income (loss), net	Total stock-holders' equity
Balance at December 31, 2012	15,118	$121,832	$75,362	$1,744	$198,938
Restricted and unrestricted stock awards issued, net of forfeitures	100	—	—	—	—
Stock option compensation expense	—	55	—	—	55
Exercise of stock options (including excess tax benefits from nonqualified stock options)	17	166	—	—	166
Restricted stock compensation expense	—	926	—	—	926
Excess tax benefits from restricted stock	—	72	—	—	72
Common stock repurchased	(557)	(8,820)	—	—	(8,820)
Net income	—	—	8,865	—	8,865
Other comprehensive loss, net of tax	—	—	—	(2,426)	(2,426)
Common stock issued in business combination	1,533	24,195	—	—	24,195
Cash dividends declared on common stock ($0.34 per share)	—	—	(5,376)	—	(5,376)
Balance at September 30, 2013	16,211	$138,426	$78,851	$(682)	$216,595
Balance at December 31, 2013	16,211	$138,659	$78,265	$(1,162)	$215,762
Restricted and unrestricted stock awards issued, net of forfeitures	124	—	—	—	—
Stock option compensation expense	—	20	—	—	20
Exercise of stock options (including excess tax benefits from nonqualified stock options)	71	766	—	—	766
Restricted stock compensation expense	—	896	—	—	896
Excess tax benefits from restricted stock	—	60	—	—	60
Common stock repurchased	(127)	(2,119)	—	—	(2,119)
Net income	—	—	13,759	—	13,759
Other comprehensive income, net of tax	—	—	—	1,108	1,108
Common stock issued in business combination	13,973	226,724	—	—	226,724
Cash dividends declared on common stock ($0.25 per share)	—	—	(5,325)	—	(5,325)
Balance at September 30, 2014	30,252	$365,006	$86,699	$(54)	$451,651

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Nine Months Ended September 30, 2014 and 2013
(Dollars in thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2014	2013
Cash flows from operating activities:		
Net income	$13,759	$8,865
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	9,043	3,996
Changes in net deferred loan fees, net of amortization	(1,200)	419
Provision for loan losses	1,743	3,244
Net change in accrued interest receivable, FDIC indemnification asset, prepaid expenses and other assets, accrued expenses and other liabilities	209	1,960
Restricted and unrestricted stock compensation expense	896	926
Stock option compensation expense	20	55
Excess tax benefits from stock options and restricted and unrestricted stock	(60)	(72)
Amortization of intangible assets	1,248	386
Bargain purchase gain on bank acquisition	—	(399)
Gain on sale of investment securities, net	(254)	—
Impairment loss on investment of securities, net	45	26
Origination of loans held for sale	(35,046)	(6,784)
Gain on sale of loans, net	(975)	(142)
Proceeds from sale of loans	35,303	8,602
Earnings on bank owned life insurance	(241)	—
Valuation adjustment on other real estate owned	—	23
Loss (gain) on other real estate owned, net	312	(307)
Loss (gain) on sale or write-off of furniture, equipment and leasehold improvements	466	(596)
Net cash provided by operating activities	25,268	20,202
Cash flows from investing activities:		
Loans originated, net of principal payments	30,363	(46,311)
Maturities of other interest earning deposits	2,487	272
Maturities of investment securities available for sale	37,480	43,272
Maturities of investment securities held to maturity	1,003	1,561
Purchase of investment securities available for sale	(251,200)	(38,155)
Purchase of investment securities held to maturity	(3,313)	(3,625)
Purchase of premises and equipment	(3,330)	(4,300)
Proceeds from sales of other real estate owned	5,173	5,590
Proceeds from sales of investment securities available for sale	158,640	—
Proceeds from redemption of FHLB stock	442	154
Proceeds from sale of premises and equipment	835	700
Investment in new market tax credit partnership	(25,000)	—
Net cash received from acquisitions	31,564	18,260
Net cash used in investing activities	(14,856)	(22,582)
Cash flows from financing activities:		
Net increase in deposits	69,986	40,559

Common stock cash dividends paid	(5,325)	(5,376)
Net increase in securities sold under agreement to repurchase	5,970	6,634
Proceeds from exercise of stock options	766	166
Excess tax benefits from stock options and restricted and unrestricted stock	60	72

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	Nine Months Ended September 30, 2014	2013
Repurchase of common stock	(2,119)	(8,820)
Net cash provided by financing activities	69,338	33,235
Net increase in cash and cash equivalents	79,750	30,855
Cash and cash equivalents at beginning of period	130,400	104,268
Cash and cash equivalents at end of period	$210,150	$135,123
Supplemental disclosures of cash flow information:		
Cash paid for interest	$3,667	$2,770
Cash paid for income taxes	11,952	3,074
Supplemental non-cash disclosures of cash flow information:		
Transfers of loans receivable to other real estate owned	$677	$1,740
Seller-financed sale of other real estate owned	—	250
Investment in low income housing tax credit partnership and related funding commitment	4,400	—
Purchases of investment securities available for sale not settled	9,365	—
Common stock issued for business combinations	226,724	24,195
Assets acquired (liabilities assumed) in acquisitions:		
Other interest earning deposits	—	14,869
Investment securities available for sale	458,312	34,197
Investment securities held to maturity	—	22,908
Loans held for sale	3,923	—
Noncovered loans receivable	895,978	168,580
Covered loans receivable	107,050	—
Other real estate owned	7,121	2,279
Premises and equipment	31,776	6,772
Federal Home Loan Bank stock	7,064	454
FDIC indemnification asset	7,174	—
Accrued interest receivable	4,943	697
Bank owned life insurance	32,519	—
Prepaid expenses and other assets	15,194	4,347
Other intangible assets	11,194	1,072
Deposits	(1,433,894)	(267,445)
Junior subordinated debentures	(18,937)	—
Accrued expenses and other liabilities	(23,803)	(1,528)

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARY
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
For the Three and Nine Months Ended September 30, 2014 and 2013
(Unaudited)

(1) Description of Business, Basis of Presentation, Significant Accounting Policies and Recently Issued Accounting Pronouncements

(a) Description of Business

Heritage Financial Corporation ("Heritage" or the “Company”) is a bank holding company that was 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 subsidiary, Heritage Bank (the “Bank”). The Bank is a Washington-chartered commercial bank and its deposits are insured by the FDIC under the Deposit Insurance Fund. The Bank is headquartered in Olympia, Washington and conducts business from its sixty-seven branch offices located throughout Washington State and the greater Portland, Oregon area. The Bank’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 Bank also makes real estate construction and land development loans and consumer loans and originates first mortgage loans on residential properties primarily located in its market area.

The Company has expanded its footprint through mergers and acquisitions. The largest of these transactions was the strategic merger with Washington Banking Company (“Washington Banking”) into the Company and its wholly owned subsidiary bank, Whidbey Island Bank ("Whidbey") into Heritage Bank. This merger was effective on May 1, 2014 and is referred to as the "Washington Banking Merger". The strategic merger is described in more detail in "Note 2 - Business Combination." The Washington Banking results since May 1, 2014 are included in this Quarterly Report on Form 10-Q.

(b) Basis of Presentation

The accompanying unaudited Condensed Consolidated Financial Statements have been prepared in accordance with the accounting principles generally accepted in the United States (“GAAP”) for interim financial information and pursuant to the rules and regulations of the SEC. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. It is recommended that these unaudited Condensed Consolidated Financial Statements and accompanying Notes be read with the audited Consolidated Financial Statements and the accompanying Notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 (“2013 Annual Form 10-K”). In management's opinion, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. In preparing the unaudited Condensed Consolidated Financial Statements, management is required to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, and expenses. Management believes that the judgments, estimates and assumptions used in the preparation of the financial statements are appropriate based on the facts and circumstances at the time. Actual results, however, could differ from those estimates. In particular, estimates related to the allowance for loan losses, other than temporary impairments in the fair value of investment securities, expected cash flows of purchased credit impaired loans and related indemnification asset, fair value measurements, stock-based compensation, impairment of goodwill and other intangible assets and income taxes are especially subject to change.

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

As a result of the Washington Banking Merger, the Company reclassified its loan portfolio. Total loans receivable are now presented in two categories: noncovered loans receivable and covered loans receivable. A description of the categories is included below.

Noncovered Loans Receivable: Noncovered loans are those that are not covered by FDIC shared-loss agreements and can include loans originated by the Company or acquired in mergers and acquisitions. Loans are stated at the unpaid principal balance, net of premiums, unearned discounts and net deferred loan origination fees and costs. The premiums and unearned discounts may include values determined in purchase accounting. The loans purchased in acquisitions included in this category include those accounted for under Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality, or those accounted for under ASC 310-20, Receivables - Nonrefundable Fees and Other Costs.

Covered Loans Receivable: Covered loans are those that are covered by FDIC shared-loss agreements. These include the majority of loans from the Company's acquisition of Cowlitz Bank and certain loans from the Washington Banking Merger, which included loans from Washington Banking's acquisitions of City Bank and North County Bank. The same accounting principles applicable to noncovered loans receivable apply to covered loans receivable, with the added benefit of shared-loss agreements.

(c) Significant Accounting Policies

The significant accounting policies used in preparation of the Company's Condensed Consolidated Financial Statements are disclosed in the 2013 Annual Form 10-K. There have not been any material changes in the Company's significant accounting policies from those contained in the 2013 Annual Form 10-K. As a result of the Washington Banking Merger, the Company has added an additional significant accounting policy which is described below.

Bank Owned Life Insurance: The Company acquired in the Washington Banking Merger fair value of $32.5 million in bank owned life insurance (“BOLI”). These policies insure the lives of certain current officers or former Whidbey officers, and name the Bank as beneficiary. Noninterest income is generated tax-free (subject to certain limitations) from the increase in the policies' underlying investments made by the insurance company. The Bank utilizes BOLI to partially offset costs associated with employee compensation and benefit programs with the earnings on the BOLI. The Company records BOLI at the amount that can be realized under the issuance contract at the statement of financial condition date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

(d) Recently Issued Accounting Pronouncements

FASB ASU 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, A Similar Tax Loss, or a Tax Credit Carryforward Exists, was issued in July 2013. This Update provides that an unrecognized tax benefit, or a portion thereof, be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except to the extent that a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date to settle any additional income taxes that would result from disallowance of a tax position, or the tax law does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, then the unrecognized tax benefit should be presented as a liability. These amendments are effective for interim and annual reporting periods beginning after December 15, 2013. The adoption of this amendment did not have a material impact on the Company's Condensed Consolidated Financial Statements.

FASB ASU 2014-01, Accounting for Investments in Qualified Affordable Housing Projects, was issued in January 2014. The objective of this amendment is to provide guidance on accounting for investments by a reporting entity in flow-through limited liability entities that manage or invest in affordable housing projects that qualify for the low-income housing tax credit. The amendments permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The standard will be effective for the Company beginning January 1, 2015; however, early adoption is permitted. The Company is currently reviewing the provisions of this Update to determine the impacts it may have on the Company’s financial condition or results of operations.

FASB ASU 2014-04, Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure, was issued in January 2014. This Update intends to reduce variations in practice by clarifying when an in-substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The amendment states that the real estate property should be recognized upon either the creditor obtaining legal title or the borrower conveying all interest through a deed in lieu of foreclosure or similar legal agreement. These amendments are effective for interim and annual reporting periods beginning after December 15, 2014. Early adoption is permitted. The Company adopted the

amendments in the first quarter of 2014. The adoption did not have an impact on the Company's Condensed Consolidated Financial Statements.
FASB ASU 2014-09, Revenue from Contracts with Customers, was issued in May 2014. Under this Update, FASB created a new Topic 606 which is in response to a joint initiative of FASB and the International Accounting Standards Board to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP and international financial reporting standards that would:
1. Remove inconsistencies and weaknesses in revenue requirements.

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2. Provide a more robust framework for addressing revenue issues.
3. Improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.
4. Provide more useful information to users of financial statements through improved disclosure requirements.
5. Simplify the preparation of financial statements by reducing the number of requirements to which an entity must refer.

The amendments in this Update are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early application is not permitted. The Company is currently evaluating the impact that this Update will have on its Condensed Consolidated Financial Statements.

FASB ASU 2014-11, Transfers and Servicing: Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures, was issued in June 2014. This Update aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements, such as secured borrowings. The guidance eliminates sale accounting and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement. The amendments in this Update require new and expanded disclosures that are effective for interim or annual reporting periods beginning after December 15, 2014. Early adoption for a public company is prohibited. The Company does not anticipate the adoption of this Update will have a material impact on its Condensed Consolidated Financial Statements.

FASB ASU 2014-14, Receivables - Troubled Debt Restructurings by Creditors: Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure, was issued in August 2014 to reduce the diversity of classification of government-guaranteed mortgages upon foreclosure. The Update requires that mortgage loans be derecognized and that a separate other receivable be recognized upon foreclosure if certain conditions are met. The separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. The amendments in this Update are effective for interim and annual periods beginning after December 15, 2014. Early adoption is permitted. The Company adopted the amendment in the third quarter of 2014. The adoption did not have an impact on the Company's Condensed Consolidated Financial Statements.

(2) Business Combination

On October 23, 2013, the Company, along with the Bank, and Washington Banking and its wholly owned subsidiary bank, Whidbey, jointly announced the signing of a merger agreement for the Washington Banking Merger. The Washington Banking Merger was effective on May 1, 2014. Pursuant to the terms of the Washington Banking Merger, Washington Banking branches adopted the Heritage Bank name in all markets, with the exception of six branches in the Whidbey Island markets which will continue to operate using the Whidbey Island Bank name. The primary reasons for the merger were to expand the Company's geographic footprint consistent with its ongoing growth strategy and to achieve operational scale and realize efficiencies of a larger combined organization.

Under the terms of the merger agreement, Washington Banking shareholders received 0.89000 shares of Heritage common stock and $2.75 in cash for each share of Washington Banking common stock. Based on the closing price of Heritage common stock of $16.16 on April 30, 2014, the fair value of the per share merger consideration paid to Washington Banking shareholders was approximately $224.2 million for 13,870,716 shares issued, net of dissenters who opted to receive cash in leiu of shares. The Company also paid $42.9 million in cash and incurred $489,000 in capitalized stock issuance costs. The terms of the merger agreement also stipulated immediate vesting of the Washington Banking options and restricted stock awards units. The estimated fair value of the 90,358 converted options issued was $481,000. The estimated fair value of the converted 129,462 restricted stock award units, of which 26,783 shares were surrendered at the request of the Washington Banking shareholders to pay applicable taxes, was approximately $2.1 million. The total consideration paid by the Company in conjunction with the Washington Banking Merger was $270.1 million and the total shares issued were 13,973,395.

The transaction qualified as a tax-free reorganization for U.S. federal income tax purposes and Washington Banking shareholders did not recognize any taxable gain or loss in connection with the share exchange and the stock consideration received.

The Washington Banking Merger resulted in $89.5 million of goodwill. This goodwill is not deductible for tax purposes. During the three months ended September 30, 2014, the Company recorded an adjustment to increase goodwill by $722,000 related to a $489,000 correction of the fair value of consumer loans, a $233,000 decrease in the

FDIC indemnification asset, a $252,000 correction of the net receivable from the FDIC for losses on covered assets and a $252,000 change in deferred taxes for these items.

During the three and nine months ended September 30, 2014, the Company incurred Washington Banking merger-related costs (including data conversion costs) of approximately $1.3 million and $7.4 million, respectively. The Company incurred Washington Banking merger-related costs of $234,000 during the three and nine months ended September 30, 2013. The Company also incurred merger-related costs of $238,000 and $1.5 million for the three and nine months ended September 30, 2013, respectively, in connection with the acquisitions of Northwest Commercial Bank and Valley Community Bancshares and in the merger of is subsidiary bank, Central Valley Bank, as discussed in the 2013 Annual Form 10-K.

Business Combination Accounting

The Washington Banking Merger constitutes a business acquisition as defined by FASB ASC 805, Business Combinations. FASB ASC 805 establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired and the liabilities assumed. Heritage was considered the acquirer in the Washington Banking Merger. Accordingly, the preliminary estimates of fair values of the Washington Banking assets, including the identifiable intangible assets, and the assumed liabilities in the Washington Banking Merger were measured and recorded as of May 1, 2014, the effective date of the merger. The Company expects to finalize the purchase price allocation by December 31, 2014 when the valuation of acquired noncovered and covered loans, and related indemnification asset, is complete.

The preliminary fair value estimates of the assets acquired and liabilities assumed in the Washington Banking Merger were as follows:

	May 1, 2014 (In thousands)
Assets	
Cash and cash equivalents	$74,947
Investment securities available for sale	458,312
Loans held for sale	3,923
Noncovered loans receivable	895,978
Covered loans receivable	107,050
FDIC indemnification asset	7,174
Other real estate owned ($5,122 covered by FDIC shared-loss agreements)	7,121
Federal Home Loan Bank stock	7,064
Premises and equipment	31,776
Bank owned life insurance	32,519
Other intangible assets	11,194
Prepaid expenses and other assets	20,137
Total assets acquired	1,657,195
Liabilities	
Deposits	1,433,894
Junior subordinated debentures	18,937
Accrued expenses and other liabilities	23,803
Total liabilities assumed	1,476,634
Net assets acquired	$180,561

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A summary of the net assets purchased, the preliminary estimated fair value adjustments and resulting goodwill recognized from the Washington Banking Merger are presented in the following tables. Goodwill represents the excess of the consideration transferred over the estimated fair value of the net assets acquired and liabilities assumed.

	May 1, 2014
	(In thousands)
Cost basis of net assets on merger date	$181,782
Consideration transferred	(270,107)
Fair value adjustments:	
Noncovered loans receivable	(12,811)
Covered loans receivable	6,384
FDIC indemnification asset	357
Other real estate owned	387
Premises and equipment	(1,540)
Other intangible assets	10,216
Prepaid expenses and other assets	(5,988)
Deposits	(1,738)
Junior subordinated debentures	6,837
Accrued expenses and other liabilities	(3,325)
Goodwill recognized from the Washington Banking Merger	$(89,546)

The operating results of the Company for the three and nine months ended September 30, 2014 include the operating results produced by the net assets acquired in the Washington Banking Merger since the May 1, 2014 effective date of the merger. The Company has considered the requirements of FASB ASC 805 related to the contribution of the Washington Banking Merger to the Company's results of operations. The table below presents the significant results for the Washington Banking Merger since the May 1, 2014 effective date.

	Three Months Ended September 30, 2014	Nine Months Ended September 30, 2014 (1)
	(In thousands)	(In thousands)
Interest income: Interest and fees on loans (2)	$15,785	$24,795
Interest income: Interest and fees on loans (3)	1,916	3,748
Interest income: Securities and other interest earning assets	1,786	3,063
Interest expense	(724)	(1,193)