HERITAGE FINANCIAL CORP /WA/
Form 10-Q
November 05, 2015
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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, 2015

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 27, 2015 there were 29,967,410 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, Inc. 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 and of our bank subsidiary by the Federal Deposit Insurance Corporation ("FDIC"), 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, initiate an enforcement action against the Company or our bank subsidiary which could require us to increase our allowance for loan losses, write-down assets, change our regulatory capital position, affect our ability to borrow funds or maintain or increase deposits, or impose additional requirements on us, any of which could affect our ability to continue our growth through merger, acquisitions or similar transactions and 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 Dodd-Frank Wall Street Reform and Consumer Protection 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, 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 including our Annual Report on Form 10-K for the year ended December 31, 2014.
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 subsidiaries, unless the context otherwise requires.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
September 30, 2015 and December 31, 2014
(Dollars in thousands)
(Unaudited)

	September 30, 2015	December 31, 2014
ASSETS		
Cash on hand and in banks	$58,930	$74,028
Interest earning deposits	83,547	47,608
Cash and cash equivalents	142,477	121,636
Other interest earning deposits	5,244	10,126
Investment securities available for sale, at fair value	703,093	742,846
Investment securities held to maturity (fair value of $34,023 and $36,874, respectively)	32,832	35,814
Loans held for sale	7,981	5,582
Loans receivable, net	2,404,044	2,251,077
Allowance for loan losses	(29,004)	(27,729)
Total loans receivable, net	2,375,040	2,223,348
FDIC indemnification asset	—	1,116
Other real estate owned	2,071	3,355
Premises and equipment, net	63,356	64,938
Federal Home Loan Bank stock, at cost	4,148	12,188
Bank owned life insurance	60,945	35,176
Accrued interest receivable	10,831	9,836
Prepaid expenses and other assets	59,019	61,871
Other intangible assets, net	9,312	10,889
Goodwill	119,029	119,029
Total assets	$3,595,378	$3,457,750
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits	$3,054,198	$2,906,331
Junior subordinated debentures	19,351	19,082
Securities sold under agreement to repurchase	22,829	32,181
Accrued expenses and other liabilities	30,304	45,650
Total liabilities	3,126,682	3,003,244
Stockholders’ equity:		
Preferred stock, no par value, 2,500,000 shares authorized; no shares issued and outstanding at September 30, 2015 and December 31, 2014	—	—
Common stock, no par value, 50,000,000 shares authorized; 29,967,555 and 30,259,838 shares issued and outstanding at September 30, 2015 and December 31, 2014, respectively	358,927	364,741
Retained earnings	104,762	86,387
Accumulated other comprehensive income, net	5,007	3,378
Total stockholders’ equity	468,696	454,506

Total liabilities and stockholders’ equity	$3,595,378	$3,457,750

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
For the Three and Nine Months Ended September 30, 2015 and 2014
(Dollars in thousands, except per share amounts)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
INTEREST INCOME:				
Interest and fees on loans	$30,179	$31,841	$91,213	$75,738
Taxable interest on investment securities	2,187	2,212	7,199	4,663
Nontaxable interest on investment securities	1,056	855	3,137	1,928
Interest and dividends on other interest earning assets	62	123	173	338
Total interest income	33,484	35,031	101,722	82,667
INTEREST EXPENSE:				
Deposits	1,335	1,534	3,961	3,685
Junior subordinated debentures	195	171	627	285
Other borrowings	14	19	50	52
Total interest expense	1,544	1,724	4,638	4,022
Net interest income	31,940	33,307	97,084	78,645
Provision for loan losses	851	594	3,247	1,743
Net interest income after provision for loan losses	31,089	32,713	93,837	76,902
NONINTEREST INCOME:				
Service charges and other fees	3,593	3,524	10,575	7,700
Merchant Visa income, net	66	278	458	839
Change in FDIC indemnification asset	—	(647)	(497)	(575)
Gain (loss) on sale of investment securities, net	393	(13)	1,362	254
Gain on sale of loans, net	1,411	742	3,828	975
Other income	4,081	1,599	9,043	3,377
Total noninterest income	9,544	5,483	24,769	12,570
NONINTEREST EXPENSE:				
Compensation and employee benefits	14,918	15,579	42,984	36,369
Occupancy and equipment	3,970	3,978	11,511	9,412
Data processing	2,398	1,978	5,950	6,977
Marketing	899	841	2,595	1,843
Professional services	894	1,113	2,602	5,173
State and local taxes	619	576	1,808	1,378
Impairment loss on investment securities, net	—	—	—	45
Federal deposit insurance premium	499	403	1,537	1,115
Other real estate owned, net	(5)	650	854	915
Amortization of intangible assets	523	603	1,577	1,248
Other expense	2,607	2,642	8,021	5,661
Total noninterest expense	27,322	28,363	79,439	70,136
Income before income taxes	13,311	9,833	39,167	19,336
Income tax expense	3,819	2,765	11,171	5,577
Net income	$9,492	$7,068	$27,996	$13,759
Basic earnings per common share	$0.32	$0.23	$0.93	$0.57
Diluted earnings per common share	$0.32	$0.23	$0.93	$0.57

Dividends declared per common share	$0.11	$0.09	$0.32	$0.25

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the Three and Nine Months Ended September 30, 2015 and 2014
(Dollars in thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Net income	$9,492	$7,068	$27,996	$13,759
Change in fair value of securities available for sale, net of tax of $1,657, $(744), $1,256 and $663, respectively	3,064	(1,384)	2,324	1,231
Reclassification adjustment for net gain from sale of investment securities included in income, net of tax of $(138), $4, $(478) and $(89), respectively	(255)	8	(884)	(166)
Accretion of other-than-temporary impairment on investment securities, net of tax of $0, $9, $4 and $27, respectively	—	13	11	43
Reclassification of other-than-temporary impairment on securities from sale of investment securities, net of tax $0, $0, $99, $0	—	—	178	—
Other comprehensive income (loss)	2,809	(1,363)	1,629	1,108
Comprehensive income	$12,301	$5,705	$29,625	$14,867

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
For the Nine Months Ended September 30, 2015 and 2014
(In thousands, except per share amounts)
(Unaudited)

	Number of common shares	Common stock	Retained earnings	Accumulated other comprehensive (loss) income, net	Total stock-holders' equity
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
Balance at December 31, 2014	30,260	$364,741	$86,387	$3,378	$454,506
Restricted and unrestricted stock awards issued, net of forfeitures	118	—	—	—	—
Exercise of stock options (including excess tax benefits from nonqualified stock options)	53	686	—	—	686
Restricted stock compensation expense	—	1,125	—	—	1,125
Excess tax benefits from restricted stock	—	105	—	—	105
Common stock repurchased	(464)	(7,730)	—	—	(7,730)
Net income	—	—	27,996	—	27,996
Other comprehensive income, net of tax	—	—	—	1,629	1,629
Cash dividends declared on common stock ($0.32 per share)	—	—	(9,621)	—	(9,621)
Balance at September 30, 2015	29,967	$358,927	$104,762	$5,007	$468,696

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Nine Months Ended September 30, 2015 and 2014
(Dollars in thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2015	2014
Cash flows from operating activities:		
Net income	$27,996	$13,759
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	10,486	9,043
Changes in net deferred loan fees, net of amortization	(1,257)	(1,200)
Provision for loan losses	3,247	1,743
Net change in accrued interest receivable, FDIC indemnification asset, prepaid expenses and other assets, accrued expenses and other liabilities	(4,085)	209
Restricted and unrestricted stock compensation expense	1,125	896
Stock option compensation expense	—	20
Excess tax benefits from stock options and restricted and unrestricted stock	(125)	(60)
Amortization of intangible assets	1,577	1,248
Gain on sale of investment securities, net	(1,362)	(254)
Impairment loss on investment of securities, net	—	45
Origination of loans held for sale	(102,310)	(35,046)
Gain on sale of loans, net	(3,828)	(975)
Proceeds from sale of loans held for sale	103,739	35,303
Earnings on bank owned life insurance	(769)	(241)
Valuation adjustment on other real estate owned	415	—
Loss on sale of other real estate owned, net	94	312
Gain on termination of FDIC shared-loss agreements	(1,747)	—
(Gain) loss on sale or write-off of furniture, equipment and leasehold improvements	(1)	466
Net cash provided by operating activities	33,195	25,268
Cash flows from investing activities:		
Loans originated, net of principal payments	(156,106)	30,363
Maturities of other interest earning deposits	4,836	2,487
Maturities of investment securities available for sale	91,915	37,480
Maturities of investment securities held to maturity	1,897	1,003
Purchase of investment securities available for sale	(158,048)	(251,200)
Purchase of investment securities held to maturity	—	(3,313)
Purchase of premises and equipment	(1,409)	(3,330)
Proceeds from sales of other real estate owned	3,199	5,173
Proceeds from sales of investment securities available for sale	102,937	158,640
Proceeds from sales of investment securities held to maturity	972	—
Proceeds from redemption of Federal Home Loan Bank stock	8,040	442
Proceeds from sale of premises and equipment	10	835
Purchase of bank owned life insurance	(25,000)	—
Investment in new market tax credit partnership	—	(25,000)
Investment in low-income housing tax credit partnership	(442)	—
Net cash used for termination of FDIC shared-loss agreements	(7,110)	—

Net cash received from acquisitions	—	31,564
Net cash used in investing activities	(134,309)	(14,856)

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	Nine Months Ended September 30, 2015	2014
Cash flows from financing activities:		
Net increase in deposits	147,867	69,986
Common stock cash dividends paid	(9,621)	(5,325)
Net (decrease) increase in securities sold under agreement to repurchase	(9,352)	5,970
Proceeds from exercise of stock options	666	766
Excess tax benefits from stock options and restricted and unrestricted stock	125	60
Repurchase of common stock	(7,730)	(2,119)
Net cash provided by financing activities	121,955	69,338
Net increase in cash and cash equivalents	20,841	79,750
Cash and cash equivalents at beginning of period	121,636	130,400
Cash and cash equivalents at end of period	$142,477	$210,150
Supplemental disclosures of cash flow information:		
Cash paid for interest	$4,841	$3,667
Cash paid for income taxes	12,286	11,952
Supplemental non-cash disclosures of cash flow information:		
Transfers of loans receivable to other real estate owned	$2,424	$677
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
Assets acquired (liabilities assumed) in acquisitions:		
Investment securities available for sale	—	458,312
Loans held for sale	—	3,923
Loans receivable	—	895,978
Loans receivable, covered at merger date	—	107,050
Other real estate owned	—	7,121
Premises and equipment	—	31,776
Federal Home Loan Bank stock	—	7,064
FDIC indemnification asset	—	7,174
Accrued interest receivable	—	4,943
Bank owned life insurance	—	32,519
Prepaid expenses and other assets	—	15,194
Other intangible assets	—	11,194
Deposits	—	(1,433,894)
Junior subordinated debentures	—	(18,937)
Accrued expenses and other liabilities	—	(23,803)

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
For the Three and Nine Months Ended September 30, 2015 and 2014
(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 67 branch offices located throughout Washington State and the greater Portland, Oregon area. The Bank’s business consists primarily of commercial 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”) and its wholly owned subsidiary bank, Whidbey Island Bank ("Whidbey"). Effective May 1, 2014, Washington Banking merged with and into Heritage and Whidbey merged with and into Heritage Bank and this transaction is referred to herein as the "Washington Banking Merger". In connection with the Washington Banking Merger, Heritage also acquired as a subsidiary the Washington Banking Master Trust, a Delaware statutory business trust. Pursuant to the merger agreement, Heritage assumed the performance and observance of the covenants to be performed by Washington Banking under an indenture relating to $25.0 million in trust preferred securities issued in 2007 and the due and punctual payment of the principal of and premium and interest on such trust preferred securities. For additional information, see Note (8) Junior Subordinated Debentures.

(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 Securities and Exchange Commission ("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, 2014 (“2014 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, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015. 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, expenses and related disclosures. 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.

Certain prior period amounts have been reclassified to conform to the current period’s presentation. Specifically, the Company has eliminated the classification of "noncovered" and "covered" loans from the Condensed Consolidated Financial Statements based on the termination of the FDIC shared-loss agreements during the three months ended September 30, 2015. For more information on the termination agreement, see Note (5) Indemnification Asset. Accordingly, all loans receivable previously reported as "noncovered" and those previously reported as "covered" by

FDIC shared-loss agreements have been combined and reclassified as "loans receivable" for all periods presented. Reclassifications had no effect on prior periods' net income or stockholders’ equity.

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(c) Significant Accounting Policies

The significant accounting policies used in preparation of the Company's Condensed Consolidated Financial Statements are disclosed in the 2014 Annual Form 10-K. There have not been any material changes in the Company's significant accounting policies from those contained in the 2014 Annual Form 10-K.

(d) Recently Issued Accounting Pronouncements

Financial Accounting Standards Board ("FASB") Accounting Standards Update ("ASU" or "Update") 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:

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

The Update is effective for annual reporting periods beginning after December 15, 2017, 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 Update requires new and expanded disclosures that are effective for interim or annual reporting periods beginning after December 15, 2014, with certain requirements applicable for periods beginning after March 31, 2015. The adoption of this Update did not have a material impact on the Company's Condensed Consolidated Financial Statements.

FASB ASU 2015-14, Revenue from Contracts with Customers, was issued in August 2015 and defers the effective date of the above-mentioned ASU 2014-09 for certain entities. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in Update 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is now permitted, but only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. The Company is a public business entity and will not early adopt as permitted in this Update. The Company is currently evaluating the impact that this Update will have on its Condensed Consolidated Financial Statements upon adoption.

FASB ASU 2015-14, Business Combinations (Topic 805), was issued in September 2015. Topic 805 requires that an acquirer retrospectively adjust provisional amounts recognized in a business combination, during the measurement period. To simplify the accounting for adjustments made to provisional amounts, the Update requires that the acquirer recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amount is determined. The acquirer is required to also record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. In addition, an entity is required to present separately on the face of the income statement or disclose in the notes to the financial statements the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. The Update did not have an impact on the Company's Condensed Consolidated Financial Statements as of September 30, 2015.

(2) Investment Securities

The Company's investment policy is designed primarily to provide and maintain liquidity, generate a favorable return on assets without incurring undue interest rate and credit risk, and complement the Bank's lending activities. Securities are classified as either available for sale or held to maturity when acquired.

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(a) Securities by Type and Maturity

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

	Securities Available for Sale September 30, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
U.S. Treasury and U.S. Government-sponsored agencies	$15,115	$47	$—	$15,162
Municipal securities	186,239	3,797	(267)	189,769
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government-sponsored agencies	482,771	5,000	(807)	486,964
Corporate obligations	9,283	—	(67)	9,216
Mutual funds and other equities	1,965	17	—	1,982
Total	$695,373	$8,861	$(1,141)	$703,093

	Securities Available for Sale December 31, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
U.S. Treasury and U.S. Government-sponsored agencies	$21,414	$44	$(31)	$21,427
Municipal securities	170,082	3,139	(184)	173,037
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government-sponsored agencies	539,859	4,015	(1,475)	542,399
Corporate obligations	4,034	—	(24)	4,010
Mutual funds and other equities	1,956	17	—	1,973
Total	$737,345	$7,215	$(1,714)	$742,846

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

	Securities Held to Maturity September 30, 2015			
	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Fair Value
	(In thousands)			
U.S. Treasury and U.S. Government-sponsored agencies	$1,578	$169	$—	$1,747
Municipal securities	21,362	619	—	21,981
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government-sponsored agencies	9,892	454	(51)	10,295

Total	$32,832	$1,242	$(51)	$34,023

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	Securities Held to Maturity December 31, 2014			
	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Fair Value
	(In thousands)			
U.S. Treasury and U.S. Government-sponsored agencies	$1,591	$167	$—	$1,758
Municipal securities	22,486	643	(11)	23,118
Mortgage backed securities and collateralized mortgage obligations-residential:				
U.S. Government-sponsored agencies	10,866	364	(74)	11,156
Private residential collateralized mortgage obligations	871	75	(104)	842
Total	$35,814	$1,249	$(189)	$36,874

There were no securities classified as trading at September 30, 2015 or December 31, 2014.

The amortized cost and fair value of securities at September 30, 2015, by contractual maturity, are set forth below. Actual maturities may differ from contractual maturities because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	Securities Available for Sale		Securities Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)			
Due in one year or less	$3,527	$3,534	$2,980	$2,989
Due after one year through three years	20,512	20,637	3,617	3,662
Due after three years through five years	41,714	42,327	6,747	7,066
Due after five years through ten years	159,618	162,025	16,370	17,168
Due after ten years	468,037	472,588	3,118	3,138
Investment securities with no stated maturities	1,965	1,982	—	—
Total	$695,373	$703,093	$32,832	$34,023

(b) Unrealized Losses and Other-Than-Temporary Impairments

Available for sale investment securities with unrealized losses as of September 30, 2015 and December 31, 2014 were as follows:

	Securities Available for Sale September 30, 2015					
	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	$30,047	$(260)	$923	$(7)	$30,970	$(267)
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	56,641	(255)	49,605	(552)	106,246	(807)
Corporate obligations	8,221	(54)	995	(13)	9,216	(67)
Total	$94,909	$(569)	$51,523	$(572)	$146,432	$(1,141)

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	Securities Available for Sale December 31, 2014					
	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-sponsored agencies	$3,567	$(31)	$—	$—	$3,567	$(31)
Municipal securities	25,176	(184)	—	—	25,176	(184)
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	182,970	(1,475)	—	—	182,970	(1,475)
Corporate obligations	2,119	(24)	—	—	2,119	(24)
Total	$213,832	$(1,714)	$—	$—	$213,832	$(1,714)

Held to maturity investment securities with unrecognized losses as of September 30, 2015 and December 31, 2014 were as follows:

	Securities Held to Maturity September 30, 2015					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrecognized Losses	Fair Value	Unrecognized Losses	Fair Value	Unrecognized Losses
	(In thousands)					
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	$—	$—	$2,028	$(51)	$2,028	$(51)
Total	$—	$—	$2,028	$(51)	$2,028	$(51)

	Securities Held to Maturity December 31, 2014					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrecognized Losses	Fair Value	Unrecognized Losses	Fair Value	Unrecognized Losses
	(In thousands)					
Municipal securities	$2,196	$(11)	$—	$—	$2,196	$(11)
Mortgage backed securities and collateralized mortgage obligations-residential:						
U.S. Government-sponsored agencies	2,553	(74)	—	—	2,553	(74)
	558	(104)	—	—	558	(104)

Private residential collateralized mortgage obligations						
Total	$5,307	$(189)	$—	$—	$5,307	$(189)

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The Company has evaluated these securities and has determined that the decline in their value is temporary. The unrealized losses are primarily due to increases in market interest rates and larger spreads in the market for mortgage-related products. The fair value of these securities 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 which may be the maturity date of the securities.

During the nine months ended September 30, 2015, the Company sold its entire portfolio of private residential collateralized mortgage obligations with a carrying value of $829,000, all of which were classified as held-to-maturity. Since acquisition, these securities had been downgraded below the Company's acceptable investment grades. As a result of these downgrades and the effects on the risk-weighting of sub-investment grade securities based on the final rule effective in July 2013 of the Federal banking regulators' capital adequacy standards of the Basel Committee on Banking Supervision, commonly called "Basel III", the Company's intent to hold these securities changed and management elected to divest of its interest in the downgraded securities. The Company recorded a realized loss of $125,000 on this sale during the nine months ended September 30, 2015. The Company's intent and ability to hold the remaining held-to-maturity securities was not impacted by this sale.

Prior to the above mentioned sale of the private residential collateralized mortgage obligations, to analyze the unrealized losses, the Company estimated expected future cash flows of these investments by estimating the expected future cash flows of the underlying collateral and applying those collateral cash flows, together with any credit enhancements such as subordinated interests owned by third parties, to the security. The expected future cash flows of the underlying collateral were 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 were 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 average discount rate used in the valuation of the present value as of September 30, 2014 were 6.0% and 9.4%, respectively.

For the nine months ended September 30, 2015, there were no investment securities determined to be other-than-temporarily impaired and the Company recorded no unrealized losses for the nine months ended September 30, 2015 in earnings or other comprehensive income. In comparison, for the nine months ended September 30, 2014, there were four private residential collateralized mortgage obligations determined to be other-than-temporarily impaired. All unrealized losses for the three and nine months ended September 30, 2014 were deemed to be credit related, and the Company recorded the impairment in earnings.

The following table summarizes activity for the nine months ended September 30, 2014 related to the amount of impairments on held to maturity securities. There were no initial or subsequent impairments recorded during the nine months ended September 30, 2015.

	Life-to-Date Gross Other-Than-Temporary Impairments (1)	Life-to-Date Other-Than-Temporary Impairments Included in Other Comprehensive Income	Life-to-Date Net Other-Than-Temporary Impairments Included in Earnings
	(In thousands)		
December 31, 2013	$2,603	$1,152	$1,451
Subsequent impairments	45	—	45
September 30, 2014	$2,648	$1,152	$1,496

(1) Life-to-date gross other-than-temporary impairments disclosed in this table are not reflective of subsequent recoveries, if any. As of September 30, 2015, the Company had no securities with other-than-temporary impairments because all such securities were sold as of September 30, 2015.

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(c) Pledged Securities

The following table summarizes the amortized cost and fair value of available for sale and held to maturity securities that are pledged as collateral for the following obligations at September 30, 2015 and December 31, 2014:

	September 30, 2015		December 31, 2014	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)			
Washington and Oregon state to secure public deposits	$218,478	$222,564	$150,507	$153,785
Federal Reserve Bank of San Francisco and Federal Home Loan Bank to secure borrowing arrangements	509	510	4,430	4,460
Repurchase agreements	29,712	30,111	43,676	44,457
Other securities pledged	2,136	2,173	14,828	14,922
Total	$250,835	$255,358	$213,441	$217,624

At September 30, 2015 and December 31, 2014, the total carrying value of pledged securities was $254.2 million and $216.7 million, respectively.

(3) Loans Receivable

The Company originates loans in the ordinary course of business and has also acquired loans through FDIC-assisted and open bank transactions.

Loans acquired in a business combination may be further classified as “purchased” loans. Loans purchased with evidence of credit deterioration since origination for which it is probable that not all contractually required payments will be collected are accounted for under FASB Accounting Standards Codification ("ASC") 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality. These loans are identified as “purchased credit impaired” ("PCI") loans. Loans purchased that are not accounted for under FASB ASC 310-30 are accounted for under FASB ASC 310-20, Receivables—Nonrefundable Fees and Other Costs and are referred to as "non-PCI" loans.

On August 4, 2015, the Company signed an agreement with the FDIC to terminate the shared-loss agreements. As a result, the Company eliminated the designation of "covered" and "noncovered" loans from current and all prior periods. All loans, including purchased loans, are included in the "loans receivable" classification. For additional information on the termination agreement with the FDIC, see Note (5) FDIC Indemnification Asset.

(a) Loan Origination/Risk Management

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

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

Commercial Business:

There are three significant classes of loans in the commercial portfolio segment: commercial and industrial loans, owner-occupied commercial real estate and non-owner occupied commercial real estate. The owner and non-owner occupied commercial real estate are both considered commercial real estate loans. As the commercial and industrial loans carry different risk characteristics than the commercial real estate loans, they are discussed separately below.

Commercial and industrial. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and

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industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may include a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

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

One-to-Four Family Residential:

The majority of the Company’s one-to-four family residential loans are secured by single-family residences located in its primary market areas. The Company’s underwriting standards require that single-family portfolio loans generally are owner-occupied and do not exceed 80% of the lower of appraised value at origination or cost of the underlying collateral. Terms of maturity typically range from 15 to 30 years. Historically, the Company sold most single-family loans in the secondary market and retained a smaller portion in its loan portfolio. From the second quarter of 2013 until May 1, 2014, the Company only originated single-family loans for its loan portfolio. As a result of the Washington Banking Merger, since May 1, 2014 the Company is originating and selling a majority of its single-family mortgages.

Real Estate Construction and Land Development:

The Company originates construction loans for one-to-four family residential and for five or more family residential and commercial properties. The one-to-four family residential construction loans generally include construction of custom homes whereby the home buyer is the borrower. The Company also provides financing to builders for the construction of pre-sold homes and, in selected cases, to builders for the construction of speculative residential property. Substantially all construction loans are short-term in nature and priced with variable rates of interest. Construction lending can involve a higher level of risk than other types of lending because funds are advanced partially based upon the value of the project, which is uncertain prior to the project’s completion. Because of the uncertainties inherent in estimating construction costs as well as the market value of a completed project and the effects of governmental regulation of real property, the Company’s estimates with regard 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 if the borrower does not repay the loan. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being dependent upon successful completion of the construction project, interest rate changes, government regulation of real property, general economic conditions and the availability of long-term financing.

Consumer:

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

As a result of the Washington Banking Merger, the Company began originating indirect consumer loans. These loans are for new and used automobile and recreational vehicles that are originated indirectly by selected dealers located in the Company's market areas. The Company has limited its purchase of indirect loans primarily to dealerships that are established and well known in their market areas and to applicants that are not classified as sub-prime.

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Loans receivable at September 30, 2015 and December 31, 2014 consisted of the following portfolio segments and classes:

	September 30, 2015	December 31, 2014
	(In thousands)	
Commercial business:		
Commercial and industrial	$618,390	$570,453
Owner-occupied commercial real estate	603,372	594,986
Non-owner occupied commercial real estate	703,771	643,636
Total commercial business	1,925,533	1,809,075
One-to-four family residential	70,577	69,530
Real estate construction and land development:		
One-to-four family residential	49,745	49,195
Five or more family residential and commercial properties	73,328	64,920
Total real estate construction and land development	123,073	114,115
Consumer	284,541	259,294
Gross loans receivable	2,403,724	2,252,014
Net deferred loan costs (fees)	320	(937)
Loans receivable, net	2,404,044	2,251,077
Allowance for loan losses	(29,004)	(27,729)
Total loans receivable, net	$2,375,040	$2,223,348

(b) Concentrations of Credit

Most of the Company’s lending activity occurs within Washington State, and to a lesser extent Oregon. The Company’s primary market areas are concentrated along the I-5 corridor from Whatcom County to Clark County in Washington State and Multnomah County in Oregon, as well as other contiguous markets. The Washington Banking Merger allowed the expansion of the Company's market area north of Seattle, Washington to the Canadian border. The majority of the Company’s loan portfolio consists of (in order of balances at September 30, 2015) non-owner occupied commercial real estate, commercial and industrial and owner-occupied commercial real estate. As of September 30, 2015 and December 31, 2014, there were no concentrations of loans related to any single industry in excess of 10% of the Company’s total loans.

(c) Credit Quality Indicators

As part of the on-going monitoring of the credit quality of the Company’s loan portfolio, management tracks certain credit quality indicators including trends related to (i) the risk grade of the loans, (ii) the level of classified loans, (iii) net charge-offs, (iv) nonperforming loans, and (v) the general economic conditions of the United States of America, and specifically the states of Washington and Oregon. The Company utilizes a risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 0 to 10. A description of the general characteristics of the risk grades is as follows:

- Grades 0 to 5: These grades are considered “pass grade” and include loans with negligible to above average but acceptable risk. These borrowers generally have strong to acceptable capital levels and consistent earnings and debt service capacity. Loans with the higher grades within the “pass” category may include borrowers who are experiencing unusual operating difficulties, but have acceptable payment performance to date. Increased monitoring of financials and/or collateral may be appropriate. Loans with this grade show no immediate loss exposure.
- Grade 6: This grade includes "Watch" loans and is considered a “pass grade”. The grade is intended to be utilized on a temporary basis for pass grade borrowers where a potentially significant risk-modifying action is anticipated in the near term.
- Grade 7: This grade includes “Other Assets Especially Mentioned” (“OAEM”) loans in accordance with regulatory guidelines, and is intended to highlight loans with elevated risks. Loans with this grade show signs of deteriorating profits and capital, and the borrower might not be strong enough to sustain

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a major setback. The borrower is typically higher than normally leveraged, and outside support might be modest and likely illiquid. The loan is at risk of further decline unless active measures are taken to correct the situation.

- Grade 8: This grade includes “Substandard” loans in accordance with regulatory guidelines, which the Company has determined have a high credit risk. These loans also have well-defined weaknesses which make payment default or principal exposure likely, but not yet certain. The borrower may have shown serious negative trends in financial ratios and performance. Such loans may be dependent upon collateral liquidation, a secondary source of repayment or an event outside of the normal course of business. Loans with this grade can be placed on accrual or nonaccrual status based on the Company’s accrual policy.
- Grade 9: This grade includes “Doubtful” loans in accordance with regulatory guidelines, and the Company has determined these loans to have excessive credit risk. Such loans are placed on nonaccrual status and may be dependent upon collateral having a value that is difficult to determine or upon some near-term event which lacks certainty. Additionally, these loans generally have a specific valuation allowance or have been partially charged-off for the amount considered uncollectible.
- Grade 10: This grade includes “Loss” loans in accordance with regulatory guidelines, and the Company has determined these loans have the highest risk of loss. Such loans are charged-off or charged-down when payment is acknowledged to be uncertain or when the timing or value of payments cannot be determined. “Loss” is not intended to imply that the loan or some portion of it will never be paid, nor does it in any way imply that there has been a forgiveness of debt.

Numerical loan grades for all commercial business loans and real estate construction and land development loans are established at the origination of the loan. Prior to November 2014, one-to-four family residential loans and consumer loans (“non-commercial loans”) were not numerically graded at origination date as these loans were determined to be “pass graded” loans. A numeric grade was assigned to these non-commercial loans if subsequent to origination, the credit department evaluated the credit and determined it necessary to classify the loan. Subsequent to November 2014, non-commercial loans were designated a loan grade “4” at origination date to reflect a "pass grade". The Bank follows the FDIC’s Uniform Retail Credit Classification and Account Management Policy for subsequent classification in the event of payment delinquencies or default. Loan grades are reviewed on a quarterly basis, or more frequently if necessary, by the credit department. Typically, an individual loan grade will not be changed from the prior period unless there is a specific indication of credit deterioration or improvement. Credit deterioration is evidenced by delinquency, direct communications with the borrower, or other borrower information that becomes known to management. Credit improvements are evidenced by known facts regarding the borrower or the collateral property.

The loan grades relate to the likelihood of losses in that the higher the grade, the greater the loss potential. Loans with a pass grade may have some estimated inherent losses, but to a lesser extent than the other loan grades. The OAEM loan grade is transitory in that the Company is waiting on additional information to determine the likelihood and extent of the potential loss. The likelihood of loss for OAEM graded loans, however, is greater than Watch graded loans because there has been measurable credit deterioration. Loans with a Substandard grade are generally loans for which the Company has individually analyzed for potential impairment. For Doubtful and Loss graded loans, the Company is almost certain of the losses, and the unpaid principal balances are generally charged-off to the realizable value.

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The following tables present the balance of the loans receivable by credit quality indicator as of September 30, 2015 and December 31, 2014.

	September 30, 2015				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	$584,337	$9,906	$23,839	$308	$618,390
Owner-occupied commercial real estate	571,283	11,955	19,878	256	603,372
Non-owner occupied commercial real estate	654,621	17,695	30,310	1,145	703,771
Total commercial business	1,810,241	39,556	74,027	1,709	1,925,533
One-to-four family residential	68,441	—	2,136	—	70,577
Real estate construction and land development:					
One-to-four family residential	40,356	1,361	8,028	—	49,745
Five or more family residential and commercial properties	68,633	—	4,695	—	73,328
Total real estate construction and land development	108,989	1,361	12,723	—	123,073
Consumer	276,929	4	7,608	—	284,541
Gross loans receivable	$2,264,600	$40,921	$96,494	$1,709	$2,403,724

	December 31, 2014				
	Pass	OAEM	Substandard	Doubtful	Total
	(In thousands)				
Commercial business:					
Commercial and industrial	$520,780	$14,618	$32,491	$2,564	$570,453
Owner-occupied commercial real estate	536,591	27,903	30,145	347	594,986
Non-owner occupied commercial real estate	593,918	17,683	32,035	—	643,636
Total commercial business	1,651,289	60,204	94,671	2,911	1,809,075
One-to-four family residential	66,599	740	2,191	—	69,530
Real estate construction and land development:					
One-to-four family residential	36,534	3,977	8,684	—	49,195
Five or more family residential and commercial properties	58,783	—	6,137	—	64,920
Total real estate construction and land development	95,317	3,977	14,821	—	114,115
Consumer	249,866	—	9,428	—	259,294
Gross loans receivable	$2,063,071	$64,921	$121,111	$2,911	$2,252,014

Potential problem loans are loans classified as OAEM, Substandard, Doubtful and Loss that are currently accruing interest and are not considered impaired, but which management is monitoring because the financial information of the borrower causes concern as to their ability to meet their loan repayment terms. Potential problem loans also include PCI loans as these loans continue to accrete loan discounts established at acquisition based on the guidance of

ASC 310-30. Potential problem loans as of September 30, 2015 and December 31, 2014 were $113.3 million and $162.9 million, respectively. The balance of potential problem loans guaranteed by a governmental agency, which guarantee reduces the Company's credit exposure, was $920,000 and $2.0 million as of September 30, 2015 and December 31, 2014, respectively.

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(d) Nonaccrual Loans

Nonaccrual loans, segregated by segments and classes of loans, were as follows as of September 30, 2015 and December 31, 2014:

	September 30, 2015	December 31, 2014
	(In thousands)	
Commercial business:		
Commercial and industrial	$4,387	$5,784
Owner-occupied commercial real estate	2,806	2,295
Non-owner occupied commercial real estate	—	517
Total commercial business	7,193	8,596
One-to-four family residential	40	—
Real estate construction and land development:		
One-to-four family residential	2,612	2,831
Total real estate construction and land development	2,612	2,831
Consumer	62	145
Gross nonaccrual loans	$9,907	$11,572

The Company had $1.4 million and $1.6 million of nonaccrual loans guaranteed by governmental agencies at September 30, 2015 and December 31, 2014, respectively.

PCI loans are not included in the nonaccrual loan table above because these loans are accounted for under ASC 310-30, which provides that accretable yield is calculated based on a loan's expected cash flow even if the loan is not performing under its conventional terms.

(e) Past due loans

The Company performs an aging analysis of past due loans using the categories of 30-89 days past due and 90 or more days past due. This policy is consistent with regulatory reporting requirements.

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The balances of past due loans, segregated by segments and classes of loans, as of September 30, 2015 and December 31, 2014 were as follows:

	September 30, 2015					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing (1)
	(In thousands)					
Commercial business:						
Commercial and industrial	$1,789	$1,789	$3,578	$614,812	$618,390	$ —
Owner-occupied commercial real estate	1,806	2,244	4,050	599,322	603,372	—
Non-owner occupied commercial real estate	1,664	183	1,847	701,924	703,771	—
Total commercial business	5,259	4,216	9,475	1,916,058	1,925,533	—
One-to-four family residential	—	—	—	70,577	70,577	—
Real estate construction and land development:						
One-to-four family residential	636	2,350	2,986	46,759	49,745	—
Five or more family residential and commercial properties	415	42	457	72,871	73,328	—
Total real estate construction and land development	1,051	2,392	3,443	119,630	123,073	—
Consumer	1,966	159	2,125	282,416	284,541	—
Gross loans receivable	$8,276	$6,767	$15,043	$2,388,681	$2,403,724	$ —

(1) Excludes PCI loans.

	December 31, 2014					
	30-89 Days	90 Days or Greater	Total Past Due	Current	Total	90 Days or More and Still Accruing (1)
	(In thousands)					
Commercial business:						
Commercial and industrial	$4,765	$3,125	$7,890	$562,563	$570,453	$ —
Owner-occupied commercial real estate	1,683	2,780	4,463	590,523	594,986	—
Non-owner occupied commercial real estate	1,826	531	2,357	641,279	643,636	—
Total commercial business	8,274	6,436	14,710	1,794,365	1,809,075	—
One-to-four family residential	312	—	312	69,218	69,530	—
Real estate construction and land development:						
One-to-four family residential	240	2,225	2,465	46,730	49,195	—
Five or more family residential and commercial properties	—	596	596	64,324	64,920	—
Total real estate construction and land development	240	2,821	3,061	111,054	114,115	—
Consumer	2,676	852	3,528	255,766	259,294	—
Gross loans receivable	$11,502	$10,109	$21,611	$2,230,403	$2,252,014	$ —

(1) Excludes PCI loans.

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(f) Impaired loans
Impaired loans include nonaccrual loans and performing troubled debt restructured loans ("TDRs"). The table below excludes $11.7 million and $10.4 million, respectively, as of September 30, 2015 and December 31, 2014, of certain performing TDR loans classified as PCI loans. The majority of these loans have remaining fair value discounts compared to outstanding principal balances and may not have further impairment. The balance of impaired loans as of September 30, 2015 and December 31, 2014 are set forth in the following tables.

	September 30, 2015				
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance
	(In thousands)				
Commercial business:					
Commercial and industrial	$1,168	$7,675	$8,843	$10,953	$943
Owner-occupied commercial real estate	—	5,150	5,150	5,233	1,016
Non-owner occupied commercial real estate	3,720	6,854	10,574	10,581	968
Total commercial business	4,888	19,679	24,567	26,767	2,927
One-to-four family residential	—	277	277	278	86
Real estate construction and land development:					
One-to-four family residential	2,549	1,150	3,699	4,327	39
Five or more family residential and commercial properties	—	1,984	1,984	1,984	196
Total real estate construction and land development	2,549	3,134	5,683	6,311	235
Consumer	—	164	164	168	32
Total	$7,437	$23,254	$30,691	$33,524	$3,280

	December 31, 2014				
	Recorded Investment With No Specific Valuation Allowance	Recorded Investment With Specific Valuation Allowance	Total Recorded Investment	Unpaid Contractual Principal Balance	Related Specific Valuation Allowance
	(In thousands)				
Commercial business:					
Commercial and industrial	$3,374	$8,000	$11,374	$13,045	$1,334
Owner-occupied commercial real estate	360	3,553	3,913	3,937	979
Non-owner occupied commercial real estate	2,459	5,270	7,729	7,719	531
Total commercial business	6,193	16,823	23,016	24,701	2,844
One-to-four family residential	—	245	245	245	75
Real estate construction and land development:					

One-to-four family residential	2,307	2,396	4,703	5,146	447
Five or more family residential and commercial properties	—	2,056	2,056	2,056	234
Total real estate construction and land development	2,307	4,452	6,759	7,202	681
Consumer	33	178	211	216	58
Total	$8,533	$21,698	$30,231	$32,364	$3,658

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The Company had governmental guarantees of $1.8 million and $2.4 million related to the impaired loan balances at September 30, 2015 and December 31, 2014, respectively.

The average recorded investment of impaired loans for the three and nine months ended September 30, 2015 and 2014 are set forth in the following table.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(In thousands)			
Commercial business:				
Commercial and industrial	$8,692	$15,296	$10,776	$15,115
Owner-occupied commercial real estate	4,882	3,811	4,151	3,500
Non-owner occupied commercial real estate	10,256	8,525	8,893	7,960
Total commercial business	23,830	27,632	23,820	26,575
One-to-four family residential	259	573	315	692
Real estate construction and land development:				
One-to-four family residential	3,639	5,689	4,312	5,640
Five or more family residential and commercial properties	1,997	2,091	2,032	2,178
Total real estate construction and land development	5,636	7,780	6,344	7,818
Consumer	159	970	329	930
Total	$29,884	$36,955	$30,808	$36,015

For the three and nine months ended September 30, 2015 and 2014, no interest income was recognized subsequent to a loan's classification as nonaccrual. For the three months ended September 30, 2015 and 2014, the Bank recorded $278,000 and $188,000, respectively, of interest income related to performing TDR loans. For the nine months ended September 30, 2015 and 2014, the Bank recorded $905,000 and $721,000, respectively, of interest income related to performing TDR loans.

(g) Troubled Debt Restructured Loans

A troubled debt restructured loan is a restructuring in which the Bank, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. TDRs are considered impaired and are separately measured for impairment under FASB ASC 310-10-35, "Receivables - Overall - Subsequent Measurement," whether on accrual ("performing") or nonaccrual ("nonperforming") status.

The majority of the Bank's TDR loans are a result of granting extensions of maturity on troubled credits which have already been adversely classified. The Bank grants such extensions to reassess the borrower's financial status and to develop a plan for repayment. Certain modifications with extensions also include interest rate reductions, which is the second most prevalent concession. Certain TDRs were additionally re-amortized over a longer period of time. The Bank also advanced funds to a troubled speculative home builder to complete established projects. These modifications would all be considered a concession for a borrower that could not obtain similar financing terms from another source other than from the Bank.

The financial effects of each modification will vary based on the specific restructure. For the majority of the Bank's TDRs, the loans were interest-only with a balloon payment at maturity. If the interest rate is not adjusted and the modified terms are consistent with other similar credits being offered, the Bank may not experience any loss associated with the restructure. If, however, the restructure involves forbearance agreements or interest rate modifications, the Bank may not collect all the principal and interest based on the original contractual terms. The Bank estimates the necessary allowance for loan losses on TDRs using the same guidance as used for other impaired loans.

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The recorded investment balance and related allowance for loan losses of performing and nonaccrual TDR loans as of September 30, 2015 and December 31, 2014 were as follows:

	September 30, 2015		December 31, 2014	
	Performing TDRs	Nonaccrual TDRs	Performing TDRs	Nonaccrual TDRs
	(In thousands)			
TDR loans	$32,460	$6,639	$29,053	$7,256
Allowance for loan losses on TDR loans	2,033	655	1,908	1,035

The unfunded commitment to borrowers related to TDRs was $585,000 and $1.8 million at September 30, 2015 and December 31, 2014, respectively.

Loans that were modified as TDRs during the three and nine months ended September 30, 2015 and 2014 are set forth in the following tables:

	Three Months Ended September 30,			
	2015		2014	
	Number of Contracts (1)	Outstanding Principal Balance (1)(2)	Number of Contracts (1)	Outstanding Principal Balance (1)(2)
	(Dollars in thousands)			
Commercial business:				
Commercial and industrial	10	$3,598	16	$3,108
Owner-occupied commercial real estate	2	1,102	1	180
Non-owner occupied commercial real estate	1	1,082	—	—
Total commercial business	13	5,782	17	3,288
One-to-four family residential	0	—	—	—
Real estate construction and land development:				
One-to-four family residential	2	1,087	4	1,223
Total real estate construction and land development	2	1,087	4	1,223
Consumer	—	—	1	68
Total TDR loans	15	$6,869	22	$4,579

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	Nine Months Ended September 30,			
	2015		2014	
	Number of Contracts (1)	Outstanding Principal Balance (1)(2)	Number of Contracts (1)	Outstanding Principal Balance (1)(2)
	(Dollars in thousands)			
Commercial business:				
Commercial and industrial	29	$6,443	20	$7,730
Owner-occupied commercial real estate	7	2,201	2	523
Non-owner occupied commercial real estate	6	15,634	2	1,020
Total commercial business	42	24,278	24	9,273
Real estate construction and land development:				
One-to-four family residential	6	2,681	5	1,406
Five or more family residential and commercial properties	1	415	—	—
Total real estate construction and land development	7	3,096	5	1,406
Consumer	2	144	4	284
Total TDR loans	51	$27,518	33	$10,963

(1) Number of contracts and outstanding principal balance represent loans which have balances as of period end as certain loans may have been paid-down or charged-off during the three and nine months ended September 30, 2015 and 2014.

(2) Includes subsequent payments after modifications and reflects the balance as of period end. As the Bank did not forgive any principal or interest balance as part of the loan modification, the Bank’s recorded investment in each loan at the date of modification (pre-modification) did not change as a result of the modification (post-modification), except when the modification was the initial advance on a one-to-four family residential real estate construction and land development loan under a master guidance line. There were no advances on these types of loans during the three and nine months ended September 30, 2015 and the three months ended September 30, 2014. During the nine months ended September 30, 2014, the Company's initial advance at the time of modification on these construction loans totaled $45,000 and the total commitment amount was $190,000.

Of the 15 loans modified during the three months ended September 30, 2015, and the 51 loans modified during the nine months ended September 30, 2015, six loans with a total outstanding principal balance of $2.3 million had no prior modifications. The remaining loans included in the tables above for the three and nine months ended September 30, 2015 were previously reported as TDRs. The Bank typically grants shorter extension periods to continually monitor the troubled credits despite the fact that the extended date might not be the date the Bank expects the cash flow. The Company does not consider these modifications a subsequent default of a TDR as new loan terms, specifically maturity dates, were granted. The potential losses related to these loans would have been considered in the period the loan was first reported as a TDR and adjusted, as necessary, in the current periods based on more recent information. The related specific valuation allowance at September 30, 2015 for loans that were modified as TDRs during the three and nine months ended September 30, 2015 was $416,000 and $1.6 million, respectively.

The loans modified during the previous twelve months ended September 30, 2015 and 2014 that subsequently defaulted during the three and nine months ended September 30, 2015 and 2014 are included in the following tables:

	Three Months Ended September 30,			
	2015		2014	
	Number of Contracts	Outstanding Principal Balance	Number of Contracts	Outstanding Principal Balance

	(Dollars in thousands)			
Commercial business:				
Commercial and industrial	1	$98	3	$775
Non-owner occupied commercial real estate	—	—	2	77
Total commercial business	1	98	5	852
Total	1	$98	5	$852

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	Nine Months Ended September 30,			
	2015		2014	
	Number of Contracts	Outstanding Principal Balance	Number of Contracts	Outstanding Principal Balance
	(Dollars in thousands)			
Commercial business:				
Commercial and industrial	2	$1,858	3	$775
Non-owner occupied commercial real estate	—	—	2	77
Total commercial business	2	1,858	5	852
Total	2	$1,858	5	$852

There was one commercial and industrial loan of $1.8 million at September 30, 2015 that was modified during the previous twelve months and subsequently defaulted during the nine months ended September 30, 2015 because the borrower did not make specific curtailment, or additional, payments on the the loan in prior periods, but for which the required payment was made during the three months ended September 30, 2015. All other loans included in the tables above for both periods defaulted as the loans were greater than 90 days past due. The Bank had a specific valuation allowance of $177,000 at September 30, 2015 related to the credits which defaulted during the nine months ended September 30, 2015.

(h) Purchased Credit Impaired Loans

The Company acquired PCI loans in the Washington Banking Merger and in previously completed acquisitions which are accounted for under FASB ASC 310-30. These previous acquisitions include the FDIC-assisted acquisitions of Cowlitz Bank ("Cowlitz") and Pierce Commercial Bank ("Pierce") on July 30, 2010 and November 8, 2010, respectively. In addition, the Company completed the acquisitions of Northwest Commercial Bank ("NCB") on January 9, 2013 and Valley Community Bancshares, Inc. ("Valley") on July 15, 2013.

The following table reflects the outstanding principal balance and recorded investment at September 30, 2015 and December 31, 2014 of the PCI loans:

	September 30, 2015		December 31, 2014	
	Outstanding Principal	Recorded Investment	Outstanding Principal	Recorded Investment
	(In thousands)			
Commercial business:				
Commercial and industrial	$21,168	$15,721	$31,779	$25,174
Owner-occupied commercial real estate	27,397	24,729	41,236	36,874
Non-owner occupied commercial real estate	32,227	30,960	33,291	31,442
Total commercial business	80,792	71,410	106,306	93,490
One-to-four family residential	5,456	5,149	6,106	5,713
Real estate construction and land development:				
One-to-four family residential	7,256	4,379	8,559	5,531
Five or more family residential and commercial properties	3,104	3,231	4,861	4,765
Total real estate construction and land development	10,360	7,610	13,420	10,296
Consumer	6,914	7,989	8,928	9,772
Gross PCI loans	$103,522	$92,158	$134,760	$119,271

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

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The following table summarizes the accretable yield on the PCI loans resulting from the Cowlitz, Pierce, NCB, and Valley acquisitions and the Washington Banking Merger for the three and nine months ended September 30, 2015 and 2014.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(In thousands)			
Balance at the beginning of the period	$18,731	$27,320	$21,092	$17,249
Accretion	(1,661)	(2,254)	(5,399)	(5,989)
Disposal and other	22	(2,756)	(2,382)	(4,527)
Change in accretable yield	1,586	723	5,367	16,300
Balance at the end of the period	$18,678	$23,033	$18,678	$23,033

(4) Allowance for Loan Losses

The allowance for loan losses is maintained at a level deemed appropriate by management to provide for probable incurred credit losses in the loan portfolio. The allowance has three components, including a specific valuation allowance for impaired loans, a general allowance for non-impaired loans, and an allowance for PCI loans.

Prior to the termination of the FDIC shared-loss agreements on August 4, 2015 and when credit deterioration occurred subsequent to the acquisition dates, a provision for loan losses was charged to earnings for the full amount of the impairment without regard to the coverage of the FDIC shared-loss agreements for the once covered loans acquired in the Cowlitz acquisition and Washington Banking Merger (including Washington Banking's prior acquisitions of City Bank and North County Bank).

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The following tables detail activity in the allowance for loan losses disaggregated by segment and class for the three and nine months ended September 30, 2015:

	Balance at Beginning of Period	Charge-offs	Recoveries	Provision for Loan Losses	Balance at End of Period
	(In thousands)				
Three Months Ended September 30, 2015					
Commercial business:					
Commercial and industrial	$9,891	$(70)	$59	$494	$10,374
Owner-occupied commercial real estate	4,587	—	—	(296)	4,291
Non-owner occupied commercial real estate	6,146	—	—	592	6,738
Total commercial business	20,624	(70)	59	790	21,403
One-to-four family residential	1,271	—	12	(88)	1,195
Real estate construction and land development:					
One-to-four family residential	1,462	—	—	79	1,541
Five or more family residential and commercial properties	1,062	—	—	(20)	1,042
Total real estate construction and land development	2,524	—	—	59	2,583
Consumer	3,167	(278)	152	174	3,215
Unallocated	692	—	—	(84)	608
Total	$28,278	$(348)	$223	$851	$29,004
Nine Months Ended September 30, 2015					
Commercial business:					
Commercial and industrial	$10,553	$(1,392)	$447	$766	$10,374
Owner-occupied commercial real estate	4,095	—	—	196	4,291
Non-owner occupied commercial real estate	5,538	(188)	—	1,388	6,738
Total commercial business	20,186	(1,580)	447	2,350	21,403
One-to-four family residential	1,200	—	13	(18)	1,195
Real estate construction and land development:					
One-to-four family residential	1,786	(106)	100	(239)	1,541
Five or more family residential and commercial properties	972	—	—	70	1,042
Total real estate construction and land development	2,758	(106)	100	(169)	2,583
Consumer	2,769	(1,208)	362	1,292	3,215
Unallocated	816	—	—	(208)	608
Total	$27,729	$(2,894)	$922	$3,247	$29,004

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The following table details the balance in the allowance for loan losses disaggregated on the basis of the Company's impairment method as of September 30, 2015.

	Loans individually evaluated for impairment	Loans collectively evaluated for impairment	PCI loans	Total Allowance for Loan Losses
	(In thousands)			
Commercial business:				
Commercial and industrial	$943	$6,711	$2,720	$10,374
Owner-occupied commercial real estate	1,016	1,780	1,495	4,291
Non-owner occupied commercial real estate	968	3,431	2,339	6,738
Total commercial business	2,927	11,922	6,554	21,403
One-to-four family residential	86	584	525	1,195
Real estate construction and land development:				
One-to-four family residential	39	492	1,010	1,541
Five or more family residential and commercial properties	196	755	91	1,042
Total real estate construction and land development	235	1,247	1,101	2,583
Consumer	32	2,293	890	3,215
Unallocated	—	608	—	608
Total	$3,280	$16,654	$9,070	$29,004

The following table details the recorded investment balance of the loan receivables disaggregated on the basis of the Company's impairment method as of September 30, 2015:

	Loans individually evaluated for impairment	Loans collectively evaluated for impairment	PCI loans	Total Gross Loans Receivable
	(In thousands)			
Commercial business:				
Commercial and industrial	$8,843	$593,826	$15,721	$618,390
Owner-occupied commercial real estate	5,150	573,493	24,729	603,372
Non-owner occupied commercial real estate	10,574	662,237	30,960	703,771
Total commercial business	24,567	1,829,556	71,410	1,925,533
One-to-four family residential	277	65,151	5,149	70,577
Real estate construction and land development:				
One-to-four family residential	3,699	41,667	4,379	49,745
Five or more family residential and commercial properties	1,984	68,113	3,231	73,328
Total real estate construction and land development	5,683	109,780	7,610	123,073
Consumer	164	276,388	7,989	284,541
Total	$30,691	$2,280,875	$92,158	$2,403,724

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The following tables detail activity in the allowance for loan losses disaggregated by segment and class for the three and nine months ended September 30, 2014.

	Balance at Beginning of Period	Charge-offs	Recoveries	Provision for Loan Losses	Balance at End of Period
	(In thousands)				
Three Months Ended September 30, 2014					
Commercial business:					
Commercial and industrial	$11,304	$(309)	$43	$234	$11,272
Owner-occupied commercial real estate	4,200	(128)		(9)	4,063
Non-owner occupied commercial real estate	5,685	(72)	—	163	5,776
Total commercial business	21,189	(509)	43	388	21,111
One-to-four family residential	1,155	—	—	200	1,355
Real estate construction and land development:					
One-to-four family residential	1,533	—	—	235	1,768
Five or more family residential and commercial properties	1,630	—	—	(926)	704
Total real estate construction and land development	3,163	—	—	(691)	2,472
Consumer	2,175	(315)	46	884	2,790
Unallocated	801	—	—	(187)	614
Total	$28,483	$(824)	$89	$594	$28,342
Nine Months Ended September 30, 2014					
Commercial business:					
Commercial and industrial	$13,478	$(1,791)	$544	$(959)	$11,272
Owner-occupied commercial real estate	4,049	(128)		142	4,063
Non-owner occupied commercial real estate	5,326	(72)	—	522	5,776
Total commercial business	22,853	(1,991)	544	(295)	21,111
One-to-four family residential	1,100	—	—	255	1,355
Real estate construction and land development:					
One-to-four family residential	1,720	(345)	43	350	1,768
Five or more family residential and commercial properties	953	—	—	(249)	704
Total real estate construction and land development	2,673	(345)	43	101	2,472
Consumer	1,597	(557)	81	1,669	2,790
Unallocated	601	—	—	13	614
Total	$28,824	$(2,893)	$668	$1,743	$28,342

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The following table details the balance in the allowance for loan losses disaggregated on the basis of the Company's impairment method as of December 31, 2014.

	Loans individually evaluated for impairment (In thousands)	Loans collectively evaluated for impairment	PCI Loans	Total Allowance for Loan Losses
Commercial business:				
Commercial and industrial	$1,334	$6,557	$2,662	$10,553
Owner-occupied commercial real estate	979	1,643	1,473	4,095
Non-owner occupied commercial real estate	531	2,547	2,460	5,538
Total commercial business	2,844	10,747	6,595	20,186
One-to-four family residential	75	538	587	1,200
Real estate construction and land development:				
One-to-four family residential	447	322	1,017	1,786
Five or more family residential and commercial properties	234	650	88	972
Total real estate construction and land development	681	972	1,105	2,758
Consumer	58	1,943	768	2,769
Unallocated	—	816	—	816
Total	$3,658	$15,016	$9,055	$27,729

The following table details the recorded investment balance of the loan receivables disaggregated on the basis of the Company’s impairment method for the year ended December 31, 2014:

	Loans individually evaluated for impairment (In thousands)	Loans collectively evaluated for impairment	PCI loans	Total Gross Loans Receivable
Commercial business:				
Commercial and industrial	$11,374	$533,905	$25,174	$570,453
Owner-occupied commercial real estate	3,913	554,199	36,874	594,986
Non-owner occupied commercial real estate	7,729	604,465	31,442	643,636
Total commercial business	23,016	1,692,569	93,490	1,809,075
One-to-four family residential	245	63,572	5,713	69,530
Real estate construction and land development:				
One-to-four family residential	4,703	38,961	5,531	49,195
Five or more family residential and commercial properties	2,056	58,099	4,765	64,920
Total real estate construction and land development	6,759	97,060	10,296	114,115
Consumer	211	249,311	9,772	259,294
Total	$30,231	$2,102,512	$119,271	$2,252,014

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(5) FDIC Indemnification Asset

Changes in the FDIC indemnification asset during the three and nine months ended September 30, 2015 and 2014 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(In thousands)			
Balance at the beginning of the period	$388	$8,887	$1,116	$4,382
Additions as a result of the Washington Banking Merger	—	—	—	7,174
Cash payments received or receivable from the FDIC	—	(3,102)	(231)	(5,843)
FDIC share of additional estimated (gains) losses	—	(249)	(352)	556
Net amortization	—	(398)	(145)	(1,131)
Change due to termination of FDIC shared-loss agreements	(388)	—	(388)	—
Balance at the end of the period	$—	$5,138	$—	$5,138

On August 4, 2015, the Bank and the FDIC entered into an agreement terminating the FDIC shared-loss agreements for all three of the FDIC-assisted acquisitions (Cowlitz Bank, and Washington Banking's acquisitions of City Bank and North County Bank). The Bank paid consideration of $7.1 million to the FDIC for the termination of the shared-loss agreements related to these acquisitions. The termination of the shared-loss agreements resulted in a pre-tax gain of $1.7 million (included in "other income" in the Condensed Consolidated Statements of Income) and the elimination of the FDIC indemnification asset and the FDIC clawback liability (included in “accrued expenses and other liabilities” in the Condensed Consolidated Statements of Financial Condition) which was recorded as of the termination date. The FDIC indemnification asset and FDIC clawback liability amounts were $388,000 and $9.3 million, respectively, as of June 30, 2015. All rights and obligations of the parties under the FDIC shared-loss agreements, including the clawback provisions, were eliminated under the termination agreement. It is not anticipated that the termination of the FDIC shared-loss agreements will have any impact on the yields for the loans that were previously covered under these agreements. All future charge-offs, recoveries, gains, losses and expenses related to covered assets will now be recognized entirely by the Bank since the FDIC will no longer be sharing in such charge-offs, recoveries, gains, losses and expenses.

(6) Other Real Estate Owned

Changes in other real estate owned during the three and nine months ended September 30, 2015 and 2014 were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(In thousands)			
Balance at the beginning of the period	$3,017	$8,106	$3,355	$4,559
Additions	611	459	2,424	677
Additions from acquisitions	—	—	—	7,121
Proceeds from dispositions	(1,560)	(1,315)	(3,199)	(5,173)
Gain (loss) on sales, net	3	(378)	(94)	(312)
Valuation adjustment	—	—	(415)	—
Balance at the end of the period	$2,071	$6,872	$2,071	$6,872

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(7) Goodwill and Other Intangible Assets

(a) Goodwill

The Company’s goodwill represents the excess of the purchase price over the fair value of net assets acquired in the Washington Banking Merger on May 1, 2014, and the acquisitions of Valley on July 15, 2013, Western Washington Bancorp in 2006 and North Pacific Bank in 1998. The Company’s goodwill is assigned to the Bank and is evaluated for impairment at the Bank level (reporting unit).

There were no additions to goodwill during the three and nine months ended September 30, 2015 and the three months ended September 30, 2014. The Company recorded $89.7 million in goodwill during the nine months ended September 30, 2014 as a result of the Washington Banking Merger. For additional information on the Washigton Banking Merger, see Note (14) Business Combination.

At September 30, 2015, the Company’s step-one analysis concluded that the reporting unit’s fair value was greater than its carrying value and therefore no goodwill impairment charges were required for the three and nine months ended September 30, 2015. The Company did not record any goodwill impairment charges for the three and nine months ended September 30, 2015 or for the three and nine months ended September 30, 2014. Even though there was no goodwill impairment at September 30, 2015, adverse events may impact the recoverability of goodwill and could result in a future impairment charge which could have a material impact on the Company’s operating results.

b) Other Intangible Assets

The other intangible assets represent the core deposit intangible ("CDI") acquired in business combinations. The useful life of the CDI related to the Washington Banking Merger, the acquisitions of Valley, NCB, Pierce, Cowlitz, and Western Washington Bancorp were estimated to be ten, ten, five, four, nine and eight years, respectively.

The following table presents the change in the other intangible assets for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(In thousands)			
Balance at the beginning of the period	$9,835	$12,164	$10,889	$1,615
Additions as a result of acquisitions	—	—	—	11,194
Less: Amortization	523	603	1,577	1,248
Balance at the end of the period	$9,312	$11,561	$9,312	$11,561

(8) Junior Subordinated Debentures

As part of the Washington Banking Merger, the Company assumed trust preferred securities and junior subordinated debentures with a total fair value of $18.9 million at May 1, 2014.

Washington Banking Master Trust ("Trust"), a Delaware statutory business trust, was a wholly-owned subsidiary of Washington Banking created for the exclusive purposes of issuing and selling capital securities and utilizing sale proceeds to acquire junior subordinated debt issued by Washington Banking. During 2007, the Trust issued $25.0 million of trust preferred securities with a 30-year maturity, callable after the fifth year by Washington Banking. The trust preferred securities have a quarterly adjustable rate based upon the three-month London Interbank Offered Rate (“LIBOR”) plus 1.56%. On the Washington Banking Merger date of May 1, 2014, the Company acquired the Trust, which retained the Washington Banking Master Trust name, and assumed the performance and observance of the covenants under the indenture related to the trust preferred securities.

The adjustable rate of the trust preferred securities at September 30, 2015 was 1.89%. The weighted average rate of the junior subordinated debentures was 4.01% and 3.57% for the three months ended September 30, 2015 and 2014, respectively, and 4.36% and 3.58% for the nine months ended September 30, 2015 and 2014, respectively. The weighted average rate includes the accretion of the discount established at the merger date which is amortized over the life of the trust preferred securities.

The junior subordinated debentures are the sole assets of the Trust, and payments under the junior subordinated debentures are the sole revenues of the Trust. At September 30, 2015, the balance of the junior subordinated debentures was $19.4 million. All of the common securities of the Trust are owned by the Company.

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Heritage has fully and unconditionally guaranteed the capital securities along with all obligations of the Trust under the trust agreements.

(9) Repurchase Agreements

The Company utilizes repurchase agreements with one-day maturities as a supplement to funding sources. Repurchase agreements are secured by pledged investment securities available for sale. Under the repurchase agreements, the Company is required to maintain an aggregate market value of securities pledged greater than the stated margin balance. The Company is required to pledge additional securities to cover any declines below the stated margin balance. The class of collateral pledged for the Company's repurchase agreement obligations as of September 30, 2015 and December 31, 2014, totaling $22.8 million and $32.2 million, respectively, were mortgage backed securities and collateralized mortgage obligation - residential: U.S. Government-sponsored agencies. Additional information on the total value of securities pledged for repurchase agreements is found in Note (2) Investment Securities.

(10) Stockholders' Equity

(a) Earnings Per Common Share

The following table illustrates the reconciliation of weighted average shares used for earnings per common share computations for the three and nine months ended September 30, 2015 and 2014:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(Dollars in thousands)			
Net income:				
Net income	$9,492	$7,068	$27,996	$13,759
Less: Dividends and undistributed earnings allocated to participating securities	(84)	(59)	(247)	(114)
Net income allocated to common shareholders	$9,408	$7,009	$27,749	$13,645
Basic:				
Weighted average common shares outstanding	29,960,133	30,293,559	30,086,057	24,085,132
Less: Restricted stock awards	(263,404)	(230,134)	(268,999)	(198,255)
Total basic weighted average common shares outstanding	29,696,729	30,063,425	29,817,058	23,886,877
Diluted:				
Basic weighted average common shares outstanding	29,696,729	30,063,425	29,817,058	23,886,877
Incremental shares from stock options	22,395	36,671	22,718	50,539
Total diluted weighted average common shares outstanding	29,719,124	30,100,096	29,839,776	23,937,416

Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. For the three months ended September 30, 2015 and 2014, potential anti-dilutive shares outstanding related to options to acquire common stock totaled 2,650 and 9,640, respectively, as the assumed proceeds from exercise price, tax benefits and future compensation was in excess of the market value. For the nine months ended September 30, 2015 and 2014, potential anti-dilutive shares outstanding related to options to acquire common stock totaled 4,883 and 25,088, respectively, for the same reasons indicated for the three-month periods.

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(b) Dividends

The timing and amount of cash dividends paid on the Company's common stock depends on the Company's earnings, capital requirements, financial condition and other relevant factors. Dividends on common stock from the Company depend substantially upon receipt of dividends from the Bank, which is the Company's predominant source of income. The following table summarizes the dividend activity for the nine months ended September 30, 2015 and calendar year 2014.

Declared	Cash Dividend per Share	Record Date	Paid Date
January 29, 2014	$0.08	February 10, 2014	February 24, 2014
March 27, 2014	$0.08	April 8, 2014	April 23, 2014
July 24, 2014	$0.09	August 7, 2014	August 21, 2014
October 23, 2014	$0.09	November 6, 2014	November 20, 2014
November 11, 2014	$0.16	December 2, 2014	December 12, 2014
January 28, 2015	$0.10	February 10, 2015	February 24, 2015
April 22, 2015	$0.11	May 7, 2015	May 21, 2015
July 22, 2015	$0.11	August 6, 2015	August 20, 2015

The FDIC and the Washington State Department of Financial Institutions, Division of Banks have the authority under their supervisory powers to prohibit the payment of dividends by the Bank to the Company. Additionally, current guidance from the Board of Governors of the Federal Reserve System ("Federal Reserve Board") provides, among other things, that dividends per share on the Company's common stock generally should not exceed earnings per share, measured over the previous four fiscal quarters. Current regulations allow the Company and the Bank to pay dividends on their common stock if the Company's or the Bank's regulatory capital would not be reduced below the statutory capital requirements set by the Federal Reserve Board and the FDIC.

(c) Stock Repurchase Program

The Company has had various stock repurchase programs since March 1999. On October 23, 2014, the Company's Board of Directors authorized the repurchase of up to 5% of the Company's outstanding common shares, or approximately 1,513,000 shares, under the eleventh stock repurchase plan. The number, timing and price of shares repurchased will depend on business and market conditions, and other factors, including opportunities to deploy the Company's capital. On August 30, 2012, the Board of Directors approved the Company's tenth stock repurchase plan, authorizing the repurchase of up to 5% of the Company's outstanding shares of common stock, or approximately 757,000 shares. The Company repurchased 704,975 shares under the tenth stock repurchase plan, leaving 52,025 shares unpurchased.

The following table provides total repurchased shares and average share prices under the applicable plans for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,		
	2015	2014	2015	2014	Plan Total (1)
Tenth Plan					
Repurchased shares	—	108,075	—	108,075	704,975
Stock repurchase average share price	$—	$16.88	$—	$16.88	$15.85
Eleventh Plan					
Repurchased shares	—	—	441,966	—	441,966
Stock repurchase average share price	$—	$—	$16.64	$—	$16.64

(1) Represents shares repurchased and average share price paid during the duration of the repurchase plans.

In addition to the stock repurchases disclosed in the table above, the Company repurchased shares to pay withholding taxes on the vesting of restricted stock. During the three months ended September 30, 2015 and 2014,

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the Company repurchased 388 and 2,751 shares of common stock at an average price of $17.63 and $16.11, respectively, to pay withholding taxes on the vesting of restricted stock that vested during the respective periods. During the nine months ended September 30, 2015 and 2014, the Company repurchased 21,998 and 18,549 shares of common stock at an average price of $17.07 and $16.99, respectively, to pay withholding taxes on the vesting of restricted stock that vested during the respective periods.

(11) Accumulated Other Comprehensive Income (Loss)

The changes in accumulated other comprehensive income (loss) ("AOCI") by component, during the three and nine months ended September 30, 2015 and 2014 are as follows:

	Three Months Ended September 30, 2015		
	Changes in fair value of available for sale securities [1]	Accretion of other-than-temporary impairment on held to maturity securities [1]	Total
	(In thousands)		
Balance of AOCI at the beginning of period	$2,198	$—	$2,198
Other comprehensive income before reclassification	3,064	—	3,064
Amounts reclassified from AOCI for gain on sale of investment securities included in net income	(255)	—	(255)
Net current period other comprehensive income	2,809	—	2,809
Balance of AOCI at the end of period	$5,007	$—	$5,007

[1] All amounts are net of tax.

	Nine Months Ended September 30, 2015		
	Changes in fair value of available for sale securities [1]	Accretion of other-than-temporary impairment on held to maturity securities [1]	Total
	(In thousands)		
Balance of AOCI at the beginning of period	$3,567	$(189)	$3,378
Other comprehensive income before reclassification	2,324	11	2,335
Amounts reclassified from AOCI for gain on sale of investment securities included in net income	(884)	178	(706)
Net current period other comprehensive income	1,440	189	1,629
Balance of AOCI at the end of period	$5,007	$—	$5,007

[1] All amounts are net of tax.

	Three Months Ended September 30, 2014		
	Changes in fair value of available for sale securities [1]	Accretion of other-than-temporary impairment on held to maturity securities [1]	Total
	(In thousands)		
Balance of AOCI at the beginning of period	$1,518	$(209)	$1,309
Other comprehensive income before reclassification	(1,384)	13	(1,371)
Amounts reclassified from AOCI for gain on sale of investment securities available for sale included in net income	8	—	8
Net current period other comprehensive income	(1,376)	13	(1,363)
Balance of AOCI at the end of period	$142	$(196)	$(54)

[1] All amounts are net of tax.

	Nine Months Ended September 30, 2014		
	Changes in fair value of available for sale securities [1]	Accretion of other-than-temporary impairment on held to maturity securities [1]	Total
	(In thousands)		
Balance of AOCI at the beginning of the period	$(923)	$(239)	$(1,162)
Other comprehensive income before reclassification	1,231	43	1,274
Amounts reclassified from AOCI for gain on sale of investment securities available for sale included in net income	(166)	—	(166)
Net current period other comprehensive income	1,065	43	1,108
Balance of AOCI at the end of the period	$142	$(196)	$(54)

[1] All amounts are net of tax.

(12) Stock-Based Compensation

Stock options generally vest ratably over three years and expire five years after they become exercisable or vest ratably over four years and expire ten years from date of grant. Restricted stock awards issued generally have a five-year cliff vesting or four year ratable vesting schedule. The Company issues new shares of common stock to satisfy share option exercises and restricted stock awards.

On July 24, 2014, the Company's shareholders approved the Heritage Financial Corporation 2014 Omnibus Equity Plan (the "Plan") that provides for the issuance of 1,500,000 shares of the Company's common stock in the form of stock options, stock appreciation rights, stock awards (which includes restricted stock units, restricted stock, performance units, performance shares or bonus shares) and cash incentive awards.

As of September 30, 2015, there remained 1,262,567 shares available for future issuances under the Company's stock-based compensation plans.

(a) Stock Option Awards

For the three and nine months ended September 30, 2015 and the three months ended September 30, 2014, the Company did not recognize compensation expense or a related tax benefit for the outstanding stock options as all compensation expense had been previously recognized. For the nine months ended September 30, 2014, the Company recognized compensation expense related to stock options of $20,000 with no related tax benefit. The intrinsic value and cash proceeds from options exercised during the nine months ended September 30, 2015 was $223,000 and $666,000, respectively. The intrinsic value and cash proceeds from options exercised during the nine months ended September 30, 2014 was $385,000 and $766,000, respectively.

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The following table summarizes the stock option activity for the nine months ended September 30, 2015 and 2014:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (In thousands)
Outstanding at December 31, 2013	194,482	$ 15.82		
Granted (1)	90,248	10.72		
Exercised	(70,854)	10.79		
Forfeited or expired	(43,984)	22.80		
Outstanding at September 30, 2014	169,892	$ 13.41	3.30	$455
Outstanding at December 31, 2014	156,407	$ 13.59		
Granted	—	—		
Exercised	(53,198)	12.45		
Forfeited or expired	(12,278)	16.73		
Outstanding at September 30, 2015	90,931	$ 13.84	3.05	$456
Vested and expected to vest at September 30, 2015	90,931	$ 13.84	3.05	$456
Exercisable at September 30, 2015	90,931	$ 13.84	3.05	$456

(1) Options granted during the nine months ended September 30, 2014 represent only the stock options issued in conjunction with the Washington Banking Merger. See Note (14) Business Combination for additional information. The weighted average exercise price reflects the exchange ratio applied to the original Washington Banking exercise price pursuant to the merger agreement.

(b) Restricted and Unrestricted Stock Awards

For the three and nine months ended September 30, 2015, the Company recognized compensation expense related to restricted and unrestricted stock awards of $409,000 and $1,125,000, respectively, and a related tax benefit of $144,000 and $395,000, respectively. For the three and nine months ended September 30, 2014, the Company recognized compensation expense related to restricted and unrestricted stock awards of $357,000 and $896,000, respectively, and a related tax benefit of $125,000 and $315,000, respectively. As of September 30, 2015, the total unrecognized compensation expense related to non-vested restricted and unrestricted stock awards was $3.2 million and the related weighted average period over which it is expected to be recognized is approximately 2.5 years. The vesting date fair value of restricted stock awards that vested during the nine months ended September 30, 2015 and 2014 was $1.6 million and $1.2 million, respectively.

The following tables summarize the restricted and unrestricted stock award activity for the nine months ended September 30, 2015 and 2014:

	Shares	Weighted-Average Grant Date Fair Value
Nonvested at December 31, 2013	202,939	$14.29
Granted	130,548	16.03
Vested	(73,336)	14.26
Forfeited	(6,806)	14.66
Nonvested at September 30, 2014	253,345	$15.19
Nonvested at December 31, 2014	238,669	$15.20
Granted	121,320	16.72
Vested	(91,642)	15.12
Forfeited	(2,837)	15.71
Nonvested at September 30, 2015	265,510	$15.92

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(13) Fair Value Measurements

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

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 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, quoted prices in markets that are not active or valuations using methodologies with observable inputs.

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 using unobservable inputs, 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.

(a) Recurring and Nonrecurring Basis

The Company used the following methods and significant assumptions to estimate fair value of certain assets on a recurring and nonrecurring basis:

Investment Securities Available for Sale and Held to Maturity:

The fair values of all investment securities are based upon the assumptions market participants would use in pricing the security. If available, investment securities are determined by quoted market prices which is generally the case for mutual funds and other equities (Level 1). For investment securities where quoted market prices are not available, fair values are calculated based on market prices on similar securities (Level 2). Level 2 includes U.S. Treasury, U.S. Government and agency debt securities, municipal securities, corporate securities and mortgage-backed securities and collateralized mortgage obligations-residential. For investment securities where quoted prices or market prices of similar securities are not available, fair values are calculated by using observable and unobservable inputs such as discounted cash flows or other market indicators (Level 3). Security valuations are obtained from third party pricing services for comparable assets or liabilities.

Impaired Loans:

At the time a loan is considered impaired, its impairment is measured based on the present value of expected future cash flows discounted at the loan’s effective interest rate, a loan’s observable market prices, or fair market value of the collateral if the loan is collateral-dependent. Impaired loans for which impairment is measured using the discounted cash flow approach are not considered to be measured at fair value because the loan’s effective interest rate is not a fair value input, and for the purposes of fair value disclosures, the fair value of these loans are measured commensurate with non-impaired loans. Generally, the Company utilizes the fair market value of the collateral, which is commonly based on recent real estate appraisals, to measure impairment. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower’s financial statements, or aging reports, adjusted or discounted based on management’s historical knowledge, changes in market conditions from the time of the valuation, and management’s expertise and knowledge of the client and client’s business (Level 3). Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

Other Real Estate Owned:

Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in Level 3 classification of the inputs for determining fair value.

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Appraisals for both collateral-dependent impaired loans and other real estate owned are performed by certified general appraisers for commercial properties or certified residential appraisers for residential properties whose qualifications and licenses have been reviewed and verified by the Company. Once received, the Company reviews the assumptions and approaches utilized in the appraisal as well as the resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics. On a quarterly basis, the Company compares the actual selling price of collateral that has been liquidated to the most recent appraised value to determine what additional adjustment should be made to the appraisal value to arrive at fair value.

The following tables summarize the balances of assets measured at fair value on a recurring basis as of September 30, 2015 and December 31, 2014.

	September 30, 2015			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Investment securities available for sale:				
U.S. Treasury and U.S. Government-sponsored agencies	$15,162	$—	$15,162	$—
Municipal securities	189,769	—	189,769	—
Mortgage backed securities and collateralized mortgage obligations—residential:				
U.S Government-sponsored agencies	486,964	—	486,964	—
Corporate obligations	9,216	—	9,216	—
Mutual funds and other equities	1,982	1,982	—	—
Total	$703,093	$1,982	$701,111	$—

	December 31, 2014			
	Total	Level 1	Level 2	Level 3
	(In thousands)			
Investment securities available for sale:				
U.S. Treasury and U.S. Government-sponsored agencies	$21,427	$—	$21,427	$—
Municipal securities	173,037	—	173,037	—
Mortgage backed securities and collateralized mortgage obligations—residential:				
U.S Government-sponsored agencies	542,399	—	542,399	—
Corporate obligations	4,010	—	4,010	—
Mutual funds and other equities	1,973	1,973	—	—
Total	$742,846	$1,973	$740,873	$—

There were no transfers between Level 1 and Level 2 during the three and nine months ended September 30, 2015 and 2014.

The Company may be required to measure certain financial assets and liabilities at fair value on a nonrecurring basis. These adjustments to fair value usually result from application of lower-of-cost-or-market accounting or write-downs of individual assets.

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The tables below represent assets measured at fair value on a nonrecurring basis at September 30, 2015 and December 31, 2014 and the related net losses (gains) recorded in earnings during three and nine months ended September 30, 2015 and 2014.

	Fair Value at September 30, 2015						
	Basis[1]	Total	Level 1	Level 2	Level 3	Net Losses (Gains) Recorded in Earnings During the Three Months Ended September 30, 2015	Net Losses (Gains) Recorded in Earnings During the Nine Months Ended September 30, 2015
	(In thousands)						
Impaired loans:							
Real estate construction and land development:							
One-to-four family residential	$865	$862	$—	$—	$862	$—	$102
Total real estate construction and land development	865	862	—	—	862	—	102
Total impaired loans	865	862	—	—	862	—	102
Total assets measured at fair value on a nonrecurring basis	$865	$862	$—	$—	$862	$—	$102

[1] Basis represents the unpaid principal balance of impaired loans.

	Fair Value at December 31, 2014						
	Basis[1]	Total	Level 1	Level 2	Level 3	Net Losses (Gains) Recorded in Earnings During the Three Months Ended September 30, 2014	Net Losses (Gains) Recorded in Earnings During the Nine Months Ended September 30, 2014
	(In thousands)						
Impaired loans:							
Commercial business:							
Commercial and industrial	$161	$138	$—	$—	$138	$118	$(79)
Non-owner occupied commercial real estate	—	—	—	—	—	63	—
Total commercial business	161	138	—	—	138	181	(79)
Real estate construction and land development:							
One-to-four family residential	2,094	1,725	—	—	1,725	381	384
Total real estate construction and land development	2,094	1,725	—	—	1,725	381	384
Consumer	49	45	—	—	45	—	—

Total impaired loans	2,304	1,908	—	—	1,908	562	305
Investment securities held to maturity:							
Mortgage back securities and collateralized mortgage obligations – residential:							
Private residential collateralized mortgage obligations	36	11	—	11	—	—	45
Total assets measured at fair value on a nonrecurring basis	$2,340	$1,919	$—	$11	$1,908	$562	$350

(1) Basis represents the unpaid principal balance of impaired loans and amortized cost of investment securities held to maturity.

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The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at September 30, 2015 and December 31, 2014.

	September 30, 2015			
	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range of Inputs; Weighted Average
	(Dollars in thousands)			
Impaired loans	$862	Market approach	Adjustment for differences between the comparable sales	(8.50%) - 10.4%; 0.95%

	December 31, 2014			
	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range of Inputs; Weighted Average
	(Dollars in thousands)			
Impaired loans	$1,908	Market approach	Adjustment for differences between the comparable sales	(47.5%) - 96.2%; 7.0%

The nonrecurring fair value measurement disclosures in the tables above exclude impaired loans that are collateral dependent buy for which the collateral value exceeds the Company's recorded investment, as well as excludes impaired loans that are measured using the discounted cash flow approach because the discount rate used is generally not a fair value input.

(b) 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.

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The tables below present the carrying value amount of the Company's financial instruments and their corresponding estimated fair values at the dates indicated.

	September 30, 2015				
	Carrying Value	Fair Value	Fair Value Measurements Using: Level 1	Level 2	Level 3
	(In thousands)				
Financial Assets:					
Cash and cash equivalents	$142,477	$142,477	$142,477	$—	$—
Other interest earning deposits	5,244	5,259	—	5,259	—
Investment securities available for sale	703,093	703,093	1,982	701,111	—
Investment securities held to maturity	32,832	34,023	—	34,023	—
Federal Home Loan Bank stock	4,148	N/A	N/A	N/A	N/A
Loans held for sale	7,981	8,177	—	8,177	—
Total loans receivable, net	2,375,040	2,393,455	—	—	2,393,455
Accrued interest receivable	10,831	10,831	9	3,421	7,401
Financial Liabilities:					
Deposits:					
Noninterest deposits, NOW accounts, money market accounts and savings accounts	$2,616,659	$2,616,659	$2,616,659	$—	$—
Certificate of deposit accounts	437,539	436,977	—	436,977	—
Total deposits	$3,054,198	$3,053,636	$2,616,659	$436,977	$—
Securities sold under agreement to repurchase	$22,829	$22,829	$22,829	$—	$—
Junior subordinated debentures	19,351	19,351	—	—	19,351
Accrued interest payable	209	209	52	137	20

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	December 31, 2014				
	Carrying Value	Fair Value	Fair Value Measurements Using: Level 1	Level 2	Level 3
	(In thousands)				
Financial Assets:					
Cash and cash equivalents	$121,636	$121,636	$121,636	$—	$—
Other interest earning deposits	10,126	10,145	—	10,145	—
Investment securities available for sale	742,846	742,846	1,973	740,873	—
Investment securities held to maturity	35,814	36,874	—	36,874	—
Federal Home Loan Bank stock	12,188	N/A	N/A	N/A	N/A
Loans held for sale	5,582	5,710	—	5,710	—
Loans receivable, net of allowance for loan losses	2,223,348	2,279,081	—	—	2,279,081
Accrued interest receivable	9,836	9,836	3	3,009	6,824
Financial Liabilities:					
Deposits:					
Noninterest deposits, NOW accounts, money market accounts and savings accounts	$2,380,934	$2,380,934	$2,380,934	$—	$—
Certificate of deposit accounts	525,397	525,768	—	525,768	—
Total deposits	$2,906,331	$2,906,702	$2,380,934	$525,768	$—
Securities sold under agreement to repurchase	$32,181	$32,181	$32,181	$—	$—
Junior subordinated debentures	19,082	19,082	—	—	19,082
Accrued interest payable	411	411	62	328	21

The methods and assumptions, not previously presented, used to estimate fair value are described as follows:

Cash and Cash Equivalents:

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 (Level 1).

Other Interest Earning Deposits:

These deposits with other banks have maturities greater than three months. The fair value is calculated based upon market prices for similar deposits (Level 2).

Federal Home Loan Bank Stock:

Federal Home Loan Bank ("FHLB") stock is not publicly traded; thus, it is not practicable to determine the fair value of FHLB stock due to restrictions placed on its transferability. At September 30, 2015 the stock was stock of the FHLB of Des Moines and at December 31, 2014 was stock of the FHLB of Seattle. The FHLB of Seattle merged with and into the FHLB of Des Moines effective in the second calendar quarter of 2015.

Loans Held for Sale:

The fair value of loans held for sale is estimated based upon binding contracts or quotes from third party investors. (Level 2).

Total Loans Receivable, net:

Except for impaired loans discussed previously, fair value is based on discounted cash flows using current market rates applied to the estimated life (Level 3). While these methodologies are permitted under U.S. GAAP, they are not based on the exit price concept of the fair value required under ASC 820-10, Fair Value Measurements and Disclosures, and generally produce a higher value.

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Accrued Interest Receivable/Payable:
The fair value of accrued interest receivable/payable balances are determined using inputs and fair value measurements commensurate with the asset or liability from which the accrued interest is generated. The carrying amounts of accrued interest approximate fair value (Level 1, Level 2 and Level 3).
Deposits:
For deposits with no contractual maturity, the fair value is assumed to equal the carrying value (Level 1). The fair value of fixed maturity deposits is based on discounted cash flows using the difference between the deposit rate and the rates offered by the Company for deposits of similar remaining maturities (Level 2).
Securities Sold Under Agreement to Repurchase:
Securities sold under agreement to repurchase are short-term in nature and they reprice on a daily basis. Fair value financial instruments that are short-term or reprice frequently and that have little or no risk are considered to have a fair value equal to carrying value (Level 1).
Junior Subordinated Debentures:
The fair value is estimated using discounted cash flow analysis based on current rates for similar types of debt, which many be unobservable, and considering recent trading activity of similar instruments in markets which can be inactive. At September 30, 2015, the fair value approximated the carrying value based on these valuation techniques (Level 3).
Off-Balance Sheet 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, no premium or discount was ascribed to these commitments (Level 1). They are excluded from the preceding tables.

(14) Business Combination
There were no acquisitions or mergers completed during the three and nine months ended September 30, 2015 or the three months ended September 30, 2014. During the nine months ended September 30, 2014, the Company completed the Washington Banking Merger.
Washington Banking Merger
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 have continued 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. The terms of the merger agreement also provided for immediate vesting of the Washington Banking options and restricted stock awards units. At April 30, 2014, the number of Washington Banking common shares outstanding was 15,587,154 and the closing price of Heritage common stock was $16.16. The total consideration transferred by the Company in conjunction with the Washington Banking Merger was $269.6 million and the total number of Heritage shares of common stock issued were 14,000,178. The Company also incurred $489,000 in capitalized stock issuance costs.

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The total consideration transferred by the Company in the Washington Banking Merger consisted of the following:

	Washington Banking (In thousands)
Consideration transferred	
Cash paid (1)	$42,895
Fair value of common shares issued (2)	224,151
Fair value of restricted stock unit awards (3)	2,092
Fair value of common stock options	481
Total consideration transferred	$269,619

(1) Includes $3,000 of cash paid due to fractional shares and $27,000 of cash paid to dissenting shareholders.

(2) Total of 13,870,716 shares issued, which excludes 1,686 shares of dissenting shareholders that were paid in cash, and 165 fractional shares paid in cash.

(3) Total number of converted shares was 129,462. Fair value includes 26,783 shares which were forfeited by Washington Banking shareholder to pay applicable taxes, with a total fair value of $433,000.

The Washington Banking Merger resulted in $89.7 million of goodwill. This goodwill is not deductible for tax purposes. 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.

During the three and nine months ended September 30, 2014, the Company incurred Washington Banking merger-related costs (including system conversion costs) of approximately $1.3 million and $7.4 million, respectively.

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 estimates of fair values of the acquired bank's assets, including the identifiable intangible assets, and the assumed liabilities in the merger were measured and recorded as of the effective date of the merger.

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

	Washington Banking (In thousands)
Assets	
Cash and cash equivalents	$74,947
Investment securities available for sale	458,312
Loans held for sale	3,923
Loans receivable	895,978
Loans receivable, covered at merger date	107,050
FDIC indemnification asset	7,174
Other real estate owned ($5,122 covered by FDIC shared-loss agreements at the May 1, 2014 merger date)	7,121
Premises and equipment	31,776
FHLB stock	7,064
Bank owned life insurance	32,519
Accrued interest receivable	4,943
Other intangible assets	11,194
Prepaid expenses and other assets	14,852
Total assets acquired	1,656,853
Liabilities	
Deposits	1,433,894
Junior subordinated debentures	18,937
Accrued expenses and other liabilities	24,067
Total liabilities assumed	1,476,898
Net assets acquired	$179,955

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

	Washington Banking (In thousands)	
Cost basis of net assets on merger date	$181,782	
Less: Consideration transferred	(269,619	)
Fair value adjustments:		
Loans held for sale	86	
Loans receivable	(12,811	)
Loans receivable, covered at merger date	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	(6,416	)
Deposits	(1,737	)
Junior subordinated debentures	6,837	
Accrued expenses and other liabilities	(3,590	)
Goodwill recognized	$(89,664	)

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The Company also considered the pro forma requirements of FASB ASC 805 and deemed it necessary for the Washington Banking Merger. The following table presents certain pro forma information, for illustrative purposes only, for the nine months ended September 30, 2014 as if the Washington Banking Merger had occurred on January 1, 2014. The estimated pro forma information combines the historical results of Washington Banking with the Company's consolidated historical results and includes certain adjustments reflecting the estimated impact of certain fair value adjustments for the respective periods. The pro forma information is not indicative of what would have occurred had the Washington Banking Merger occurred on January 1, 2014. In particular, no adjustments have been made to eliminate the impact of the Washington Banking loans previously accounted for under ASC 310-30 that may have been necessary if these loans had been recorded at fair value at January 1, 2014. The pro forma information also does not consider any changes to the provision for loan losses resulting from recorded loans at fair value. Additionally, Heritage expects to achieve further operating savings and other business synergies, including interest income growth, as a result of the Washington Banking Merger which are not reflected in the pro forma amounts in the following table. As a result, actual amounts will differ from the pro forma information presented.

	Nine Months Ended September 30, 2014 (Dollars In Thousands, except per share amounts)
Net interest income	$105,367
Net income	$25,589
Basic earnings per common share	$0.85
Diluted earnings per common share	$0.85

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

The following discussion is intended to assist in understanding the financial condition and results of the Company as of and for the three and nine months ended September 30, 2015. The information contained in this section should be read with the unaudited Condensed Consolidated Financial Statements and the accompanying Notes included herein, and the December 31, 2014 audited Consolidated Financial Statements and the accompanying Notes included in our Annual Report on Form 10-K for the year ended December 31, 2014.

Overview

Heritage Financial Corporation is a bank holding company, which primarily engages in the business activities of its wholly owned subsidiary, Heritage Bank. We provide financial services to our local communities with an ongoing strategic focus on expanding our commercial lending relationships and market area and a continual focus on asset quality. At September 30, 2015, we had total assets of $3.60 billion and total stockholders’ equity of $468.7 million. The Company’s business activities generally are limited to passive investment activities and oversight of its investment in the Bank. Accordingly, the information set forth in this report relates primarily to the Bank’s operations.

Our business consists primarily of commercial lending and deposit relationships with small businesses and their owners in our market areas and attracting deposits from the general public. We also originate real estate construction and land development loans, consumer loans and one-to-four family residential loans collateralized by residential properties located in western and central Washington State and the greater Portland, Oregon area.

Our core profitability depends primarily on our net interest income. Net interest income is the difference between interest income, which is the income that we earn on interest earning assets, comprised primarily of loans and investments, and interest expense, which is the amount we pay on our interest bearing liabilities, including primarily deposits. Management strives to match the repricing characteristics of the interest earning assets and interest bearing liabilities to protect net interest income from changes in market interest rates and changes in the shape of the yield curve. Like most financial institutions, our net interest income is affected significantly by general and local economic conditions, particularly changes in market interest rates, and by governmental policies and actions of regulatory agencies. Net interest income is additionally affected by changes on the volume and mix of interest earning assets, interest earned on these assets, the volume and mix of interest bearing liabilities and interest paid on interest bearing liabilities.

Our net income is affected by many factors, including the provision for loan losses. The provision for loan losses is dependent on changes in the loan portfolio and management's assessment of the collectability of the loan portfolio as well as prevailing economic and market conditions. The allowance for loan losses reflects the amount that the Company believes is appropriate to provide for known and inherent credit losses in its loan portfolio.

Net income is also affected by noninterest income and noninterest expense. Noninterest income primarily consists of service charges and other fees, gain on sale of loans (net) and other income. Noninterest expense consists primarily of compensation and employee benefits, occupancy and equipment, data processing, professional services and other expenses. Compensation and employee benefits consist primarily of the salaries and wages paid to our employees, payroll taxes, expenses for retirement and other employee benefits. Occupancy and equipment expenses, which are the fixed and variable costs of buildings and equipment, consist primarily of lease payments, taxes, depreciation charges, maintenance and costs of utilities.

Results of operations may also be affected significantly by general and local economic and competitive conditions, governmental policies and actions of regulatory authorities. Other income and other expenses are also impacted by growth of operations and growth in the number of loan and deposit accounts through acquisitions and core banking business growth. Growth in operations affects other expenses primarily as a result of additional employees, branch facilities and marketing expense. Growth in the number of loan and deposit accounts affects other income, including service charges as well as other expenses such as data processing services, supplies, postage, telecommunications and other miscellaneous expenses.

Recent Developments

We completed the Washington Banking Merger on May 1, 2014. Legacy Washington Banking results since May 1, 2014 are included in the results of operations herein; therefore, the results included in this Quarterly Report on Form 10-Q for the three and nine months ended September 30, 2015 include three and nine months, respectively, of operations of legacy Washington Banking. The results included in this Quarterly Report on Form 10-Q for the three and nine months ended September 30, 2014 contains three and five months, respectively, of the operating results of legacy Washington Banking.

As of September 30, 2015 the Company had 67 branching locations. We intend to continue executing our lending practices across our newly expanded market area. We will focus on commercial and consumer lending, including increased small business lending. As a result of the Washington Banking Merger, we have a greater, more diversified noninterest income stream through increased mortgage banking operations and Small Business Administration ("SBA") lending operations.

Earnings Summary

Net income was $0.32 per diluted common share for the three months ended September 30, 2015 compared to $0.23 per diluted common share for the three months ended September 30, 2014 and $0.93 per diluted common share for the nine months ended September 30, 2015 compared to $0.57 for the nine months ended September 30, 2014. Net income for the three months ended September 30, 2015 was $9.5 million compared to net income of $7.1 million for the same period in 2014. Net income was $28.0 million for the nine months ended September 30, 2015 compared to $13.8 million for the nine months ended September 30, 2014. The $2.4 million, or 34.3% increase in net income for the three months ended September 30, 2015 compared to the three months ended September 30, 2014 was primarily the result of the $1.7 million gain on the FDIC shared-loss termination agreement signed during the three months ended September 30, 2015 as well as an increase in the gain on sale of loans, net, and a decrease in other real estate owned expenses. The $14.2 million, or 103.5% increase in net income for the nine months ended September 30, 2015 compared to the same period in 2014 was primarily the result of the Washington Banking Merger as well as an increase in the gain on sale of loans.

The efficiency ratio consists of noninterest expense divided by the sum of net interest income before provision for loan losses plus noninterest income. The Company's efficiency ratio decreased to 65.9% for the three months ended September 30, 2015 from 73.1% for the three months ended September 30, 2014 and decreased to 65.2% for the nine months ended September 30, 2015 from 76.9% for the nine months ended September 30, 2014. The decrease for the three months ended September 30, 2015 compared to the same period in 2014 is due primarily to the increases in noninterest income. The decrease in the efficiency ratio for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014 is also attributable to the increase in noninterest income as well as the increase in net interest income primarily as a result of the Washington Banking Merger, offset partially by the increase

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in noninterest expense due to the merger. The improvement in the efficiency ratio for the three and nine months ended September 30, 2015 and 2014 was partially mitigated by a continued decline in the net interest margin, as a result of the continued low interest rate environment.

Net Interest Income

One of the Company's key sources of earnings is net interest income. There are several factors that affect net interest income including, but not limited to, the volume, pricing, mix and maturity of interest earning assets and interest bearing liabilities; the volume of noninterest bearing deposits and other liabilities and shareholders' equity; the volume of noninterest earning assets; market interest rate fluctuations; and asset quality.

Net interest income decreased $1.4 million, or 4.1%, to $31.9 million for the three months ended September 30, 2015, compared to $33.3 million for the same period in 2014. Net interest income increased $18.4 million, or 23.4%, to $97.1 million for nine months ended September 30, 2015, compared to $78.6 million for the same period in 2014. The following tables provides relevant net interest income information for the dates indicated. The average loan balances presented in the table are net of allowances for loan losses. Nonaccrual loans have been included in the tables as loans carrying a zero yield. Yields on tax-exempt securities and loans have not been stated on a tax-equivalent basis.

	Three Months Ended September 30,							
	2015				2014			
	Average Balance	Interest Earned/ Paid	Average Yield/ Rate (1)		Average Balance	Interest Earned/ Paid	Average Yield/ Rate (1)	
	(Dollars in thousands)							
Interest Earning Assets:								
Total loans receivable, net	$2,356,090	$30,179	5.08	%	$2,194,460	$31,841	5.76	%
Taxable securities	525,013	2,187	1.65		517,802	2,212	1.69	
Nontaxable securities	201,233	1,056	2.08		176,827	855	1.92	
Other interest earning assets	81,909	62	0.30		170,707	123	0.29	
Total interest earning assets	3,164,245	33,484	4.20	%	3,059,796	35,031	4.54	%
Noninterest earning assets	385,065				377,001			
Total assets	$3,549,310				$3,436,797			
Interest Bearing Liabilities:								
Certificates of deposit	$447,425	$586	0.52	%	$604,708	$896	0.59	%
Savings accounts	424,620	118	0.11		349,685	59	0.07	
Interest bearing demand and money market accounts	1,383,212	631	0.18		1,259,704	579	0.18	
Total interest bearing deposits	2,255,257	1,335	0.23		2,214,097	1,534	0.27	
Securities sold under agreement to repurchase	21,197	14	0.26		28,565	19	0.26	
Junior subordinated debentures	19,314	195	4.01		18,985	171	3.57	
Total interest bearing liabilities	2,295,768	1,544	0.27	%	2,261,647	1,724	0.30	%
Demand and other noninterest bearing deposits	760,004				688,140			
Other noninterest bearing liabilities	29,715				34,571			
Stockholders’ equity	463,823				452,439			
Total liabilities and stockholders’ equity	$3,549,310				$3,436,797			
Net interest income		$31,940				$33,307		
Net interest spread			3.93	%			4.24	%
Net interest margin			4.00	%			4.32	%

Average interest earning assets to average interest bearing liabilities	137.83 %	135.29 %

(1) Annualized

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	Nine Months Ended September 30,							
	2015				2014			
	Average Balance	Interest Earned/ Paid	Average Yield/ Rate [(1)]		Average Balance	Interest Earned/ Paid	Average Yield/ Rate [(1)]	
	(Dollars in thousands)							
Interest Earning Assets:								
Total loans receivable, net	$2,295,881	$91,213	5.31	%	$1,763,081	$75,738	5.74	%
Taxable securities	548,282	7,199	1.76		329,183	4,663	1.89	
Nontaxable securities	201,796	3,137	2.08		129,422	1,928	1.99	
Other interest earning assets	69,493	173	0.33		150,429	338	0.30	
Total interest earning assets	3,115,452	101,722	4.37	%	2,372,115	82,667	4.66	%
Noninterest earning assets	374,938				268,794			
Total assets	$3,490,390				$2,640,909			
Interest Bearing Liabilities:								
Certificates of deposit	$475,826	1,844	0.52	%	$476,444	$2,225	0.62	%
Savings accounts	391,273	316	0.11		256,599	151	0.08	
Interest bearing demand and money market accounts	1,358,521	1,801	0.18		966,227	1,309	0.18	
Total interest bearing deposits	2,225,620	3,961	0.24		1,699,270	3,685	0.29	
FHLB advances and other borrowings	2,267	5	0.29		147	—	—	
Securities sold under agreement to repurchase	23,222	45	0.26		26,878	52	0.26	
Junior subordinated debentures	19,233	627	4.36		10,629	285	3.58	
Total interest bearing liabilities	2,270,342	4,638	0.27	%	1,736,924	4,022	0.31	%
Demand and other noninterest bearing deposits	722,665				529,677			
Other noninterest bearing liabilities	34,993				26,507			
Stockholders’ equity	462,390				347,801			
Total liabilities and stockholders’ equity	$3,490,390				$2,640,909			
Net interest income		$97,084				$78,645		
Net interest spread			4.10	%			4.35	%
Net interest margin			4.17	%			4.43	%
Average interest earning assets to average interest bearing liabilities			137.22	%			136.57	%

(1) Annualized

The decrease in net interest income for the three months ended September 30, 2015 compared to the same period in 2014 was primarily due to the decrease in loan yields. A decrease in the contractual loan note rates and a decrease in the effects of incremental accretion income caused the yield to decrease to 5.08% for the three months ended September 30, 2015 compared to 5.76% for the same period in 2014. The effect on loan yields from incremental accretion income decreased to 0.33% for the three months ended September 30, 2015 from 0.69% for the three months ended September 30, 2014. The decrease in loan yields was partially mitigated by an increase in average loans receivable of $161.6 million, or 7.4%, to $2.36 billion for the three months ended September 30, 2015 from $2.19 billion for the same period in 2014. The increase in net interest income for the nine months ended September 30, 2015 compared to the same period in 2014 was primarily the result of an increase in the interest on loans as a result of the Washington Banking Merger. The average loans receivable increased $532.8 million, or 30.2%, to $2.30 billion for the nine months ended September 30, 2015 compared to $1.76 billion for the same period in 2014. The increase in net interest income for the nine months ended September 30, 2015 was reduced by a decline in loan yields to 5.31% from 5.74% in same period of 2014 due to decreases in contractual note rates.

The increase in average balances of taxable securities and nontaxable securities to $726.2 million for the three months ended September 30, 2015 from $694.6 million for the three months ended September 30, 2014 is due primarily to investment purchases. The increase in the average balances of taxable securities and nontaxable securities to $750.1 million for the nine months ended September 30, 2015 compared to $458.6 million for the nine months ended September 30, 2014 is primarily attributable to the Washington Banking Merger as well as investment purchases,

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which also caused an increase in net interest income. The increase in interest income from securities was also due to increases in yields on nontaxable securities to 2.08% for both the three and nine months ended September 30, 2015 from 1.92% and 1.99% for the same periods in 2014, respectively. The increase in interest income from securities was partially offset by decreases in yield on taxable securities to 1.65% and 1.76% for the three and nine months ended September 30, 2015, respectively, from 1.69% and 1.89% for the same periods in 2014, respectively.

The average balance of interest bearing deposits increased $41.2 million, or 1.9%, to $2.26 billion for the three months ended September 30, 2015 from $2.21 billion for the three months ended September 30, 2014 and increased $526.4 million, or 31.0%, to $2.23 billion for the nine months ended September 30, 2015 from $1.70 billion for the same period in 2014. A decrease in the average rates to 0.23% from 0.27% resulted in a decrease of $198,000, or 12.9%, in interest expense on deposits for the three months ended September 30, 2015 compared to the same period in 2014. For the nine months ended September 30, 2015, the cost of deposits decreased to 0.24% from 0.29% for the comparable period in 2014, but the substantial increase in average deposits resulted in an increase of $276,000, or 7.5%, in interest expense on deposits for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014.

In connection with the Washington Banking Merger, the Company acquired the junior subordinated debentures of Washington Banking. The average rate of these debentures, including the effects of accretion of the discount established as of the date of the merger, for the three months ended September 30, 2015 was 4.01%, an increase of 44 basis points from 3.57% for the same period in 2014.

Net interest income as a percentage of average interest earning assets (net interest margin) for the three months ended September 30, 2015, decreased 32 basis points to 4.00% from 4.32% for the same period in 2014. The net interest margin for the nine months ended September 30, 2015, decreased 26 basis points to 4.17% from 4.43% for the same period in 2014. The net interest spread for the three and nine months ended September 30, 2015 decreased to 3.93% and 4.10%, respectively, from 4.24% and 4.35%, respectively, for the same periods in 2014.

The following table presents the net interest margins and effects of the incremental accretion on purchased loans for the three and nine months ended September 30, 2015 and 2014:

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2015		2014		2015		2014	
Net interest margin, excluding incremental accretion on purchased loans [1]	3.76	%	3.83	%	3.83	%	4.01	%
Impact on net interest margin from incremental accretion on purchased loans [1]	0.24		0.49		0.34		0.42	
Net interest margin	4.00	%	4.32	%	4.17	%	4.43	%

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

The impact on net interest margin from incremental accretion on purchased loans decreased 25 basis points to 0.24% for the three months ended September 30, 2015 from 0.49% for the same period in 2014 and decreased eight basis points to 0.34% for the nine months ended September 30, 2015 from 0.42% for the same period in 2014. The dollar amount of incremental accretion income was $1.9 million and $3.8 million for the three months ended September 30, 2015 and 2014, respectively. The decrease in the incremental accretion was primarily a result of a decrease in the prepayment of purchased loans, primarily from the Washington Banking Merger, during the three months ended September 30, 2015 compared to the same period in 2014. The dollar amount of incremental accretion income was $8.0 million for the nine months ended September 30, 2015 compared to $7.5 million for the same period in 2014. The increase in accretion during the nine months ended September 30, 2015 was primarily as a result of four additional months of income in 2015 as the Washington Banking Merger was not completed until May 1, 2014.

Total interest income decreased $1.5 million, or 4.4%, to $33.5 million for the three months ended September 30, 2015, from $35.0 million for the three months ended September 30, 2014 primarily as a result of the decrease in loan yields during the periods. Total interest income increased $19.1 million, or 23.1% to $101.7 million for the nine months ended September 30, 2015 from $82.7 million for the same period in 2014. The increase in interest income was primarily due to the increase in interest and fees on loans as a result of the Washington Banking Merger as well as organic loan growth. This increase for the nine months ended September 30, 2015 compared to the same period in 2014 was partially offset by a decrease in the loan yields as a result of lower contractual note rates as a result of the continuing low interest rate environment.

The balance of average interest earning assets (including nonaccrual loans) increased $104.4 million, or 3.4%, to $3.16 billion for the three months ended September 30, 2015, from $3.06 billion for the three months ended September 30, 2014. The increase for the three months is primarily a result of the increase in the balance of loans receivable. The balance of average interest earning assets (including nonaccrual loans) increased $743.3 million, or 31.3%, to $3.12 billion for the nine months ended September 30, 2015 from $2.37 billion for the same period in 2014. The increase in average interest earning assets is primarily due to the Washington Banking Merger. The Company acquired $1.00 billion of fair value in loans, excluding loans held for sale, and $458.3 million of fair value in investment securities in the Washington Banking Merger.

The yield on total interest earning assets decreased 34 basis points to 4.20% for the three months ended September 30, 2015 from 4.54% for the three months ended September 30, 2014 and decreased 29 basis points to 4.37% for the nine months ended September 30, 2015 from 4.66% for the same period in 2014. The decreases in the yield on interest earning assets reflects the decrease in loan and taxable securities yields primarily as a result of lower contractual rates from the low interest rate environment.

Total interest expense decreased by $180,000, or 10.4%, to $1.5 million for the three months ended September 30, 2015 from $1.7 million for the three months ended September 30, 2014. The decrease in interest expense was primarily due to a decrease in the yield on certificates of deposit to 0.52% for the three months ended September 30, 2015 from 0.59% for the same period in 2014. Total interest expense increased $616,000, or 15.3%, to $4.6 million for the nine months ended September 30, 2015 from $4.0 million for the same period in 2014. The increase in interest expense was attributable to the combination of higher average interest bearing deposit balances and the addition of the junior subordinated debenture as a result of the Washington Banking Merger, partially offset by lower average rates paid on certificates of deposit.

The average cost of interest bearing liabilities decreased three basis points to 0.27% for the three months ended September 30, 2015 from 0.30% for the three months ended September 30, 2014 and decreased four basis points to 0.27% for the nine months ended September 30, 2015 from 0.31% for the same period in the prior year. Total average interest bearing liabilities increased by $34.1 million, or 1.5%, to $2.30 billion for the three months ended September 30, 2015 from $2.26 billion for the three months ended September 30, 2014, primarily as a result of an increase in interest bearing demand and money market accounts. Total average interest bearing liabilities increased $533.4 million, or 30.7%, to $2.27 billion for the nine months ended September 30, 2015 from $1.74 billion for the same period in 2014. The increase in average interest bearing liabilities was due primarily to the Washington Banking Merger which had approximately $1.43 billion in fair value of assumed deposits (including noninterest bearing deposits) and $18.9 million in fair value of assumed junior subordinated debentures.

Deposit interest expense decreased $199,000, or 13.0%, to $1.3 million for the three months ended September 30, 2015 compared to $1.5 million for the same quarter in 2014 and increased $276,000, or 7.5%, to $4.0 million for the nine months ended September 30, 2015 from $3.7 million for the same period in 2014. The decrease in interest expense for the three months ended September 30, 2015 was due to a decrease in the cost of funds based on the low interest rate environment. The increase in deposit interest expense during the nine months ended September 30, 2014 compared to the same period in 2014 is primarily a result of the increase in the average deposit balance as a result of the Washington Banking Merger, offset partially by a decrease in the deposit average rate to 0.23% and 0.24%, respectively, for the three and nine months ended September 30, 2015, from 0.27% and 0.29%, respectively, for the same periods in 2014.

Due to the current low interest rate environment, together with the projected principal reduction in higher yielding purchased loans, the Company expects the net interest margin will continue to have downward pressure in future periods.

Provision for Loan Losses

The provision for loan losses is dependent on the Company’s ability to manage asset quality and control the level of net charge-offs through prudent underwriting standards. In addition, a decline in general economic conditions could increase future provisions for loan losses and have a material effect on the Company’s net income.

The provision for loan losses increased $257,000, or 43.3% to $851,000 for the three months ended September 30, 2015 from $594,000 for the three months ended September 30, 2014 and increased $1.5 million, or 86.3%, to $3.2 million for the nine months ended September 30, 2015 from $1.7 million for the same period in 2014. The amount of the provision was calculated in accordance with the Company's methodology for determining the allowance for loan losses as discussed below. The increase in provision for loan losses from prior year periods was primarily the result of loan growth from the prior year periods.

Based on the change in mix and volume of the loan portfolio at September 30, 2015 compared to December 31, 2014, as well as the decrease in certain historical loss factors and improvements in certain environmental factors, the Company determined that the provision for loan losses for the three and nine months ended September 30, 2015 was appropriate. The ratio of net charge-offs (recoveries) to average loans outstanding was 0.02% and 0.11% for the three and nine months ended September 30, 2015, respectively, compared to 0.13% and 0.17% for the three and nine months ended September 30, 2014, respectively.

The Bank has established a comprehensive methodology for determining the allowance for loan losses on non-PCI loans. On a quarterly basis, the Bank performs an analysis taking into consideration pertinent factors underlying the credit quality of the loan portfolio. These factors include changes in the amount and composition of the loan portfolio, historical loss experience for various loan classes, changes in economic conditions, delinquency rates, a detailed analysis of individual loans on nonaccrual status, and other factors to determine the level of the allowance for loan losses.

For the PCI loans, the acquisition date fair value incorporated our estimate of future expected cash flows until the ultimate resolution of these credits. To the extent actual or projected cash flows are less than previously estimated, additional provisions for loan losses on the PCI loan portfolio will be recognized immediately into earnings. To the extent actual or projected cash flows are more than previously estimated, the increase in cash flows is recognized immediately as a recapture of provision for loan losses up to the previously recognized provision for that loan or pool of loans, if any, and then prospectively recognized in interest income as a yield adjustment.

The allowance for loan losses increased by $1.3 million, or 4.6%, to $29.0 million at September 30, 2015 from $27.7 million at December 31, 2014. As of September 30, 2015, the Bank identified $30.7 million of impaired loans, of which $7.4 million have no allowances for credit losses as their estimated collateral value or discounted estimated cash flow is equal to or exceeds their carrying value. The remaining $23.3 million of impaired loans have related allowances for credit losses totaling $3.3 million.

Based on the established comprehensive methodology, management deemed the allowance for loan losses of $29.0 million at September 30, 2015 (1.21% of loans receivable, net and 292.76% of nonperforming loans) appropriate to provide for probable incurred credit losses based on an evaluation of known and inherent risks in the loan portfolio at that date. This compares to an allowance for loan losses at December 31, 2014 of $27.7 million (1.23% of loans receivable, net and 239.62% of nonperforming loans). At the applicable acquisition or merger dates, no allowance for loan losses was established on purchased loans as the loans were accounted for at their fair value and a discount was established for the loans. At September 30, 2015 and December 31, 2014, the remaining fair value discount for the purchased loans was $21.6 million and $29.7 million, respectively.

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The following table outlines the allowance for loan losses on loans and related loan balances at September 30, 2015 and December 31, 2014:

	September 30, 2015	December 31, 2014
	(Dollars in thousands)	
General Valuation Allowance:		
Allowance for loan losses	$16,654	$15,016
Gross loans, excluding PCI and impaired loans	$2,280,875	$2,102,512
Percentage	0.73 %	0.71 %
PCI Allowance:		
Allowance for loan losses	$9,070	$9,055
Gross PCI loans	$92,158	$119,271
Percentage	9.84 %	7.59 %
Specific Valuation Allowance:		
Allowance for loan losses	$3,280	$3,658
Gross impaired loans	$30,691	$30,231
Percentage	10.69 %	12.10 %
Total Allowance for Loan Losses:		
Allowance for loan losses	$29,004	$27,729
Gross loans receivable	$2,403,724	$2,252,014
Percentage	1.21 %	1.23 %

While the Bank believes it has established its existing allowances for loan losses in accordance with GAAP, there can be no assurance that bank regulators, in reviewing the Bank’s loan portfolio, will not request the Bank to increase significantly its allowance for loan losses. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is appropriate or that increased provisions will not be necessary should the credit 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.

Noninterest Income

Total noninterest income increased $4.1 million, or 74.1%, to $9.5 million for the three months ended September 30, 2015 compared to $5.5 million for the same period in 2014. Total noninterest income increased $12.2 million, or 97.0%, to $24.8 million for the nine months ended September 30, 2015 compared to $12.6 million for the same period in 2014. The following tables present the change in the key components of noninterest income for the periods noted.

	Three Months Ended September 30,			
	2015	2014	Change	Percentage Change
	(Dollars in thousands)			
Service charges and other fees	$3,593	$3,524	$69	2.0 %
Merchant Visa income, net	66	278	(212)	(76.3)
Change in FDIC indemnification asset	—	(647)	647	100.0
Gain (loss) on sale of investment securities, net	393	(13)	406	3,123.1
Gain on sale of loans, net	1,411	742	669	90.2
Other income	4,081	1,599	2,482	155.2
Total noninterest income	$9,544	$5,483	$4,061	74.1 %

	Nine Months Ended September 30,			
	2015	2014	Change	Percentage Change
	(Dollars in thousands)			
Service charges and other fees	$10,575	$7,700	$2,875	37.3 %
Merchant Visa income, net	458	839	(381)	(45.4)
Change in FDIC indemnification asset	(497)	(575)	78	13.6
Gain on sale of investment securities, net	1,362	254	1,108	436.2
Gain on sale of loans, net	3,828	975	2,853	292.6
Other income	9,043	3,377	5,666	167.8
Total noninterest income	$24,769	$12,570	$12,199	97.0 %

Service charges and other fees increased $69,000, or 2.0%, for the three months ended September 30, 2015 compared to the same period in 2014 and increased $2.9 million, or 37.3%, for the nine months ended September 30, 2015 compared to the same period in 2014. The increase in service charges and other fees are primarily the result of customer balance increases in deposit accounts, which increased during the nine months ended September 30, 2015 compared to the same period in 2014 primarily as a result of the Washington Banking Merger. For the three and nine months ended September 30, 2015, average total deposits were $3.02 billion and $2.95 billion, respectively, compared to $2.90 billion and $2.23 billion for the three and nine months ended September 30, 2014, respectively. On the effective date of the Washington Banking Merger, the Bank assumed fair value of $1.43 billion of deposits.

Gain on sale of investment securities, net was $393,000 and $1.4 million for the three and nine months ended September 30, 2015, respectively, compared to a net loss of $13,000 and a net gain of $254,000 for the same periods in 2014, respectively. The increase in gains is primarily due to additional restructuring of the investment portfolio in anticipation of rising interest rates.

Gain on sale of loans, net was $1.4 million and $3.8 million for the three and nine months ended September 30, 2015, respectively, and $742,000 and $975,000 for the three and nine months ended September 30, 2014, respectively, and includes net gains on sale of one-to-four family residential loans as well as net gains on the sale of the government guaranteed portion of certain SBA loans. The increase in both periods was due to impact of the Washington Banking Merger. The Company discontinued its mortgage banking operations in the second quarter of 2013 and did not sell the government guaranteed portion of SBA loans prior to the Washington Banking Merger. Mortgage banking operations were resumed with the consummation of the Washington Banking Merger on May 1, 2014 as were the sales of government guaranteed portions of certain SBA loans.

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Other income increased $2.5 million, or 155.2%, to $4.1 million for the three months ended September 30, 2015 from $1.6 million for the three months ended September 30, 2014 and increased $5.7 million, or 167.8%, to $9.0 million for the nine months ended September 30, 2015 from $3.4 million for the same period in 2014. The increase in the three months ended September 30, 2015 compared to the same period in 2014 was primarily the result of the $1.7 million pre-tax gain on the FDIC shared-loss termination agreement. The increase during the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014 was also due to the Company's sale of its merchant Visa portfolio in January 2015, which generated a gain of $1.7 million. The effects of this sale will result in lower merchant Visa income. As indicated in the table above, the merchant Visa income, net decreased $212,000, or 76.3%, to $66,000 for the three months ended September 30, 2015 from $278,000 for the three months ended September 30, 2014 primarily due to the sale. The increase in other income for the three and nine months ended September 30, 2015 was also partially a result of loan loss recoveries primarily of Washington Banking loans which were charged-off prior to consummation of the Washington Banking Merger. These off-balance sheet loan deficiencies had a zero fair value estimate at the May 1, 2014 effective date of the Washington Banking Merger. Other income also included $352,000 and $707,000 of income from bank-owned life insurance policies for the three and nine months ended September 30, 2015, respectively, compared to $146,000 and $241,000, respectively, for the three and nine months ended September 30, 2014. The Company purchased $25.0 million in bank-owned life insurance policies during the second quarter of 2015, which increased other income during the three months ended September 30, 2015. The Company did not have bank-owned life insurance policies prior to the Washington Banking Merger.

The change in FDIC indemnification asset includes amortization of and changes to the FDIC indemnification asset as a result of changes in the projected remaining cash flows of the purchased loans which were covered prior to the termination agreement on August 4, 2015. As a result of the termination agreement and based on management's estimates, the Bank did not record amortization or change in the cash flows for the purchased loans during the three months ended September 30, 2015. The Bank recorded $398,000 of amortization of the FDIC indemnification asset during the three months ended September 30, 2014, and recorded $145,000 and $1.1 million of amortization during the nine months ended September 30, 2015 and 2014, respectively.

Noninterest Expense

Noninterest expense decreased $1.0 million, or 3.7%, to $27.3 million during the three months ended September 30, 2015 compared to $28.4 million for the three months ended September 30, 2014 and increased $9.3 million, or 13.3%, to $79.4 million for the nine months ended September 30, 2015 compared to $70.1 million for the same period in 2014. The following tables present the change in the key components of noninterest expense for the periods noted.

	Three Months Ended September 30,			
	2015	2014	Change	Percentage Change
	(Dollars in thousands)			
Compensation and employee benefits	$14,918	$15,579	$(661)	(4.2)%
Occupancy and equipment	3,970	3,978	(8)	(0.2)
Data processing	2,398	1,978	420	21.2
Marketing	899	841	58	6.9
Professional services	894	1,113	(219)	(19.7)
State and local taxes	619	576	43	7.5
Federal deposit insurance premium	499	403	96	23.8
Other real estate owned, net	(5)	650	(655)	(100.8)
Amortization of intangible assets	523	603	(80)	(13.3)
Other expense	2,607	2,642	(35)	(1.3)
Total noninterest expense	$27,322	$28,363	$(1,041)	(3.7)%

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	Nine Months Ended September 30,			
	2015	2014	Change	Percentage Change
	(Dollars in thousands)			
Compensation and employee benefits	$42,984	$36,369	$6,615	18.2 %
Occupancy and equipment	11,511	9,412	2,099	22.3
Data processing	5,950	6,977	(1,027)	(14.7)
Marketing	2,595	1,843	752	40.8
Professional services	2,602	5,173	(2,571)	(49.7)
State and local taxes	1,808	1,378	430	31.2
Impairment loss on investment securities, net	—	45	(45)	100.0
Federal deposit insurance premium	1,537	1,115	422	37.8
Other real estate owned, net	854	915	(61)	(6.7)
Amortization of intangible assets	1,577	1,248	329	26.4
Other expense	8,021	5,661	2,360	41.7
Total noninterest expense	$79,439	$70,136	$9,303	13.3 %

The decrease in total noninterest expense for the three months ended September 30, 2015 compared to the same period in 2014 is primarily a result of a decrease in compensation and employee benefit expense as well as a decrease in other real estate owned expense. The increase in total noninterest expense for the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014 was due primarily to increased expenses related to the Washington Banking Merger.

Compensation and employee benefits decreased $661,000, or 4.2%, to $14.9 million during the three months ended September 30, 2015 compared to $15.6 million during the three months ended September 30, 2014 and increased $6.6 million, or 18.2%, to $43.0 million for the nine months ended September 30, 2015 compared to $36.4 million for the nine months ended September 30, 2014. The decrease in the three months ended September 30, 2015 compared to the same period in 2014 is primarily the result of a decrease in number of full-time equivalent employees. The increase in compensation and employee benefits in the nine months ended September 30, 2015 compared to the nine months ended September 30, 2014 is attributable to the Washington Banking Merger.

Occupancy and equipment remained relatively unchanged at $4.0 million for the three months ended September 30, 2015, decreasing $8,000, or 0.2%, from the comparable period in 2014, and increased $2.1 million, or 22.3%, to $11.5 million for the nine months ended September 30, 2015 compared to $9.4 million for the same period in 2014. The increase for the nine month period was primarily the result of lease expenses associated with the acquired Whidbey branches.

Data processing increased $420,000, or 21.2%, to $2.4 million for the three months ended September 30, 2015 from $2.0 million for the same period in 2014 primarily due to a $429,000 cancellation fee incurred during the third quarter of 2015 as a result of the early termination of a data processing contract. Data processing expense decreased $1.0 million, or 14.7%, to $6.0 million for the nine months ended September 30, 2015 compared to $7.0 million for the same period in 2014 due to merger-related data processing expenses of $2.8 million recognized during the nine months ended September 30, 2014, partially offset by the above-mentioned cancellation fee and additional data processing costs associated with a larger post-merger organization with an increase in the number of accounts and users.

Professional services decreased $219,000, or 19.7%, to $894,000 for the three months ended September 30, 2015 from $1.1 million for the three months ended September 30, 2014 and decreased $2.6 million, or 49.7%, to $2.6 million for the nine months ended September 30, 2015 compared to $5.2 million for the same period in 2014. The decrease in professional services was related to expenses incurred during the three and nine months ended September 30, 2014 of $430,000 and $3.7 million, respectively, for attorney, accountant and financial advisor fees in conjunction primarily with the Washington Banking Merger.

Other real estate owned, net expense decreased $655,000, or 100.8%, to a gain of $5,000 during the three months ended September 30, 2015 compared to a $650,000 expense during the three months ended September 30, 2014 and decreased $61,000, or 6.7%, to $854,000 for the nine months ended September 30, 2015 compared to $915,000 for the same period in 2014. The decrease in other real estate owned expense during the three months ended September 30, 2015 compared to the three months ended September 30, 2014 was primarily the result of the

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gain on sale of other real estate owned of $3,000 compared to a loss on sale of other real estate owned of $378,000 during the three months ended September 30, 2015 and 2014, respectively. The decrease in other real estate owned expense for the nine months ended September 30, 2015 compared to the same prior year period was primarily due to a decrease in related operating expenses based on a decrease in the number of owned properties evidenced also by a decrease in the other real estate owned balance to $2.1 million at September 30, 2015 from $3.4 million at December 31, 2014. The decrease in operating expenses was partially offset by a valuation adjustments of $415,000 and losses on sales of other real estate owned in the amount of $94,000 which were incurred during the three months ended September 30, 2015 compared to loss on sales of other real estate owned of $312,000 during the comparable period in 2014. There were no valuation adjustments during the nine months ended September 30, 2014.

Other expense remained relatively unchanged at $2.6 million for the three months ended September 30, 2015, decreasing only $35,000, or 1.3%, from the same period in 2014, and increased $2.4 million, or 41.7%, to $8.0 million for the nine months ended September 30, 2015 compared to $5.7 million for the same period in 2014. The increase for the nine months ended September 30, 2015 compared to the same period in 2014 was primarily the result of the increases in employee-related expenses such as courier services, travel expenses, telephone and Visa card expenses given the increase in employees and market area as a result of the Washington Banking Merger.

The ratio of noninterest expense to average assets (annualized) was 3.05% and 3.04% for the three and nine months ended September 30, 2015, respectively, compared to 3.27% and 3.55% for the three and nine months ended September 30, 2014, respectively. The decreases were primarily a result of cost efficiencies gained from the Washington Banking Merger as well as merger-related expenses incurred during 2014.

Income Tax Expense

Income tax expense increased by $1.1 million, or 38.1%, to $3.8 million for the three months ended September 30, 2015 from $2.8 million for the three months ended September 30, 2014 and increased $5.6 million, or 100.3%, to $11.2 million for the nine months ended September 30, 2015 compared to $5.6 million for the same period in 2014. The Company’s effective tax rate was 28.7% and 28.5% for the three and nine months ended September 30, 2015, respectively, compared to 28.1% and 28.8% for the same periods in 2014, respectively. The increases in the income tax expense was primarily due to the increases in pre-tax income. The increase in the Company's effective tax rate for the three months ended September 30, 2015 is primarily due the tax credits as a result of investment in new markets tax credit partnerships recorded during the three months ended September 30, 2014. The decrease in the Company’s effective tax rate for the nine months ended September 30, 2015 compared to the same period in 2014 is due primarily to the purchase of an additional $25.0 million in bank-owned life insurance policies in May 2015, the income of which is exempt from income taxes.

Financial Condition Overview

Total assets increased $137.6 million, or 4.0%, to $3.60 billion as of September 30, 2015 compared to $3.46 billion as of December 31, 2014. The total loans receivable, net increased $151.7 million, or 6.8%, to $2.38 billion at September 30, 2015 compared to $2.22 billion at December 31, 2014. Loans were primarily funded through an increase in deposits and secondarily through the decrease in investment securities available for sale. Investment securities available for sale decreased $39.8 million, or 5.4%, to $703.1 million at September 30, 2015 from $742.8 million at December 31, 2014. Cash and cash equivalents increased $20.8 million, or 17.1%, to $142.5 million at September 30, 2015 from $121.6 million at December 31, 2014.

FHLB stock decreased $8.0 million, or 66.0%, to $4.1 million at September 30, 2015 from $12.2 million at December 31, 2014 due to the repurchase of stock by the FHLB of Seattle as a result of the FHLB of Seattle merger with the FHLB of Des Moines which was effective during the second quarter of 2015. Based on the FHLB of Des Moines structure, the amount of stock to be held by participating banks is substantially less than that of the former FHLB of Seattle.

Bank owned life insurance increased $25.8 million, or 73.3%, to $60.9 million as of September 30, 2015 from $35.2 million at December 31, 2014. The increase was due primarily to the purchase of an additional $25.0 million in bank owned life insurance policies during the second quarter of 2015.

Deposits increased by $147.9 million, or 5.1%, to $3.05 billion as of September 30, 2015 compared to $2.91 billion as of December 31, 2014. Total non-maturity deposits increased to 85.7% of total deposits at September 30, 2015 from 81.9% at December 31, 2014 and certificates of deposits decreased to 14.3% of total deposits at September 30, 2015 from 18.1% at December 31, 2014.

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Securities sold under agreement to repurchase decreased $9.4 million, or 29.1%, to $22.8 million as of September 30, 2015 from $32.2 million as of December 31, 2014. The decrease is primarily due to changes in customer deposit balances.

Accrued expenses and other liabilities decreased $15.3 million, or 33.6%, to $30.3 million at September 30, 2015 from $45.7 million at December 31, 2014 primarily as a result of the FDIC shared-loss termination agreement signed during the three months ended September 30, 2015. The Bank paid the FDIC $7.1 million based on the terms of the agreement. The FDIC clawback liability, included in accrued expenses and other liabilities, was $9.3 million at the termination date. The FDIC termination agreement also eliminated the FDIC indemnification Asset which was $388,000 at the termination date. The decrease in accrued expenses and other liabilities was also a result of federal income tax payments and incentive compensation payments made during the first quarter of 2015.

Total stockholders' equity increased by $14.2 million, or 3.1%, to $468.7 million as of September 30, 2015 from $454.5 million at December 31, 2014. The increase during the nine months ended September 30, 2015 was due primarily to net income of $28.0 million, partially offset by cash dividends declared of $9.6 million and common stock repurchases totaling $7.7 million. The Company's equity position remains strong at 13.0% of total assets as of September 30, 2015 compared to 13.1% as of December 31, 2014.

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The table below provides a comparison of the changes in the Company's financial condition from December 31, 2014 to September 30, 2015.

	September 30, 2015	December 31, 2014	Change between September 30, 2015 and December 31, 2014
Assets			
Cash and cash equivalents	$142,477	$121,636	$20,841
Other interest earning deposits	5,244	10,126	(4,882)
Investment securities	735,925	778,660	(42,735)
Loans held for sale	7,981	5,582	2,399
Total loans receivable, net	2,375,040	2,223,348	151,692
FDIC indemnification asset	—	1,116	(1,116)
Other real estate owned	2,071	3,355	(1,284)
Premises and equipment, net	63,356	64,938	(1,582)
Federal Home Loan Bank stock, at cost	4,148	12,188	(8,040)
Bank owned life insurance	60,945	35,176	25,769
Accrued interest receivable	10,831	9,836	995
Prepaid expenses and other assets	59,019	61,871	(2,852)
Other intangible assets, net	9,312	10,889	(1,577)
Goodwill	119,029	119,029	—
Total assets	$3,595,378	$3,457,750	$137,628
Liabilities			
Deposits	$3,054,198	$2,906,331	$147,867
Junior subordinated debentures	19,351	19,082	269
Securities sold under agreement to repurchase	22,829	32,181	(9,352)
Accrued expenses and other liabilities	30,304	45,650	(15,346)
Total liabilities	3,126,682	3,003,244	123,438
Stockholders' equity			
Common stock	358,927	364,741	(5,814)
Retained earnings	104,762	86,387	18,375
Accumulated other comprehensive income, net	5,007	3,378	1,629
Total stockholders' equity	468,696	454,506	14,190
Total liabilities and stockholders' equity	$3,595,378	$3,457,750	$137,628

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Lending Activities

As indicated in the table below, loans receivable, net was $2.40 billion at September 30, 2015, an increase of $153.0 million, or 6.8%, from $2.25 billion at December 31, 2014. The increase in loans receivable for the nine months ended September 30, 2015 was primarily due to increased commercial business loans.

	September 30, 2015			December 31, 2014		
	Balance	% of Total		Balance	% of Total	
	(Dollars in thousands)					
Commercial business:						
Commercial and industrial	$618,390	25.7	%	$570,453	25.3	%
Owner-occupied commercial real estate	603,372	25.1		594,986	26.4	
Non-owner occupied commercial real estate	703,771	29.3		643,636	28.6	
Total commercial business	1,925,533	80.1		1,809,075	80.3	
One-to-four family residential	70,577	2.9		69,530	3.1	
Real estate construction and land development:						
One-to-four family residential	49,745	2.1		49,195	2.2	
Five or more family residential and commercial properties	73,328	3.1		64,920	2.9	
Total real estate construction and land development	123,073	5.2		114,115	5.1	
Consumer	284,541	11.8		259,294	11.5	
Gross loans receivable	2,403,724	100.0		2,252,014	100.0	
Deferred loan costs (fees), net	320	—		(937)	—	
Loans receivable, net	$2,404,044	100.0	%	$2,251,077	100.0	%

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Nonperforming Assets

The following table describes our nonperforming assets at the dates indicated:

	September 30, 2015		December 31, 2014	
	(Dollars in thousands)			
Nonaccrual loans:				
Commercial business	$7,193		$8,596	
One-to-four family residential	40		—	
Real estate construction and land development	2,612		2,831	
Consumer	62		145	
Total nonaccrual loans (1)(2)	9,907		11,572	
Other real estate owned	2,071		3,355	
Total nonperforming assets	$11,978		$14,927	
Performing TDR loans:				
Commercial business	$28,515		$24,269	
One-to-four family residential	238		245	
Real estate construction and land development	3,500		4,355	
Consumer	207		184	
Total performing TDR loans (3)	$32,460		$29,053	
Accruing loans past due 90 days or more (4)	$—		$—	
Potential problem loans (5)	113,271		162,930	
Allowance for loan losses	29,004		27,729	
Allowance for loan losses to loans receivable, net	1.21	%	1.23	%
Allowance for loan losses to nonperforming loans	292.76	%	239.62	%
Nonperforming loans to total loans receivable, net	0.41	%	0.51	%
Nonperforming assets to total assets	0.33	%	0.43	%

(1) At September 30, 2015 and December 31, 2014, $6.6 million and $7.3 million of nonperforming loans, respectively, were considered troubled debt restructurings.

(2) At September 30, 2015 and December 31, 2014, $1.4 million and $1.6 million of nonperforming loans, respectively, were guaranteed by government agencies.

(3) At September 30, 2015 and December 31, 2014, $452,000 and $751,000 of performing TDR loans, respectively, were guaranteed by government agencies.

(4) There were no accruing loans past due 90 days or more that were guaranteed by government agencies at September 30, 2015 or December 31, 2014.

(5) At September 30, 2015 and December 31, 2014, $920,000 and $2.0 million of potential problem loans, respectively, were guaranteed by government agencies.

Nonperforming assets decreased $2.9 million, or 19.8%, to $12.0 million, or 0.33% of total assets, at September 30, 2015 from $14.9 million, or 0.43% of total assets at December 31, 2014 due to a decrease of $1.7 million in nonaccrual loans and a decrease of $1.3 million in other real estate owned. For the nine months ended September 30, 2015, the decrease in nonaccrual loans was primarily due to $2.8 million in net principal reductions and $408,000 in charge-offs, offset partially by additions of $1.8 million in nonaccrual loans. The other real estate owned balance decreased to $2.1 million at September 30, 2015 from $3.4 million at December 31, 2014 as a result of the sale of 14 properties with net proceeds of $3.2 million and losses of $94,000 along with a $415,000 valuation adjustment to record seven properties at their estimated proceeds value based on recent purchase and sales agreements.

Performing TDR loans were $32.5 million and $29.1 million as of September 30, 2015 and December 31, 2014, respectively. The $3.4 million, or 11.7%, increase in the performing TDR loans for the nine months ended September 30, 2015 was primarily the result of the restructuring of $7.8 million of loans during the period, which was partially offset by net principal payments of $3.3 million and $1.1 million of loans transferred to nonaccrual status. At

September 30, 2015 and December 31, 2014, the Company had recorded $2.0 million and $1.9 million, respectively, in allowance for loan losses on the performing TDR loans.

Potential problem loans as of September 30, 2015 and December 31, 2014 were $113.3 million and $162.9 million, respectively. Potential problem loans are those loans that are currently accruing interest and are not considered impaired, but which we are monitoring because the financial information of the borrower causes us concerns as to their ability to comply with their loan repayment terms. Loans that are past due 90 days or more and still accruing interest are both well secured and in the process of collection. The $49.7 million, or 30.5%, decrease in potential problem loans was primarily the result of $35.0 million of loan principal payments (net), $24.0 million in loan grade improvements and $3.5 million of loans transferred to impaired status, partially offset by the addition of $13.6 million of loans graded as potential problem loans during the nine months ended September 30, 2015.

Analysis of Allowance for Loan Losses

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

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

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

•The impact of environmental factors, including:

Levels of and trends in delinquencies and impaired loans;

Levels and trends in charge-offs and recoveries;

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

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

National and local economic trends and conditions;

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

Effects of changes in credit concentrations.

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

For the PCI loans, the acquisition date fair value incorporated our estimate of future expected cash flows until the ultimate resolution of these credits. To the extent actual or projected cash flows are less than previously estimated, additional provisions for loan losses on the PCI loan portfolio will be recognized immediately into earnings. To the extent actual or projected cash flows are more than previously estimated, the increase in cash flows is recognized immediately as a recapture of provision for loan losses up to the previously recognized provision for that loan or pool of loans, if any, and then prospectively recognized in interest income as a yield adjustment.

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

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The following table provides information regarding changes in our allowance for loan losses as of and for the three and nine months ended September 30, 2015:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
	(Dollars in thousands)			
Loans receivable, net at the end of the period	$2,404,044	$2,202,883	$2,404,044	$2,202,883
Average loans receivable during the period	$2,356,090	$2,194,460	$2,295,881	$1,763,081
Allowance for loan losses on loans at the beginning of the period	$28,278	$28,483	$27,729	$28,824
Provision for loan losses	851	594	3,247	1,743
Charge-offs:				
Commercial business	(70)	(509)	(1,580)	(1,991)
Real estate construction and land development	—	—	(106)	(345)
Consumer	(278)	(315)	(1,208)	(557)
Total charge-offs	(348)	(824)	(2,894)	(2,893)
Recoveries:				
Commercial business	59	43	447	544
One-to-four family residential	12	—	13	—
Real estate construction and land development	—	—	100	43
Consumer	152	46	362	81
Total recoveries	223	89	922	668
Net charge-offs	(125)	(735)	(1,972)	(2,225)
Allowance for loan losses at end of period	$29,004	$28,342	$29,004	$28,342
Allowance for loan losses to loans receivable, net	1.21%	1.29%	1.21%	1.29%
Ratio of net charge-offs during period to average loans receivable (annualized)	0.02%	0.13%	0.11%	0.17%

The allowance for loan losses increased $1.3 million, or 4.6%, to $29.0 million at September 30, 2015 from $27.7 million as of December 31, 2014. The allowance for loan losses to loans receivable, net ratio decreased slightly to 1.21% at September 30, 2015 from 1.23% at December 31, 2014.

The nonperforming loans decreased $1.7 million, or 14.4%, to $9.9 million at September 30, 2015 from $11.6 million at December 31, 2014. Nonperforming loans to loans receivable, net was 0.41% at September 30, 2015 compared to 0.51% December 31, 2014, and the allowance for loan losses to nonperforming loans was 292.76% at September 30, 2015 and 239.62% at December 31, 2014.

Based on management’s assessment of loan quality and current economic conditions, the Company believes that its allowance for loan losses was appropriate to absorb the probable incurred credit losses and inherent risks of loss in the loan portfolio at September 30, 2015.

Deposits and Other Borrowings

As indicated in the table below, total deposits were $3.05 billion at September 30, 2015, an increase of $147.9 million, or 5.1%, from $2.91 billion at December 31, 2014.

	September 30, 2015		December 31, 2014	
	Balance	% of Total	Balance	% of Total
	(Dollars in thousands)			
Non-interest bearing demand deposits	$762,240	25.0 %	$709,673	24.4 %
NOW accounts	893,031	29.2	793,362	27.3
Money market accounts	513,859	16.8	520,065	17.9
Savings accounts	447,529	14.7	357,834	12.3
Total non-maturity deposits	2,616,659	85.7	2,380,934	81.9
Certificates of deposit	437,539	14.3	525,397	18.1
Total deposits	$3,054,198	100.0 %	$2,906,331	100.0 %

The increase in deposits was the result of customer activities. Non-maturity deposits (total deposits less certificates of deposit) have increased $235.7 million, or 9.9%, to $2.62 billion at September 30, 2015 from $2.38 billion at December 31, 2014 and certificate of deposit accounts have decreased $87.9 million, or 16.7%, to $437.5 million at September 30, 2015 from $525.4 million at December 31, 2014. Based on the change in the mix and volume of deposits, the percentage of certificates of deposit to total deposits decreased to 14.3% at September 30, 2015 from 18.1% at December 31, 2014.

Borrowings may 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. The Bank is utilizing securities sold under agreement to repurchase as a supplement to its funding sources. Our repurchase agreements are secured by available for sale investment securities. At September 30, 2015, the Bank had securities sold under agreement to repurchase totaling $22.8 million, a decrease of $9.4 million, or 29.1%, from $32.2 million at December 31, 2014. The decrease is the result of customer activity during the period.

As part of the Washington Banking Merger, the Company acquired junior subordinated debentures with fair value of $18.9 million. The debentures have a par value of $25.0 million, and pay quarterly interest based on three-month LIBOR plus 1.56%. The debentures mature in 2037. The balance of the junior subordinated debentures at September 30, 2015 was $19.4 million.

We are required to 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 September 30, 2015, cash and cash equivalents totaled $142.5 million, or 4.0% of total assets. In addition, $1.5 million of the $5.2 million of other interest earning deposits are scheduled to mature within one year of September 30, 2015. The fair value of investment securities available for sale totaled $703.1 million at September 30, 2015 of which $222.6 million were pledged to secure public deposits or borrowing arrangements. The fair value of investment securities available for sale that were not pledged to secure public deposits or borrowing arrangements totaled $480.5 million, or 13.0%, of total assets at September 30, 2015. The fair value of investment securities available for sale with maturities of one year or less were $3.5 million, or 0.1% of total assets at September 30, 2015.

At September 30, 2015, the Bank maintained credit facilities with the FHLB for $501.3 million and credit facilities with the Federal Reserve Bank of San Francisco for $57.3 million, of which there were no borrowings outstanding at September 30, 2015. The Bank also maintains lines of credit with four correspondent banks to purchase federal funds totaling $90.0 million as of September 30, 2015. There were no federal funds purchased as of September 30, 2015.

Liquidity and Cash Flows

Our primary sources of funds are customer deposits, loan principal and interest payments and interest earned on and proceeds from sales and maturities of investment securities. These funds, together with retained earnings, equity and other borrowed funds (as necessary), are used to make loans, acquire investment securities and other assets, and fund continuing operations. While maturities and scheduled amortization of loans are predictable sources of funds, deposit flows and prepayments are greatly influenced by the level of interest rates, economic conditions, and competition. In addition to customer deposits, management may utilize the use of brokered deposits on an as-needed basis.

Heritage Bank: The principal objective of the Bank's liquidity management program is to maintain the ability to meet day-to-day cash flow requirements of its customers who either wish to withdraw funds or to draw upon credit facilities to meet their cash needs. The Bank monitors the sources and uses of funds on a daily basis to maintain an acceptable liquidity position. In addition to liquidity from core deposits and the repayment and maturities of loans, the Bank can utilize established credit facilities and lines with correspondent banks or sale of investment securities.

Heritage Financial Corporation: The Company is a separate legal entity from the Bank and must provide for its own liquidity. Substantially all of the Company's revenues are obtained from dividends declared and paid by the Bank. There are statutory and regulatory provisions that could limit the ability of the Bank to pay dividends to the Company. However, management believes that such restrictions will not have an adverse impact on the ability of the Company to meets its ongoing cash obligations.

Consolidated Cash Flows: As disclosed in the Condensed Consolidated Statements of Cash Flows, net cash provided by operating activities was $33.2 million for the nine months ended September 30, 2015, and primarily consisted of proceeds from sale of loans held for sale of $103.7 million, net income of $28.0 million and depreciation and amortization of $10.5 million, partially offset by originations for loans held for sale of $102.3 million, gain on sale of loans, net, of $3.8 million and net change in other assets and liabilities of $4.1 million. During the nine months ended September 30, 2015, net cash used in investing activities was $134.3 million, which consisted primarily of purchases of investment securities available for sale of $158.0 million, net loan originations of $156.1 million and the purchase of $25.0 million of bank-owned life insurance, offset partially by proceeds from sales of investment securities available for sale of $102.9 million and maturities of investment securities available for sale of $91.9 million. Net cash provided in financing activities was $122.0 million for the nine months ended September 30, 2015, and primarily consisted of a net increase in deposits of $147.9 million, offset partially by a $9.6 million payment of cash dividends on common stock, a $9.4 million decrease in the securities sold under agreement to repurchase, and $7.7 million of repurchases of common stock.

Capital and Capital Requirements

Stockholders' equity at September 30, 2015 was $468.7 million compared with $454.5 million at December 31, 2014. During the nine months ended September 30, 2015, the Company realized net income of $28.0 million, declared and paid cash dividends of $9.6 million, recorded $1.6 million in other comprehensive income, recorded stock-based compensation expense related to restricted stock totaling $1.2 million, recorded $686,000 related to the exercise of stock options, net of tax effect, and repurchased common stock for $7.7 million.

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

Pursuant to minimum capital requirements of the FDIC effective on January 1, 2015, all FDIC-insured financial institutions, including Heritage Bank, are required to maintain a minimum common equity Tier 1 risk-based capital to risk-weighted assets ratio of 4.5%, a minimum Tier 1 leverage ratio to average assets of 4.0% and minimum

risk-based capital ratios of Tier 1 capital to risk-weighted assets and total capital to risk-weighted assets of 6.0% and 8.0%, respectively.
As of September 30, 2015 and December 31, 2014, the most recent regulatory notifications categorized Heritage Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank’s categories.

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	Minimum Requirements			Well-Capitalized Requirements		Actual		
	$	%		$	%	$	%	
	(Dollars in thousands)							
As of September 30, 2015:								
The Company consolidated								
Common equity Tier 1 capital to risk-weighted assets	$122,231	4.5	%	N/A	N/A	$341,740	12.6	%
Tier 1 leverage capital to average assets	136,949	4.0		N/A	N/A	360,885	10.5	
Tier 1 capital to risk-weighted assets	162,974	6.0		N/A	N/A	360,885	13.3	
Total capital to risk-weighted assets	217,299	8.0		N/A	N/A	389,333	14.3	
Heritage Bank								
Common equity Tier 1 capital to risk-weighted assets	130,472	4.5		188,460	6.5	353,850	12.2	
Tier 1 leverage capital to average assets	136,883	4.0		171,103	5.0	353,850	10.3	
Tier 1 capital to risk-weighted assets	173,963	6.0		231,951	8.0	353,850	12.2	
Total capital to risk-weighted assets	231,951	8.0		289,939	10.0	383,027	13.2	
As of December 31, 2014:								
The Company consolidated								
Tier 1 leverage capital to average assets	$132,881	4.0	%	N/A	N/A	$340,292	10.2	%
Tier 1 capital to risk-weighted assets	97,620	4.0		N/A	N/A	340,292	13.9	
Total capital to risk-weighted assets	195,240	8.0		N/A	N/A	368,198	15.1	
Heritage Bank								
Tier 1 leverage capital to average assets	132,853	4.0		166,066	5.0	332,147	10.0	
Tier 1 capital to risk-weighted assets	97,585	4.0		146,378	6.0	332,147	13.6	
Total capital to risk-weighted assets	195,171	8.0		243,964	10.0	360,053	14.8	

In July 2013, the Federal banking regulators approved a final rule to implement the revised capital adequacy standards of the Basel Committee on Banking Supervision, commonly called Basel III, and to address relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The final rule strengthens the definition of regulatory capital, increases risk-based capital requirements, makes selected changes to the calculation of risk-weighted assets, and adjusts the prompt corrective action thresholds. Although new capital requirements were effective on January 1, 2015, certain provisions of the new rule will be phased in over the period of 2015 through 2019, including, among others, a new capital conservation buffer requirement, which requires banking organizations to maintain a common equity capital ratio more than 2.5% above the minimum common equity Tier 1 capital, Tier 1 capital and total risk-based capital ratios in order to avoid limitations on capital distributions, including dividend payments, and certain discretionary bonus payments. The capital conservation buffer requirement will be phased in beginning on January 1, 2016 at 0.625% and will be fully phased in at 2.50% by January 1, 2019.

Quarterly, the Company reviews the potential payment of cash dividends to its common shareholders. The timing and amount of cash dividends paid on our common stock depends on the Company's earnings, capital requirements, financial condition and other relevant factors. Dividends on common stock from the Company depend substantially upon receipt of dividends from the Bank, which is the Company's predominant source of income. On October 21, 2015, the Company's Board of Directors declared a regular dividend of $0.11 per common share and a special dividend of $0.10 per common share payable on November 18, 2015 to shareholders of record on November 4, 2015.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our results of operations are highly dependent upon our ability to manage interest rate risk. We consider interest rate risk to be a significant market risk that could have a material effect on our financial condition and results of operations. Interest rate risk is measured and assessed on a quarterly basis. In our opinion, there has not been a material change in our interest rate risk exposure since the information disclosed in our annual report on Form 10-K for the year-ended at December 31, 2014.

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

ITEM 4. CONTROLS AND PROCEDURES

(a) Evaluation of Disclosure Controls and Procedures

An evaluation of the Company’s disclosure controls and procedure (as defined in Section 13a-15(e) or 15d-15(e) of the Securities Exchange Act of 1934 (the “Act”)) was carried out under the supervision and with the participation of the Company’s Chief Executive Officer, Chief Financial Officer and the Company’s Disclosure Committee as of the end of the period covered by this quarterly report. In designing and evaluating the Company’s disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Based on their evaluation, the Company’s Chief Executive Officer and Chief Financial Officer concluded that the Company’s disclosure controls and procedures as of September 30, 2015 are effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Act is (i) accumulated and communicated to the Company’s management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms.

(b) Changes in Internal Control Over Financial Reporting

There have been no changes in the Company’s internal control over financial reporting (as defined in Rule 13a-15(f) of the Act) that occurred during the nine months ended September 30, 2015, that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting. The Company does not expect that its internal control over financial reporting will prevent all error and all fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any control procedure also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Heritage and Heritage Bank are not a party to any material pending legal proceedings other than ordinary routine litigation incidental to the business of the Bank.

ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors set forth in Part I. Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2014.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The Company has had various stock repurchase programs since March 1999. On October 23, 2014, the Company's Board of Directors authorized the repurchase of up to 5% of the Company's outstanding common shares, or approximately 1,513,000 shares, under the eleventh stock repurchase plan. The number, timing and price of shares repurchased will depend on business and market conditions, and other factors, including opportunities to deploy the Company's capital. On August 30, 2012, the Board of Directors approved the Company’s tenth stock repurchase plan, authorizing the repurchase of up to 5% of the Company’s outstanding shares of common stock, or approximately 757,000 shares. As the eleventh plan superseded the tenth stock repurchase program, the Company did not repurchase the total number of shares available under the tenth plan.

The following table provides total repurchased shares and average share prices under the applicable plans for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,		
	2015	2014	2015	2014	Plan Total (1)
Tenth Plan					
Repurchased shares	—	108,075		108,075	704,975
Stock repurchase average share price	$—	$16.88		$16.88	$15.85
Eleventh Plan					
Repurchased shares	—	—	441,966	—	441,966
Stock repurchase average share price	$—	$—	$16.64	$—	$16.64

(1) Represents shares repurchased and average share price paid during the duration of the plan.

In addition to the stock repurchases disclosed in the table above, the Company repurchased shares to pay withholding taxes on the vesting of restricted stock. During the three months ended September 30, 2015 and 2014, the Company repurchased 388 and 2,751 shares at an average price of $17.63 and $16.11, respectively, to pay withholding taxes on the vesting of restricted stock that vested during the three months ended September 30, 2015 and 2014, respectively. During the nine months ended September 30, 2015 and 2014, the Company repurchased 21,998 and 18,549 shares at an average price of $17.07 and $16.99, respectively, to pay withholding taxes on the vesting of restricted stock that vested during the nine months ended September 30, 2015 and 2014, respectively.

The following table sets forth information about the Company’s purchases of its outstanding common stock during the quarter ended September 30, 2015.

Period	Total Number of Shares Purchased(1)	Average Price Paid Per Share(1)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 1, 2015— July 31, 2015	314	$17.52	7,755,389	1,073,034
August 1, 2015— August 31, 2015	—	—	7,755,389	1,073,034
September 1, 2015—September 30, 2015	74	18.10	7,755,389	1,073,034
Total	388	$17.63	7,755,389	1,073,034

(1) All common shares repurchased by the Company between July 1, 2015 and September 30, 2015 were the cancellation of shares of restricted stock to pay withholding taxes.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

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ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS

Exhibit No.	Description of Exhibit
2.1	Purchase and Assumption Agreement for Cowlitz Acquisition (1)
2.2	Purchase and Assumption Agreement for Pierce Acquisition (2)
2.3	Definitive Agreement for Valley Acquisition (3)
2.4	Agreement and Plan of Merger with Washington Banking Company (4)
3.1	Articles of Incorporation (5)
3.2	Amended and Restated Bylaws of the Company (6)
10.1	1998 Stock Option and Restricted Stock Award Plan (7)
10.2	1997 Stock Option and Restricted Stock Award Plan (8)
10.3	2002 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan (9)
10.4	2006 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan (10)
10.5	Annual Incentive Compensation Plan (11)
10.6	2010 Omnibus Equity Plan (12)
10.7	2014 Omnibus Equity Plan (13)
10.8	Form of Nonqualified Stock Option Award Agreement under the Heritage Financial Corporation 2014 Omnibus Equity Plan (14)
10.9	Form of Restricted Stock Award Agreement under the Heritage Financial Corporation 2014 Omnibus Equity Plan (14)
10.10	Form of Restricted Stock Unit Award Agreement under the Heritage Financial Corporation 2014 Omnibus Equity Plan (14)
10.11	Deferred Compensation Plan and Participation Agreements by and between Heritage and each of Brian L. Vance, Jeffrey J. Deuel and Donald J. Hinson (15)
10.12	

	Employment Agreements by and between Heritage and each of Brian L. Vance, Jeffrey J. Deuel and Donald J. Hinson (15)
10.13	Employment Agreement and Deferred Compensation Participation Agreement by and between Heritage and David A. Spurling (16)
10.14	Employment Agreement by and between Heritage and Bryan McDonald (17)
10.15	Employment Agreements by and between Heritage and Edward Eng (17)
10.16	Deferred Compensation Plan and Participation Agreement by and between Heritage and Bryan D. McDonald (18)
10.17	Form of Split Dollar Agreements, dated August 3, 2015, by and between Heritage and Brian L. Vance, Jeffrey J. Deuel, Donald J. Hinson, Bryan D. McDonald and David A. Spurling (19)
11	Statement regarding computation of earnings per share (20)

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14.0	Code of Ethics and Conduct Policy (21)
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	The following materials from Heritage Financial Corporation’s Quarterly Report on Form 10-Q for the quarter ended September 30, 2015, formatted in Extensible Business Reporting Language (“XBRL”): (i) Unaudited Condensed Consolidated Statements of Financial Condition, (ii) Unaudited Condensed Consolidated Statements of Income; (iii) Unaudited Condensed Consolidated Statements of Comprehensive Income, (iv) Unaudited Condensed Consolidated Statements of Stockholders' Equity; (v) Unaudited Condensed Consolidated Statements of Cash Flows, and (vi) Unaudited Notes to Condensed Consolidated Financial Statements

(1) Incorporated by reference to the Current Report on Form 8-K dated July 30, 2010.
(2) Incorporated by reference to the Current Report on Form 8-K dated November 5, 2010.
(3) Incorporated by reference to the Current Report on Form 8-K dated March 11, 2013.
(4) Incorporated by reference to the Current Report on Form 8-K dated October 23, 2013.
(5) 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.
(6) Incorporated by reference to the Current Report on Form 8-K dated April 30, 2014.
(7) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-71415).
(8) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-57513).
(9) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-88980; 333-88982; 333-88976).
(10) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-134473; 333-134474; 333-134475).
(11) Incorporated by reference to the Annual Report on Form 10-K dated March 2, 2010.
(12) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 33-167146).
(13) Incorporated by reference to Heritage Financial Corporation's definitive proxy statement dated June 11, 2014.
(14) Incorporated by reference to the Current Report on Form 10-Q dated August 6, 2014.
(15) Incorporated by reference to the Current Report on Form 8-K dated September 7, 2012.
(16) Incorporated by reference to the Current Report on Form 8-K dated January 6, 2014.
(17) Incorporated by reference to the Registration Statement on Form S-4 (Reg. No. 333-192985).
(18) Incorporated by reference to the Annual Report on Form 10-K dated March 10, 2015.
(19) Incorporated by reference to the Current Report on Form 10-Q dated August 6, 2015.
(20) Reference is made to Note (10)—Stockholders' Equity in the Notes to Condensed Consolidated Financial Statements under Part 1. Item 1. herein.
(21) Registrant elects to satisfy Regulation S-K §229.406(c) by posting its Code of Ethics on its website at www.HF-WA.com in the section titled Investor Information: Corporate Governance.

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SIGNATURES

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

HERITAGE FINANCIAL CORPORATION

Date:
November 5, 2015

/S/ BRIAN L. VANCE
Brian L. Vance
President and Chief Executive Officer
(Duly Authorized Officer)

Date:
November 5, 2015

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

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EXHIBIT INDEX

Exhibit No.	Description of Exhibit
31.1	Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	The following financial information from Heritage Financial Corporation’s Quarterly Report on Form 10-Q for the quarter ended September 30, 2015 is formatted in XBRL: (i) the Unaudited Condensed Consolidated Statements of Financial Condition, (ii) the Unaudited Condensed Consolidated Statements of Income, (iii) the Unaudited Condensed Consolidated Statements Comprehensive Income, (iv) the Unaudited Condensed Consolidated Statements of Stockholders’ Equity, (v) the Unaudited Condensed Consolidated Statements of Cash Flows, and (vi) the Unaudited Notes to Condensed Consolidated Financial Statements.