HERITAGE FINANCIAL CORP /WA/
Form 10-Q
August 08, 2017
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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 June 30, 2017
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File Number 000-29480

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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, smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨	Smaller reporting company	¨
Emerging Growth Company	¨		

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

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 August 1, 2017 there were 29,930,530 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: 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 nonperforming 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 mergers, acquisitions or similar transactions and adversely affect our liquidity and earnings; legislative or regulatory changes; our ability to control operating costs and expenses; 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 growth strategies; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may 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; increased competitive pressures among financial service companies; changes in consumer spending, borrowing and savings habits; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board ("FASB"), including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; and other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and other risks detailed from time to time in our filings with the Securities and Exchange Commission including our Annual Report on Form 10-K for the year ended December 31, 2016.

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
(Unaudited)

	June 30, 2017	December 31, 2016
	(Dollars in thousands)	
ASSETS		
Cash on hand and in banks	$81,912	$77,117
Interest earning deposits	42,322	26,628
Cash and cash equivalents	124,234	103,745
Investment securities available for sale, at fair value	790,594	794,645
Loans held for sale	5,787	11,662
Loans receivable, net	2,749,507	2,640,749
Allowance for loan losses	(32,751)	(31,083)
Total loans receivable, net	2,716,756	2,609,666
Other real estate owned	786	754
Premises and equipment, net	60,603	63,911
Federal Home Loan Bank stock, at cost	9,083	7,564
Bank owned life insurance	71,112	70,355
Accrued interest receivable	11,081	10,925
Prepaid expenses and other assets	75,162	79,351
Other intangible assets, net	6,727	7,374
Goodwill	119,029	119,029
Total assets	$3,990,954	$3,878,981
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits	$3,291,250	$3,229,648
Federal Home Loan Bank advances	110,900	79,600
Junior subordinated debentures	19,863	19,717
Securities sold under agreement to repurchase	21,255	22,104
Accrued expenses and other liabilities	47,638	46,149
Total liabilities	3,490,906	3,397,218
Stockholders’ equity:		
Preferred stock, no par value, 2,500,000 shares authorized; no shares issued and outstanding at June 30, 2017 and December 31, 2016	—	—
Common stock, no par value, 50,000,000 shares authorized; 29,928,232 and 29,954,931 shares issued and outstanding at June 30, 2017 and December 31, 2016, respectively	359,535	359,060
Retained earnings	138,956	125,309
Accumulated other comprehensive income (loss), net	1,557	(2,606)
Total stockholders’ equity	500,048	481,763
Total liabilities and stockholders’ equity	$3,990,954	$3,878,981

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
	(Dollars in thousands, except per share amounts)			
INTEREST INCOME				
Interest and fees on loans	$31,500	$30,503	$61,985	$60,680
Taxable interest on investment securities	3,141	2,838	6,190	5,634
Nontaxable interest on investment securities	1,304	1,193	2,572	2,364
Interest and dividends on other interest earning assets	142	58	203	149
Total interest income	36,087	34,592	70,950	68,827
INTEREST EXPENSE				
Deposits	1,407	1,242	2,673	2,496
Junior subordinated debentures	249	216	487	426
Other borrowings	251	49	464	60
Total interest expense	1,907	1,507	3,624	2,982
Net interest income	34,180	33,085	67,326	65,845
Provision for loan losses	1,131	1,120	1,998	2,259
Net interest income after provision for loan losses	33,049	31,965	65,328	63,586
NONINTEREST INCOME				
Service charges and other fees	4,426	3,476	8,639	6,832
Gain on sale of investment securities, net	117	201	117	761
Gain on sale of loans, net	4,138	1,242	5,333	1,971
Interest rate swap fees	282	227	415	363
Other income	1,700	1,430	3,508	3,639
Total noninterest income	10,663	6,576	18,012	13,566
NONINTEREST EXPENSE				
Compensation and employee benefits	16,272	14,898	32,296	30,019
Occupancy and equipment	3,818	4,111	7,628	7,947
Data processing	2,002	1,829	3,917	3,621
Marketing	805	781	1,612	1,509
Professional services	1,053	833	2,062	1,678
State and local taxes	639	604	1,188	1,211
Federal deposit insurance premium	357	528	657	1,020
Other real estate owned, net	21	61	52	472
Amortization of intangible assets	323	363	647	698
Other expense	2,519	2,469	4,973	4,671
Total noninterest expense	27,809	26,477	55,032	52,846
Income before income taxes	15,903	12,064	28,308	24,306
Income tax expense	4,075	3,169	7,164	6,320
Net income	$11,828	$8,895	$21,144	$17,986
Basic earnings per common share	$0.40	$0.30	$0.71	$0.60
Diluted earnings per common share	$0.39	$0.30	$0.70	$0.60
Dividends declared per common share	$0.13	$0.12	$0.25	$0.23

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
	(Dollars in thousands)			
Net income	$11,828	$8,895	$21,144	$17,986
Change in fair value of investment securities available for sale, net of tax of $1,491, $2,267, $2,285 and $5,553, respectively	2,766	4,203	4,239	10,278
Reclassification adjustment for net gain from sale of investment securities available for sale included in income, net of tax of $(41), $(71), $(41) and $(267), respectively	(76)	(130)	(76)	(494)
Other comprehensive income	2,690	4,073	4,163	9,784
Comprehensive income	$14,518	$12,968	$25,307	$27,770

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(Unaudited)

	Number of common shares	Common stock	Retained earnings	Accumulated other comprehensive income, net	Total stock-holders' equity
	(Dollars in thousands, except per share amounts)				
Balance at December 31, 2015	29,975	$359,451	$107,960	$ 2,559	$469,970
Restricted stock awards granted, net of forfeitures	115	—	—	—	—
Exercise of stock options (including excess tax benefits from nonqualified stock options)	26	390	—	—	390
Stock-based compensation expense	—	872	—	—	872
Net excess tax benefits from vesting of restricted stock	—	76	—	—	76
Common stock repurchased	(124)	(2,126)	—	—	(2,126)
Net income	—	—	17,986	—	17,986
Other comprehensive income, net of tax	—	—	—	9,784	9,784
Cash dividends declared on common stock ($0.23 per share)	—	—	(6,894)	—	(6,894)
Balance at June 30, 2016	29,992	$358,663	$119,052	$ 12,343	$490,058
Balance at December 31, 2016	29,955	$359,060	$125,309	$ (2,606)	$481,763
Restricted stock awards forfeited	(7)	—	—	—	—
Exercise of stock options	8	109	—	—	109
Stock-based compensation expense	—	1,040	—	—	1,040
Common stock repurchased	(28)	(674)	—	—	(674)
Net income	—	—	21,144	—	21,144
Other comprehensive income, net of tax	—	—	—	4,163	4,163
Cash dividends declared on common stock ($0.25 per share)	—	—	(7,497)	—	(7,497)
Balance at June 30, 2017	29,928	$359,535	$138,956	$ 1,557	$500,048

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Six Months Ended June 30,	
	2017	2016
	(Dollars in thousands)	
Cash flows from operating activities:		
Net income	$21,144	$17,986
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,459	6,483
Changes in net deferred loan costs, net of amortization	(509)	(455)
Provision for loan losses	1,998	2,259
Net change in accrued interest receivable, prepaid expenses and other assets, accrued expenses and other liabilities	3,482	(3,071)
Stock-based compensation expense	1,040	872
Net excess tax benefit from exercise of stock options and vesting of restricted stock	—	(97)
Amortization of intangible assets	647	698
Gain on sale of investment securities, net	(117)	(761)
Origination of loans held for sale	(54,449)	(57,975)
Gain on sale of loans, net	(5,333)	(1,971)
Proceeds from sale of loans	71,436	60,498
Earnings on bank owned life insurance	(747)	(695)
Valuation adjustment on other real estate owned	—	383
Gain on sale of assets held for sale	(53)	—
Gain on sale of other real estate owned, net	—	(42)
Loss on sale or write-off of furniture, equipment and leasehold improvements	12	244
Net cash provided by operating activities	44,010	24,356
Cash flows from investing activities:		
Loans originated, net of principal payments	(114,390)	(126,335)
Maturities of other interest earning deposits	—	1,248
Maturities, calls and payments of investment securities available for sale	52,461	60,803
Purchase of investment securities available for sale	(57,972)	(128,046)
Purchase of premises and equipment	(1,382)	(1,088)
Proceeds from sales of other real estate owned	—	770
Proceeds from sales of investment securities available for sale	15,032	75,837
Proceeds from sale of assets held for sale	265	—
Proceeds from redemption of Federal Home Loan Bank stock	16,456	10,460
Purchases of Federal Home Loan Bank stock	(17,975)	(12,012)
Investment in low-income housing tax credit partnership	(7)	(2,254)
Net cash used in investing activities	(107,512)	(120,617)
Cash flows from financing activities:		
Net increase in deposits	61,602	50,619
Federal Home Loan Bank advances	442,700	294,500
Repayments of Federal Home Loan Bank advances	(411,400)	(261,500)
Common stock cash dividends paid	(7,497)	(6,894)
Net decrease in securities sold under agreement to repurchase	(849)	(6,499)

Proceeds from exercise of stock options	109	369
Net excess tax benefit from exercise of stock options and vesting of restricted stock	—	97
Repurchase of common stock	(674)	(2,126)
Net cash provided by financing activities	83,991	68,566

	Six Months Ended June 30,	
	2017	2016
	(Dollars in thousands)	
Net increase (decrease) in cash and cash equivalents	20,489	(27,695)
Cash and cash equivalents at beginning of period	103,745	126,640
Cash and cash equivalents at end of period	$124,234	$98,945
Supplemental disclosures of cash flow information:		
Cash paid for interest	$3,688	$3,008
Cash paid for income taxes	1,007	6,000
Supplemental non-cash disclosures of cash flow information:		
Transfers of loans receivable to other real estate owned	$32	$652
Transfers of loans receivable to loans held for sale	5,779	—
Transfers of premises and equipment, net to prepaid expenses and other assets for properties held for sale	2,687	—
Investment in low income housing tax credit partnership and related funding commitment	—	10,224
Purchases of investment securities available for sale not settled	2,268	1,164

See accompanying Notes to Condensed Consolidated Financial Statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(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. The Bank is headquartered in Olympia, Washington and conducts business from its 59 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, consumer loans and originates first mortgage loans on residential properties primarily located in its market areas.

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 ('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 (“U.S. 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, 2016 (“2016 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 six months ended June 30, 2017 are not necessarily indicative of the results that may be expected for the year ending December 31, 2017. 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.

(c) Significant Accounting Policies

The significant accounting policies used in preparation of the Company's Condensed Consolidated Financial Statements are disclosed in the 2016 Annual Form 10-K. There have not been any material changes in the Company's significant accounting policies from those contained in the 2016 Annual Form 10-K, except for accounting policies for stock-based compensation relating to the issuance of restricted stock units, including grants subject to performance-based and market-based vesting conditions, adopted January 1, 2017 as discussed below.

Stock-Based Compensation

Compensation cost is recognized for stock options, restricted stock awards and restricted stock units issued to employees and directors, based on the fair value of these awards at the date of grant. Compensation cost is recognized over the requisite service period, generally defined as the vesting period, on a straight-line basis. Compensation cost for restricted stock units with market-based vesting is recognized over the service period to the extent the restricted stock units are expected to vest. With the adoption of FASB ASU 2016-09 on January 1, 2017, forfeitures are recognized as they occur.

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The market price of the Company's common stock at the date of grant is used to fair value the restricted stock awards and restricted stock units. The fair value of stock options granted is estimated based on the date of grant using the Black-Scholes-Merton option pricing model. Certain restricted stock unit grants are subject to performance-based vesting as well as other approved vesting conditions and cliff vest based on those conditions, and the fair value is estimated using a Monte Carlo simulation pricing model. The assumptions used in the Black-Scholes-Merton option pricing model and the Monte Carlo simulation pricing model include the expected term based on the valuation date and the remaining contractual term of the award; the risk-free interest rate based on the U.S. Treasury curve at the valuation date of the award; the expected dividend yield based on expected dividends being payable to the holders; and the expected stock price volatility over the expected term based on the historical volatility over the equivalent historical term.

(d) Recently Issued Accounting Pronouncements

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 original effective date for this Update was deferred in FASB ASU 2015-14 below.

FASB ASU 2015-14, Revenue from Contracts with Customers (Topic 606), was issued in August 2015 and defers the effective date of the above-mentioned FASB 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 expects to adopt the revenue recognition guidance on January 1, 2018 using the modified retrospective approach. A significant amount of the Company's revenues are derived from net interest income on financial assets and liabilities, which are excluded from the scope of the amended guidance. With respect to noninterest income and related disclosures, the Company is in its preliminary stages of identifying and evaluating the revenue streams and underlying revenue contracts within the scope of the guidance. The Company is expecting to begin developing processes and procedures during 2017 to ensure it is fully compliant with these amendments. To date, the Company has not yet identified any significant changes in the timing of revenue recognition when considering the amended accounting guidance; however, the Company's implementation efforts are ongoing and such assessments may change prior to the January 1, 2018 implementation date.

FASB ASU 2016-01, Recognition and Measurement of Financial Assets and Financial Liabilities (Subtopic 825-10), was issued in January 2016, to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information. This Update contains several provisions, including but not limited to 1) requiring equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income; 2) simplifying the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; 3) eliminating the requirement to disclose the method(s) and significant assumptions used to estimate fair value; and 4) requiring separate presentation of financial assets and liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements. The Update also changes certain financial statement disclosure requirements, including requiring disclosures of the fair value of financial instruments be made on the basis of exit price. The Update is effective for public entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not expect the adoption of this Update will have a significant impact on the Company’s statements of financial condition or income. Management is in the planning stages of developing processes and procedures to comply with the disclosures requirements of this Update, which could impact the disclosures the Company makes related to fair value of its financial instruments.

FASB ASU 2016-02, Leases (Topic 842), was issued in February 2016, to increase transparency and comparability of leases among organizations and to disclose key information about leasing arrangements. The Update sets out the principles for the recognition, measurement, presentation and disclosure of leases for both lessees and lessors. The Update requires lessees to apply a dual approach, classifying leases as either a finance or operating lease. This classification will determine whether the lease expense is recognized based on an effective interest method or on a straight-line basis over the term of the lease. A lessee is also required to record a right-of-use asset and a lease liability for all leases with a term greater than 12 months regardless of their classification. All cash payments will be classified within operating activities in the statement of cash flows. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The Update is effective for public entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company anticipates adopting the Update on January 1, 2019. Upon adoption of the guidance, the Company expects to report increased assets and increased liabilities on its Condensed Consolidated Statements of Financial Condition as a result of recognizing right-of-use assets and lease liabilities related to certain banking offices and certain equipment under noncancelable operating lease agreements, which currently are not reflected in its Condensed Consolidated Statements of Financial Condition. The Company is anticipating electing an accounting policy to not recognize lease assets and lease liabilities for leases with a term of twelve months or less. The Company was committed to $14.7 million of minimum lease payments under noncancelable operating lease agreements at December 31, 2016. The Company does not expect the adoption of this amendment will have a significant impact to its Condensed Consolidated Financial Statements.

FASB ASU 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations, was issued in March 2016 and it clarifies the implementation guidance of the above-mentioned FASB ASU 2014-09 as it relates to principal versus agent considerations. The Update addresses identifying the unit of account and nature of the goods or services as well as applying the control principle and interactions with the control principle. The amendments to the Update do not change the core principle of the guidance. The effective date, transition requirements and impact on the Company's Condensed Consolidated Financial Statements for this Update are the same as those described in FASB ASU 2015-14 above.

FASB ASU 2016-09, Stock Compensation (Topic 718), issued in March 2016, is intended to simplify several aspects of the accounting for share-based payment award transactions. For public business entities, the guidance is effective for annual periods after December 15, 2016, including interim periods within those annual periods with early adoption permitted. Certain amendments are required to be applied using a modified retrospective transition method by means of a cumulative-effect adjustment to equity as of the beginning of the period in which the guidance is adopted. Other amendments are applied retroactively (such as presentation of employee taxes paid on the statement of cash flows) or prospectively (such as recognition of excess tax benefits on the income statement). The Company adopted this standard effective January 1, 2017. The Company made an accounting policy election to account for forfeitures as they occur and this change resulted in a cumulative adjustment that was immaterial to all periods presented. Changes to the statement of cash flows have been applied prospectively and the Company recorded excess tax benefits in its income tax expense. Adoption of all other changes under this Update did not have a material impact on the Condensed Consolidated Financial Statements.

FASB ASU 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing, was issued in April 2016 which clarifies the implementation guidance of the above-mentioned FASB ASU 2014-09 as it relates to identifying performance obligations and licensing. The effective date, transition requirements and impact on the Company's Condensed Consolidated Financial Statements for this Update are the same as those described in FASB ASU 2015-14 above.

FASB ASU 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-scope Improvements and Practical Expedients, was issued in May 2016. The amendments in this Update do not change the core principle of the guidance in Topic 606. Rather, the amendments in this Update affect only the narrow aspects of Topic 606. The effective date, transition requirements and impact on the Company's Condensed Consolidated Financial Statements for this Update are the same as those described in FASB ASU 2015-14 above.

FASB ASU 2016-13, Financial Instruments: Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, was issued in June 2016. Commonly referred to as the current expected credit loss model ("CECL"), this

Update requires financial assets measured at amortized cost basis to be presented at the net amount expected to be collected. The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset to present the net carrying value at the amount expected to be collected on the financial asset. The measurement of expected credit losses is based on relevant information about past events including historical experience, current conditions and reasonable and supportable forecasts that affect the collectibility of the reported amount. The amendment affects loans, debt securities, trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables and any other financial asset not excluded from the scope that have the contractual right to receive cash. The Update replaces the incurred loss impairment methodology, which generally only considered past events and current conditions, with a methodology that reflects the expected credit losses and required consideration of a broader range of reasonable and supportable information to estimate all expected credit losses. The Update additionally addresses purchased assets and introduces the purchased financial asset with a more-than-insignificant amount of credit deterioration since origination ("PCD"). The accounting for these PCD assets is similar to the existing accounting guidance of FASB Accounting Standards Codification ("ASC") 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality, for purchased credit impaired ("PCI") assets, except the subsequent improvements in estimated cash flows will be immediately recognized into income, similar to the immediate recognition of subsequent deteriorations in cash flows. Current guidance only allows for the prospective recognition of these cash flow improvements. Because the terminology has been changed to a "more-than-insignificant" amount of credit deterioration, the presumption is that more assets might qualify for this accounting under the Update than those under current guidance. For public business entities, the Update is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years with early adoption permitted for fiscal years after December 15, 2018. An entity will apply the Update through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is adopted. A prospective transition approach is required for debt securities. An entity that has previously applied the guidance of FASB ASC 310-30 will prospectively apply the guidance in this Update for PCD assets. A prospective transition approach should be used for PCD assets where upon adoption, the amortized cost basis should be adjusted to reflect the addition of the allowance for credit losses. The Company is anticipating adopting the Update on January 1, 2020. Upon adoption, the Company expects a change in the processes and procedures to calculate the allowance for loan losses, including changes in assumptions and estimates to consider expected credit losses over the life of the loan versus the current accounting practice that utilizes the incurred loss model. The new guidance may result in an increase in the allowance for loan losses which will also reflect the new requirement to include the nonaccretable principal differences on PCI loans; however, the Company is still in the process of determining the magnitude of the increase and its impact on the Condensed Consolidated Financial Statements. In addition, the current accounting policy and procedures for other-than-temporary impairment on investment securities available for sale will be replaced with an allowance approach. The Company created a CECL steering committee which will begin developing and implementing processes and procedures to ensure it is fully compliant with the amendments at the adoption date.

FASB ASU 2016-15, Statement of Cash Flows (Topic 213): Classification of Certain Cash Receipts and Cash Payments, was issued in August 2016. The Update addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice. For public business entities, the guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted and must be applied using a retrospective transitional method to each period presented. The Company has evaluated the new guidance and does not anticipate that its adoption of this Update on January 1, 2018 will have a significant impact on its Condensed Consolidated Financial Statements.

FASB ASU 2017-03, Accounting Changes and Error Corrections (Topic 250) and Investments—Equity Method and Joint Ventures (Topic 323): Amendments to SEC Paragraphs Pursuant to Staff Announcements at the September 22, 2016 and November 17, 2016 EITF Meetings (SEC Update), was issued in January 2017. The SEC staff view is that a registrant should evaluate FASB ASC Updates that have not yet been adopted to determine the appropriate financial disclosures about the potential material effects of the updates on the financial statements when adopted. If a registrant does not know or cannot reasonably estimate the impact of an update, then in addition to making a statement to that effect, the registrant should consider additional qualitative financial statement disclosures to assist the reader in assessing the significance of the impact. The staff expects the additional qualitative disclosures to include a description of the effect of the accounting policies expected to be applied compared to current accounting policies. Also, the registrant should describe the status of its process to implement the new standards and the significant implementation matters yet to be addressed. The amendments specifically addressed recent FASB ASC amendments to Topic 326, Financial Instruments - Credit Losses; Topic 842, Leases; and Topic 606, Revenue from Contracts with Customers; although, the amendments apply to any subsequent amendments to guidance in the FASB ASC. The

Company adopted the amendments in this Update during the fourth quarter of 2016 and appropriate disclosures have been included in this Note for each recently issued accounting standard.

FASB ASU 2017-04, Goodwill (Topic 350), was issued in January 2017 and eliminates Step 2 from the goodwill impairment test. Under the amendments, an entity should perform its goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. The loss recognized, however, should not exceed the total amount of goodwill allocated to that reporting unit. Additionally, an entity should consider income tax effects from any tax deductible goodwill on the carrying amount of the reporting unit when measuring the goodwill impairment loss, if applicable. The Update is effective for annual periods or any interim goodwill impairment tests beginning after

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December 15, 2019 using a prospective transition method and early adoption is permitted. The Company does not expect the Update will have a material impact on its Condensed Consolidated Financial Statements.

FASB ASU 2017-09, Compensation--Stock Compensation (Topic 718): Scope of Modification Accounting was issued in May 2017 to provide clarity as to when to apply modification accounting when there is a change in the terms or conditions of a share-based payment award. According to this Update, an entity should account for the effects of a modification unless the fair value, vesting conditions and balance sheet classification of the award is the same after the modification as compared to the original award prior to the modification. The standard is effective for reporting periods beginning after December 15, 2017, with early adoption permitted. The Company does not expect the Update will have a material impact on its Condensed Consolidated Financial Statements.

(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.

(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:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In thousands)			
June 30, 2017				
U.S. Treasury and U.S. Government-sponsored agencies	$9,468	$ 9	$ (29)	$9,448
Municipal securities	239,881	5,313	(864)	244,330
Mortgage-backed securities and collateralized mortgage obligations[1]:				
Residential	282,997	851	(2,012)	281,836
Commercial	210,079	825	(2,245)	208,659
Collateralized loan obligations	6,798	14	(17)	6,795
Corporate obligations	13,552	213	—	13,765
Other securities	25,406	360	(5)	25,761
Total	$788,181	$ 7,585	$ (5,172)	$790,594
December 31, 2016				
U.S. Treasury and U.S. Government-sponsored agencies	$1,563	$ 6	$ —	$1,569
Municipal securities	237,305	2,427	(2,476)	237,256
Mortgage-backed securities and collateralized mortgage obligations[1]:				
Residential	310,391	985	(2,200)	309,176
Commercial	211,259	599	(3,540)	208,318
Collateralized loan obligations	10,505	4	(31)	10,478
Corporate obligations	16,611	104	(9)	16,706
Other securities	11,005	156	(19)	11,142
Total	$798,639	$ 4,281	$ (8,275)	$794,645

(1) Issued and guaranteed by U.S. Government-sponsored agencies.

There were no securities classified as trading or held to maturity at June 30, 2017 or December 31, 2016.

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The amortized cost and fair value of investment securities available for sale at June 30, 2017, 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.

	Amortized Cost	Fair Value
	(In thousands)	
Due in one year or less	$5,612	$5,653
Due after one year through five years	110,610	111,912
Due after five years through ten years	248,162	248,257
Due after ten years	423,752	424,644
Investment securities with no stated maturities	45	128
Total	$788,181	$790,594

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

The following table shows the gross unrealized losses and fair value of the Company's investment securities available for sale that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that the individual securities have been in continuous unrealized loss positions as of June 30, 2017 and December 31, 2016:

	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(In thousands)					
June 30, 2017						
U.S. Treasury and U.S. Government-sponsored agencies	$4,533	$(29)	$—	$—	$4,533	$(29)
Municipal securities	36,220	(812)	2,498	(52)	38,718	(864)
Mortgage-backed securities and collateralized mortgage obligations(1):						
Residential	145,878	(1,897)	12,541	(115)	158,419	(2,012)
Commercial	129,184	(2,148)	6,820	(97)	136,004	(2,245)
Collateralized loan obligations	2,883	(17)	—	—	2,883	(17)
Other Securities	2,933	(5)	—	—	2,933	(5)
Total	$321,631	$(4,908)	$21,859	$(264)	$343,490	$(5,172)
December 31, 2016						
Municipal securities	$90,188	$(2,476)	$—	$—	$90,188	$(2,476)
Mortgage-backed securities and collateralized mortgage obligations(1):						
Residential	181,562	(2,148)	10,854	(52)	192,416	(2,200)
Commercial	157,055	(3,446)	12,597	(94)	169,652	(3,540)
Collateralized loan obligations	2,976	(1)	2,969	(30)	5,945	(31)
Corporate obligations	4,032	(9)	—	—	4,032	(9)
Other Securities	6,998	(19)	—	—	6,998	(19)
Total	$442,811	$(8,099)	$26,420	$(176)	$469,231	$(8,275)

(1) Issued and guaranteed by U.S. Government-sponsored agencies.

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The Company has evaluated these investment securities available for sale as of June 30, 2017 and December 31, 2016 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. None of the underlying issuers of the municipal securities had credit ratings that were below investment grade levels at June 30, 2017 or December 31, 2016. The Company has the ability and intent to hold the investments until recovery of the securities' amortized cost, which may be the maturity date of the securities.
For the three and six months ended June 30, 2017 and 2016, there were no investment securities determined to be other-than-temporarily impaired.

(c) Pledged Securities
The following table summarizes the amortized cost and fair value of investment securities available for sale that are pledged as collateral for the following obligations at June 30, 2017 and December 31, 2016:

	June 30, 2017		December 31, 2016	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)			
Washington and Oregon state to secure public deposits	$208,907	$210,420	$214,834	$215,247
Repurchase agreements	32,731	32,591	29,481	29,294
Other securities pledged	3,534	3,536	3,557	3,546
Total	$245,172	$246,547	$247,872	$248,087

(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. Disclosures related to the Company's recorded investment in loans receivable generally exclude accrued interest receivable and net deferred costs because they are insignificant.
Loans acquired in a business combination are 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 ASC 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality. These loans are identified as "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.
(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 for 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.

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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 business portfolio segment: commercial and industrial, 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 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 and Industrial loans carry more risk than other loans because the borrowers' cash flow is less predictable, and in the event of a default, loss given default is potentially greater because the value of the collateral securing these loans is more difficult to quantify.
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 that these loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate properties. Commercial real estate lending typically involves higher loan principal amounts and payments on loans, and repayment is dependent on successful operation and management of the properties. The value of the real estate securing these loans can be adversely affected by conditions in the real estate market or the economy. There is little difference in risk between owner-occupied commercial real estate loans and non-owner occupied commercial real estate loans.
One-to-Four Family Residential: