SUNGARD DATA SYSTEMS INC
Form 10-Q
May 10, 2007
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United States

Securities and Exchange Commission

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended March 31, 2007

OR

¨ **Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from ______ to ______

Commission file number 1-12989

SunGard® Data Systems Inc.

(Exact name of registrant as specified in its charter)

Delaware	**51-0267091**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**

680 East Swedesford Road, Wayne, Pennsylvania 19087

(Address of principal executive offices, including zip code)

484-582-2000

(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 ¨ No x

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

Large accelerated filer ¨. Accelerated filer ¨. Non-accelerated filer x.

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

There were 100 shares of the registrant s common stock outstanding as of March 31, 2007.

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SunGard Data Systems Inc.

And Subsidiaries

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SunGard Data Systems Inc.

Consolidated Balance Sheets

(In millions except share and per-share amounts)

	December 31, 2006	March 31, 2007 (unaudited)
Assets		
Current:		
Cash and cash equivalents	$ 316	**$ 305**
Trade receivables, less allowance for doubtful accounts of $14 and $16	216	**206**
Earned but unbilled receivables	63	**62**
Prepaid expenses and other current assets	145	**152**
Clearing broker assets	420	**497**
Retained interest in accounts receivable sold	275	**215**
Deferred income taxes	34	**33**
Total current assets	1,469	**1,470**
Property and equipment, less accumulated depreciation of $304 and $354	773	**776**
Software products, less accumulated amortization of $304 and $364	1,386	**1,353**
Customer base, less accumulated amortization of $266 and $315	2,857	**2,819**
Other tangible and intangible assets, less accumulated amortization of $13 and $15	216	**200**
Trade name	1,019	**1,019**
Goodwill	6,951	**6,972**
Total Assets	$ 14,671	**$ 14,609**
Liabilities and Stockholder s Equity		
Current:		
Short-term and current portion of long-term debt	$ 45	**$ 48**
Accounts payable	80	**55**
Accrued compensation and benefits	224	**156**
Accrued interest expense	164	**63**
Other accrued expenses	275	**298**
Clearing broker liabilities	376	**463**
Deferred revenue	762	**777**
Total current liabilities	1,926	**1,860**
Long-term debt	7,394	**7,495**
Deferred income taxes	1,777	**1,773**
Total liabilities	11,097	**11,128**
Commitments and contingencies		
Stockholder s equity:		

Common stock, par value $.01 per share; 100 shares authorized, issued and outstanding		
Capital in excess of par value	3,664	**3,669**
Accumulated deficit	(147)	**(243)**
Accumulated other comprehensive income	57	**55**
Total stockholder s equity	3,574	**3,481**
Total Liabilities and Stockholder s Equity	$ 14,671	**$ 14,609**

The accompanying notes are an integral part of these financial statements.

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SunGard Data Systems Inc.

Consolidated Statements of Operations

(In millions)

(Unaudited)

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2007
Revenue:		
Services	$ 923	**$ 1,022**
License and resale fees	53	**65**
Total products and services	976	**1,087**
Reimbursed expenses	27	**29**
	1,003	**1,116**
Costs and expenses:		
Cost of sales and direct operating	472	**525**
Sales, marketing and administration	223	**240**
Product development	64	**74**
Depreciation and amortization	57	**59**
Amortization of acquisition-related intangible assets	96	**104**
Merger costs	2	
	914	**1,002**
Income from operations	89	**114**
Interest income	3	**5**
Interest expense and amortization of deferred financing fees	(157)	**(165)**
Other expense	(12)	**(37)**
Loss before income taxes	(77)	**(83)**
Provision (benefit) for income taxes	(31)	**13**
Net loss	$ (46)	**$ (96)**

The accompanying notes are an integral part of these financial statements.

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SunGard Data Systems Inc.

Consolidated Statements of Cash Flows

(In millions)

(Unaudited)

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2007
Cash flow from operations:		
Net loss	$ (46)	**$ (96)**
Reconciliation of net loss to cash flow used in operations:		
Depreciation and amortization	153	**163**
Deferred income tax benefit	(29)	**(21)**
Stock compensation expense	8	**6**
Amortization of deferred financing costs and debt discount	8	**19**
Other non-cash credits	(9)	**2**
Accounts receivable and other current assets	13	**75**
Accounts payable and accrued expenses	(178)	**(180)**
Clearing broker assets and liabilities, net	4	**10**
Deferred revenue	23	**10**
Cash flow used in operations	(53)	**(12)**
Investment activities:		
Cash paid for businesses acquired by the Company, net of cash acquired	(8)	**(13)**
Cash paid for property and equipment and software	(78)	**(69)**
Other investing activities	(5)	**(4)**
Cash used in investment activities	(91)	**(86)**
Financing activities:		
Cash received from borrowings, net of fees	125	**503**
Cash used to repay debt	(12)	**(414)**
Cash provided by financing activities	113	**89**
Effect of exchange rate changes on cash		**(2)**
Decrease in cash and cash equivalents	(31)	**(11)**
Beginning cash and cash equivalents	317	**316**
Ending cash and cash equivalents	$ 286	**$ 305**
Supplemental information:		
Businesses acquired by the Company:		
Property and equipment	$	**$ 1**
Software products	3	**7**

Customer base		6		**9**
Goodwill		2		**11**
Other tangible and intangible assets				**1**
Deferred income taxes				**(5)**
Purchase price obligations and debt assumed		(4)		**(4)**
Net current (liabilities) assets assumed		1		**(7)**
Cash paid for businesses acquired by the Company, net of cash acquired of $0 and $7, respectively	$	8	**$**	**13**

The accompanying notes are an integral part of these financial statements.

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SUNGARD DATA SYSTEMS INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. Basis of Presentation:

SunGard Data Systems Inc. (SunGard or the Company) was acquired on August 11, 2005 (the Transaction) by a consortium of private equity investment funds associated with Bain Capital Partners, The Blackstone Group, Goldman Sachs & Co., Kohlberg Kravis Roberts & Co., Providence Equity Partners, Silver Lake and Texas Pacific Group (collectively, the Sponsors).

SunGard is a wholly owned subsidiary of SunGard Holdco LLC, which is wholly owned by SunGard Holding Corp., which is wholly owned by SunGard Capital Corp. II, which is a subsidiary of SunGard Capital Corp. All of these companies were formed for the purpose of facilitating the Transaction and are collectively referred to as the Holding Companies.

SunGard has three segments: Financial Systems (FS), Higher Education and Public Sector Systems (HEPS) and Availability Services (AS). The Company s Software & Processing Solutions business is comprised of the FS and HEPS segments. The consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. All significant intercompany transactions and accounts have been eliminated. The consolidated financial statements exclude the accounts of the Holding Companies.

The accompanying interim consolidated financial statements of the Company have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP), consistent in all material respects with those applied in the Company s Annual Report on Form 10-K for the year ended December 31, 2006. Interim financial reporting does not include all of the information and footnotes required by GAAP for complete financial statements. The interim financial information is unaudited, but reflects all normal adjustments which are, in the opinion of management, necessary to provide a fair statement of results for the interim periods presented. Operating results for the interim periods presented are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

2. Acquisitions

The Company seeks to acquire businesses that broaden its existing product lines and service offerings by adding complementary products and service offerings and by expanding its geographic reach. During the three months ended March 31, 2007, the Company completed three acquisitions in its FS segment. Cash paid, subject to certain adjustments, was $13 million. The allocations of purchase price for these acquisitions and others completed in the fourth quarter of 2006 are preliminary.

The following table lists the businesses the Company acquired in the first quarter of 2007:

Acquired Company/Business	Date Acquired	Description
XRT SA s High-End Treasury Business	1/25/2007	Treasury and cash management applications.
Maxim Insurance Software Corporation	2/6/2007	Premium billing systems to the property and casualty industry.
Aceva Technologies, Inc.	2/14/2007	Credit and collections software solutions.

During April 2007, the Company completed two acquisitions in its FS segment for aggregate cash paid of approximately $21 million.

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Goodwill

The following table summarizes changes in goodwill by segment (in millions):

	FS	HE/PS	AS	Total
Balance at December 31, 2006	$ 2,918	$ 1,880	$ 2,153	$ 6,951
2007 acquisitions	11			11
Adjustments to previous acquisitions	(1)	1	6	6
Effect of foreign currency translation	2		2	4
Balance at March 31, 2007	$ 2,930	$ 1,881	$ 2,161	$ 6,972

3. Clearing Broker Assets and Liabilities:

Clearing broker assets and liabilities are comprised of the following (in millions):

	December 31, 2006	March 31, 2007
Segregated customer cash and treasury bills	$ 48	**$ 58**
Securities owned	28	**18**
Securities borrowed	305	**379**
Receivables from customers and other	39	**42**
Clearing broker assets	$ 420	**$ 497**
Payables to customers	$ 70	**$ 71**
Securities loaned	275	**351**
Customer securities sold short, not yet purchased	15	**9**
Payable to brokers and dealers	16	**32**
Clearing broker liabilities	$ 376	**$ 463**

Segregated customer cash and treasury bills are held by the Company on behalf of customers. Clearing broker securities consist of trading and investment securities at fair market values, which are based on quoted market rates. Securities borrowed and loaned are collateralized financing transactions which are cash deposits made to or received from other broker/dealers. Receivables from and payables to customers represent amounts due or payable on cash and margin transactions.

4. Debt:

In February 2007 the Company amended its senior secured credit facility to reduce the effective interest rates on the term loan facility, increase the size of that facility from $4.0 billion to $4.4 billion, extend the maturity by one year and change certain other terms. In March 2007 the Company used the additional borrowings to redeem the $400 million in aggregate principal amount of senior floating rate notes due 2013. The related redemption premium of $19 million and approximately $9 million of deferred financing costs were included in other expense.

5. Income Taxes:

The Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48) on January 1, 2007 with no material effect. The Company s reserve for unrecognized income tax benefits at March 31, 2007 is $28 million. This liability includes approximately $3 million (net of federal and state benefit) in accrued interest and penalties. Since substantially all of the liability relates to matters existing at the date of the Transaction, any reversal of reserve is not expected to have a material impact on the Company s annual effective tax rate. The Company recognizes interest and penalties related to uncertain tax positions in income tax expense.

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The Company is currently under audit by the Internal Revenue Service for the calendar years 2003, 2004 and 2005 and various state and foreign jurisdiction tax years remain open to examination as well. At any given time some portion of the Company s operations are under audit. Accordingly, certain matters may be resolved within the next 12 months which could result in a change of the liability. The Company is unable to estimate the range of any possible adjustment at this time.

6. Comprehensive Income (Loss):

Comprehensive loss consists of net loss adjusted for other increases and decreases affecting stockholder s equity that are excluded from the determination of net loss. The calculation of comprehensive loss follows (in millions):

	Three Months Ended March 31,	
	2006	2007
Net loss	$ (46)	$ (96)
Foreign currency translation gains	4	1
Unrealized gain (loss) on derivative instruments	9	(3)
Comprehensive loss	$ (33)	$ (98)

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7. Segment Information:

The Company has three segments: FS and HEPS, which together form the Company s Software & Processing Solutions business, and AS. Effective January 1, 2007, the Company reclassified one business from FS to HEPS. This change has been reflected in all periods presented. The operating results for each segment follow (in millions):

	Three Months Ended March 31,	
	2006	2007
Revenue:		
Financial systems	$ 471	$ 543
Higher education and public sector systems	202	231
Software & processing solutions	673	774
Availability services	330	342
	$ 1,003	$ 1,116
Income (loss) from operations:		
Financial systems	$ 34	$ 48
Higher education and public sector systems	22	34
Software & processing solutions	56	82
Availability services	61	58
Corporate administration	(26)	(26)
Merger costs	(2)	
	$ 89	$ 114
Depreciation and amortization:		
Financial systems	$ 13	$ 13
Higher education and public sector systems	4	4
Software & processing solutions	17	17
Availability services	40	42
Corporate administration		
	$ 57	$ 59
Amortization of acquisition-related intangible assets:		
Financial systems	$ 51	$ 58
Higher education and public sector systems	16	17
Software & processing solutions	67	75
Availability services	29	29
Corporate administration		
	$ 96	$ 104
Cash paid for property and equipment and software:		
Financial systems	$ 17	$ 19
Higher education and public sector systems	4	5
Software & processing solutions	21	24

Availability services		57		45
Corporate administration				
	$	78	$	69

8. Related Party Transactions:

In accordance with the Management Agreement between the Company and the Sponsors, the Company recorded $4 million and $3 million of management fees in sales, marketing and administration expenses during the three months ended March 31, 2006 and 2007, respectively. At December 31, 2006 and March 31, 2007, $3 million and $2 million, respectively, were included in other accrued expenses.

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9. Supplemental Guarantor Condensed Consolidating Financial Statements:

On August 11, 2005, in connection with the Transaction, the Company issued $3.0 billion aggregate principal amount of the outstanding senior notes and the outstanding senior subordinated notes. The senior notes are jointly and severally, fully and unconditionally guaranteed on a senior unsecured basis and the senior subordinated notes are jointly and severally, fully and unconditionally guaranteed on an unsecured senior subordinated basis, in each case, subject to certain exceptions, by substantially all wholly owned domestic subsidiaries of the Company (collectively, the Guarantors). Each of the Guarantors is 100% owned, directly or indirectly, by the Company. All other subsidiaries of the Company, either direct or indirect, do not guarantee the senior notes and senior subordinated notes (Non-Guarantors). The Guarantors also unconditionally guarantee the senior secured credit facilities.

The following tables present the financial position, results of operations and cash flows of the Company (Parent), the Guarantor Subsidiaries, the Non-Guarantor Subsidiaries and Eliminations as of December 31, 2006 and March 31, 2007 and for each of the three month periods ended March 31, 2006 and 2007, to arrive at the information for SunGard Data Systems Inc. on a consolidated basis.

Supplemental Condensed Consolidating Balance Sheet

(in millions)	**December 31, 2006**				
	Parent Company	**Guarantor Subsidiaries**	**Non-Guarantor Subsidiaries**	**Eliminations**	**Consolidated**
Assets					
Current:					
Cash and cash equivalents	$ 56	$ (19)	$ 279	$	$ 316
Intercompany balances	(2,282)	2,244	38		
Trade receivables, net	(1)	40	240		279
Prepaid expenses, taxes and other current assets	578	83	762	(549)	874
Total current assets	(1,649)	2,348	1,319	(549)	1,469
Property and equipment, net	1	526	246		773
Intangible assets, net	184	4,764	530		5,478
Intercompany balances	(757)	727	30		
Goodwill		6,166	785		6,951
Investment in subsidiaries	13,074	1,757		(14,831)	
Total Assets	$ 10,853	$ 16,288	$ 2,910	$ (15,380)	$ 14,671
Liabilities and Stockholder s Equity					
Current:					
Short-term and current portion of long-term debt	$ 37	$ 2	$ 6	$	$ 45
Accounts payable and other current liabilities	194	1,332	904	(549)	1,881
Total current liabilities	231	1,334	910	(549)	1,926
Long-term debt	7,053	3	338		7,394
Intercompany debt		246	(129)	(117)	
Deferred income taxes	(5)	1,631	151		1,777
Total liabilities	7,279	3,214	1,270	(666)	11,097
Total stockholder s equity	3,574	13,074	1,640	(14,714)	3,574
Total Liabilities and Stockholder s Equity	$ 10,853	$ 16,288	$ 2,910	$ (15,380)	$ 14,671

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Supplemental Condensed Consolidating Balance Sheet

(in millions)	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
	March 31, 2007				
Assets					
Current:					
Cash and cash equivalents	$ 21	$ (23)	$ 307	$	$ 305
Intercompany balances	(3,846)	3,765	81		
Trade receivables, net	1	31	236		268
Prepaid expenses, taxes and other current assets	1,192	88	779	(1,162)	897
Total current assets	(2,632)	3,861	1,403	(1,162)	1,470
Property and equipment, net	1	517	258		776
Intangible assets, net	172	4,700	519		5,391
Intercompany balances	624	(641)	17		
Goodwill		6,163	809		6,972
Investment in subsidiaries	12,598	1,842		(14,440)	
Total Assets	$ 10,763	$ 16,442	$ 3,006	$ (15,602)	$ 14,609
Liabilities and Stockholder s Equity					
Current:					
Short-term and current portion of long-term debt	$ 37	$ 2	$ 9	$	$ 48
Accounts payable and other current liabilities	88	1,906	980	(1,162)	1,812
Total current liabilities	125	1,908	989	(1,162)	1,860
Long-term debt	7,152	2	341		7,495
Intercompany debt	(3)	312	(167)	(142)	
Deferred income taxes	8	1,622	143		1,773
Total liabilities	7,282	3,844	1,306	(1,304)	11,128
Total stockholder s equity	3,481	12,598	1,700	(14,298)	3,481
Total Liabilities and Stockholder s Equity	$ 10,763	$ 16,442	$ 3,006	$ (15,602)	$ 14,609

Supplemental Condensed Consolidating Schedule of Operations

(in millions)	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
	Three Months Ended March 31, 2006				
Total revenue	$	$ 748	$ 294	$ (39)	$ 1,003
Costs and expenses:					
Cost of sales and direct operating		360	151	(39)	472
Sales, marketing and administration	28	129	66		223
Product development		43	21		64
Depreciation and amortization		42	15		57
Amortization of acquisition-related intangible assets		80	16		96
Merger costs	2				2

	30	654	269	(39)	914
Income (loss) from operations	(30)	94	25		89
Net interest income (expense)	(151)		(3)		(154)
Other income (expense)	(144)	(28)	(9)	169	(12)
Income (loss) before income taxes	(325)	66	13	169	(77)
Provision (benefit) for income taxes	(279)	210	38		(31)
Net income (loss)	$ (46)	$ (144)	$ (25)	$ 169	$ (46)

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Supplemental Condensed Consolidating Schedule of Operations

(in millions)	Three Months Ended March 31, 2007				
	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Total revenue	$	$ 802	$ 344	$ (30)	$ 1,116
Costs and expenses:					
Cost of sales and direct operating		366	189	(30)	525
Sales, marketing and administration	23	132	85		240
Product development		51	23		74
Depreciation and amortization		43	16		59
Amortization of acquisition-related intangible assets	1	86	17		104
Merger costs					
	24	678	330	(30)	1,002
Income (loss) from operations	(24)	124	14		114
Net interest income (expense)	(157)	(3)			(160)
Other income (expense)	11	3	(9)	(42)	(37)
Income (loss) before income taxes	(170)	124	5	(42)	(83)
Provision (benefit) for income taxes	(74)	85	2		13
Net income (loss)	$ (96)	$ 39	$ 3	$ (42)	$ (96)

Supplemental Condensed Consolidating Schedule of Cash Flows

(in millions)	Three Months Ended March 31, 2006				
	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Cash Flow From Operations					
Net income (loss)	$ (46)	$ (144)	$ (25)	$ 169	$ (46)
Non cash adjustments	163	105	32	(169)	131
Changes in operating assets and liabilities	(277)	113	26		(138)
Cash flow provided by (used in) operations	(160)	74	33		(53)
Investment Activities					
Intercompany transactions		(1)	1		
Cash paid for businesses acquired by the Company, net of cash acquired		(8)			(8)
Cash paid for property and equipment		(64)	(14)		(78)
Other investing activities	(7)		2		(5)
Cash provided by (used in) investment activities	(7)	(73)	(11)		(91)
Financing Activities					
Net borrowings (repayments) of long-term debt	115	(1)	(1)		113

Cash provided by (used in) financing activities	115	(1)	(1)		113
Increase (decrease) in cash and cash equivalents	(52)		21		(31)
Beginning cash and cash equivalents	74	(8)	251		317
Ending cash and cash equivalents	$ 22	$ (8)	$ 272	$	$ 286

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Supplemental Condensed Consolidating Schedule of Cash Flows

(in millions)	Three Months Ended March 31, 2007				
	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Eliminations	Consolidated
Cash Flow From Operations					
Net income (loss)	$ (96)	$ 39	$ 3	$ (42)	$ (96)
Non cash adjustments	(16)	109	34	42	169
Changes in operating assets and liabilities	(710)	573	52		(85)
Cash flow provided by (used in) operations	(822)	721	89		(12)
Investment Activities					
Intercompany transactions	696	(664)	(32)		
Cash paid for businesses acquired by the Company, net of cash acquired		(13)			(13)
Cash paid for property and equipment and software		(45)	(24)		(69)
Other investing activities		(1)	(3)		(4)
Cash provided by (used in) investment activities	696	(723)	(59)		(86)
Financing Activities					
Net borrowings (repayments) of long-term debt	91	(2)			89
Cash provided by (used in) financing activities	91	(2)			89
Effect of exchange rate changes on cash			(2)		(2)
Increase (decrease) in cash and cash equivalents	(35)	(4)	28		(11)
Beginning cash and cash equivalents	56	(19)	279		316
Ending cash and cash equivalents	$ 21	$ (23)	$ 307	$	$ 305

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations
Introduction

The following discussion and analysis supplement the management s discussion and analysis in the Company s Annual Report on Form 10-K for the year ended December 31, 2006 and presume that readers have read or have access to the discussion and analysis in our Annual Report. The following discussion and analysis includes historical and certain forward-looking information that should be read together with the accompanying Consolidated Financial Statements, related footnotes, and the discussion below of certain risks and uncertainties that could cause future operating results to differ materially from historical results or from the expected results indicated by forward-looking statements.

Results of Operations:

The following table sets forth, for the periods indicated, certain amounts included in our Consolidated Statements of Operations, the relative percentage that those amounts represent to consolidated revenue (unless otherwise indicated), and the percentage change in those amounts from period to period.

	Three Months Ended March 31, 2006	percent of revenue	Three Months Ended March 31, 2007	percent of revenue	Percent Increase (Decrease) 2007 vs. 2006
(in millions)					
Revenue					
Financial systems (FS)	$ 471	47%	$ 543	49%	15%
Higher education and public sector systems (HEPS)	202	20%	231	21%	14%
Software & processing solutions	673	67%	774	69%	15%
Availability services (AS)	330	33%	342	31%	4%
	$ 1,003	100%	$ 1,116	100%	11%
Costs and Expenses					
Cost of sales and direct operating	$ 472	47%	$ 525	47%	11%
Sales, marketing and administration	223	22%	240	22%	8%
Product development	64	6%	74	7%	16%
Depreciation and amortization	57	6%	59	5%	4%
Amortization of acquisition- related intangible assets	96	10%	104	9%	8%
Merger costs	2	%		%	(100)%
	$ 914	91%	$ 1,002	90%	10%
Operating Income					
Financial systems [1]	$ 34	7%	$ 48	9%	41%
Higher education and public sector systems [1]	22	11%	34	15%	55%
Software & processing solutions [1]	56	8%	82	11%	46%
Availability services [1]	61	18%	58	17%	(5)%
Corporate administration	(26)	(3)%	(26)	(2)%	%
Merger costs	(2)	%		%	(100)%

	$ 89	9%	$ 114	10%	28%

(1) Percent of revenue is calculated as a percent of revenue from FS, HEPS, Software & Processing Solutions, and AS, respectively.

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The following table sets forth, for the periods indicated, certain supplemental revenue data, the relative percentage that those amounts represent to total revenue and the percentage change in those amounts from period to period.

(in millions)	Three Months Ended March 31, 2006	percent of revenue	Three Months Ended March 31, 2007	percent of revenue	Percent Increase (Decrease) 2007 vs. 2006
Financial Systems					
Services	$ 421	42%	$ 491	44%	17%
License and resale fees	29	3%	29	3%	%
Total products and services	450	45%	520	47%	16%
Reimbursed expenses	21	2%	23	2%	10%
	$ 471	47%	$ 543	49%	15%
Higher Education and Public Sector Systems					
Services	$ 177	18%	$ 196	18%	11%
License and resale fees	22	2%	32	3%	45%
Total products and services	199	20%	228	20%	15%
Reimbursed expenses	3	%	3	%	%
	$ 202	20%	$ 231	21%	14%
Software & Processing Solutions					
Services	$ 598	60%	$ 687	62%	15%
License and resale fees	51	5%	61	5%	20%
Total products and services	649	65%	748	67%	15%
Reimbursed expenses	24	2%	26	2%	8%
	$ 673	67%	$ 774	69%	15%
Availability Services					
Services	$ 325	32%	$ 335	30%	3%
License and resale fees	2	%	4	%	100%
Total products and services	327	33%	339	30%	4%
Reimbursed expenses	3	%	3	%	%
	$ 330	33%	$ 342	31%	4%
Total Revenue					
Services	$ 923	92%	$ 1,022	92%	11%
License and resale fees	53	5%	65	6%	23%

Total products and services	976	97%	1,087	97%	11%
Reimbursed expenses	27	3%	29	3%	7%
	$ 1,003	100%	$ 1,116	100%	11%

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Income from Operations:

Our total operating margin was 10% for the three months ended March 31, 2007, compared to 9% for the three months ended March 31, 2006. The increase represents improvement in FS and HEPS offset by a decline in AS.

Financial Systems:

The FS operating margin was 9% and 7% for the three months ended March 31, 2007 and 2006, respectively. The increase of $14 million is primarily due to the growth in professional services revenue and operating leverage from other services revenue.

Higher Education and Public Sector Systems:

The HEPS operating margin was 15% and 11% for the three months ended March 31, 2007 and 2006, respectively. The increase of $12 million is due to the improved operating profit contribution from services revenue and from a $4 million increase in software license fees.

Availability Services:

The AS operating margin was 17% and 18% for the three months ended March 31, 2007 and 2006, respectively. The decrease of $3 million is primarily due to the higher expense base associated with additional capacity put into service late in 2006 and in the first quarter of 2007.

Revenue:

Total revenue increased $113 million or 11% for the three months ended March 31, 2007 compared to the first quarter of 2006. The increase in total revenue in 2007 is due primarily to organic revenue growth of approximately 10%, of which approximately 3% results from the impact of changes in currency exchange rates. Organic revenue is defined as revenue for businesses owned for at least one year and further adjusted for the effects of businesses sold in the previous twelve months.

Financial Systems:

FS revenue increased $72 million or 15% in 2007. Organic revenue growth was approximately 12% in the first quarter of 2007, primarily the result of a $70 million increase in services revenue. Professional services revenue had the most significant contribution to the growth, having increased $39 million or 42%, primarily in the benefit administration and insurance group. In addition, broker/dealer revenue increased $13 million or 33% due to volume of business. Revenue from license and resale fees included software license revenue of $26 million in each of the three months ended March 31, 2007 and 2006.

Higher Education and Public Sector Systems:

RevenueONT
SIZE="1"> 2/17/2013 - - - 2,350 - $25.94 4/28/2014 - - - 5,100 - $11.35 2/26/2017 - - 5/25/2010 2,598 2,598[7] $14.77 5/25/2020 - -

David A. Spurling

- 1,260 - $20.50 2/17/2013 - - - 1,600 - $25.94 4/28/2014 - - - 2,400 - $11.35 2/26/2017 - - 5/25/2010 2,294 2,293[7] $14.77 5/25/2

(1) All awards reflected in the stock awards columns represent grants of restricted stock. The market value of restricted stock is the number of shares that have not vested multiplied by the December 31, 2012 closing stock price of $14.69.
(2) Reflects 2,000 shares granted on February 28, 2008 and 5,000 shares granted on September 29, 2009, each of which vests five years from the date of grant; 2,418 shares granted on May 25, 2010, 5,073 shares granted on February 24, 2011 and 6,886 shares granted on June 25, 2012, which each vest ratably over the four years from the date of grant.
(3) Reflects 5,000 shares granted on February 25, 2010, which vest five years from the date of grant; 2,979 shares granted on February 24, 2011 and 4,044 shares granted on June 25, 2012, which both vest ratably over the four years from the date of grant as well as 7,128 shares granted on September 7, 2012, which vest four years from date of grant.
(4) Reflects 700 shares granted February 28, 2008, which vest five years from the date of grant; 1,000 shares granted on May 25, 2010, which vest three years from the date of grant, 555 shares granted on May 25, 2010, 2,496 shares granted on February 24, 2011 and 3,389 shares granted on June 25, 2012, which each vest ratably over the four years from the date of grant, as well as 7,128 shares granted on September 7, 2012, which vest four years from date of grant.
(5)

Reflects 800 shares granted on February 28, 2008, which vest five years from the date of grant; 1,000 shares granted on May 25, 2010, which vest three years from the date of grant, as well as 588 shares granted on May 25, 2010, 2,340 shares granted on February 24, 2011 and 3,177 shares granted on June 25, 2012, which each vest ratably over the four years from the date of grant.

(6) One-third vests each year over the three-year period from the date of grant.

(7) One-fourth vests each year over the four-year period from the date of grant.

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Option Exercises and Stock Vested

The following table shows the value realized upon the vesting of stock awards for the named executive officers during the year ended December 31, 2012. The named executive officers did not exercise any stock options in 2012.

	Stock Awards	
Name	**Number of Shares Acquired on Vesting (#)**	**Value Realized on Vesting ($)**
Brian L. Vance	4,551	63,000
Jeffrey J. Deuel	993	13,703
Donald J. Hinson	3,911	56,236
D. Michael Broadhead	7,712	107,238
David A. Spurling	1,875	26,078

Nonqualified Deferred Compensation

The following table provides information for the named executive officers regarding participation in plans that provide for the deferral of compensation on a non-tax qualified basis during the year ended December 31, 2012.

Name	**Executive Contributions in 2012 ($)**	**Registrant Contributions in 2012 ($)**	**Aggregate Earnings in 2012 ($)**	**Aggregate Withdrawals/ Distributions ($)**	**Aggregate Balance at December 31, 2012 ($)**
Brian L. Vance	-	150,000	2,801	-	152,801
Jeffrey J. Deuel	-	-	-	-	-
Donald J. Hinson	-	-	-	-	-
D. Michael Broadhead	-	-	-	-	-
David A. Spurling	-	-	-	-	-

Effective June 2012, the Compensation Committee adopted a deferred compensation plan. The Company entered into contribution agreements with Messrs. Vance, Deuel and Hinson that provided for potential 2012 contributions to each executive s account by the Company on a 50% pro-rata basis. The potential contributions were based on a percentage of the respective executive s salary, with a pre-determined minimum, target and maximum level, with the amount of the contributions based on the achievement of performance goals under the Deferred Compensation Plan. Mr. Vance also received an initial contribution of $150,000 as of July 1, 2012 under his participation agreement.

Under Mr. Vance s Deferred Compensation Plan participation agreement, Heritage s contributions for 2012 were set at 16% of salary for minimum achievement of performance goals, 33% for target achievement and 50% for maximum achievement. With respect to Mr. Vance, the 16% minimum achievement is a fixed amount to be contributed annually, that may be increased based upon performance that is greater than the minimum performance threshold. The initial contribution made on behalf of Mr. Vance was not performance based. In both bases, the Compensation Committee intended for these portions of Mr. Vance s benefit to also act as a retirement benefit. Mr. Vance s Company contributions under the Deferred Compensation Plan vest 30% as of July 1, 2012 and 10% as of January 1, 2013 and an additional 10% as of each January 1 thereafter through January 1, 2019. Mr. Vance s participation agreement provides for Company contributions under the Deferred Compensation Plan for the years 2012 through and including 2019.

Under their respective Deferred Compensation Plan participation agreements, Heritage s contributions on behalf of Messrs. Deuel and Hinson for 2012 were set at 10% of salary for minimum achievement of

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performance goals, 20% for target achievement and 35% for maximum achievement. Mr. Deuel s and Mr. Hinson s Company contributions under the Deferred Compensation Plan vest 10% as of January 1, 2013 and 10% as of each January 1 thereafter through January 1, 2022. Their participation agreements provide for Company contributions under the Deferred Compensation Plan for the years 2012 through and including 2016. In 2013, the Compensation Committee approved Company contributions to the Deferred Compensation Plan of $85,867, $35,222, and $33,571 on behalf of Messrs. Vance, Deuel, and Hinson, respectively, based on the achievement of 2012 performance goals under their respective Deferred Compensation Plan participation agreements.

Potential Payments Upon Termination or Change in Control

The following table reflects the estimated amount of compensation that would be paid to each of our named executive officers in the event of various terminations of employment and in the event of a change in control of Heritage. The values assume a termination date of December 31, 2012. The exact values would need to be calculated upon the actual termination of employment. The calculations do not include compensation and benefits the executives receive that are generally available to our employees.

Name	Compensation and/ or Benefits Payable upon Termination	Termination Without Cause by Employer or Termination for Good Reason by Employee ($)	Qualifying Termination in Connection with a Change in Control ($)	Termination in the Event of Disability ($)	Termination in the Event of Death ($)	Change in Control No Termination ($)
Brian L. Vance	Cash Severance	1,064,441	1,598,161	-	-	-
	Accelerated Vesting of Equity Awards(1)	-	314,028	314,028	314,028	314,028
	Accelerated Vesting of Deferred Compensation(2)	-	105,000	105,000	105,000	105,000
	Continued Medical and Dental Coverage	20,975	20,975	-	-	-
	Total	**1,085,416**	**2,038,164**	**419,028**	**419,028**	**419,028**
Jeffrey J. Deuel	Cash Severance	322,963	645,927	-	-	-
	Accelerated Vesting of Equity Awards(1)	-	281,328	281,328	281,328	281,328
	Continued Medical and Dental Coverage	16,130	24,196	-	-	-
	Total	**339,093**	**951,451**	**281,328**	**281,328**	**281,328**
Donald J. Hinson	Cash Severance	296,032	592,064	-	-	-
	Accelerated Vesting of Equity Awards(1)	-	234,307	234,307	234,307	234,307
	Continued Medical and Dental Coverage	21,812	32,719	-	-	-
	Total	**317,844**	**859,090**	**234,307**	**234,307**	**234,307**
D. Michael Broadhead	Cash Severance	200,004	400,008	-	-	-
	Accelerated Vesting of Equity Awards(1)	-	17,034	17,034	17,034	17,034
	Continued Employee Benefits	15,504	15,504	-	-	-
	Total	**215,508**	**432,546**	**17,034**	**17,034**	**17,034**
David A. Spurling	Cash Severance	-	383,383	-	-	-
	Accelerated Vesting of Equity Awards(1)	-	124,140	124,140	124,140	124,140
	Continued Medical and Dental Coverage	-	16,358	-	-	-
	Total	**-**	**523,881**	**124,140**	**124,140**	**124,140**

(1) Based on Heritage s common stock closing price of $14.69 on December 31, 2012.
(2) The incremental cost or unvested portion of Mr. Vance s deferred compensation account is reflected in this table.

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Employment Agreements and Severance/Change in Control Benefits

The rationale for having employment and severance/change in control agreements in place is to retain the employment of the named executive officers, and the talent, skills, experience and expertise that they provide to Heritage. Retention of the current leadership team is a critical goal of the Board as it protects Heritage and the shareholders and provides stability and the type of skilled leadership needed in the current environment. Employment agreements also provide critical protection to Heritage by subjecting the executives to non-competition, non-solicitation and other restrictions following their employment.

Employment Agreements Messrs. Vance, Deuel, Hinson and Broadhead. On September 7, 2012, Heritage entered into a restated employment agreement with Mr. Vance, President and Chief Executive Officer of Heritage and Chief Executive Officer of Heritage Bank and Central Valley Bank, and new employment agreements with Mr. Deuel, Executive Vice President of Heritage and President and Chief Operating Officer of Heritage Bank, and Mr. Hinson, Executive Vice President and Chief Financial Officer of Heritage and Heritage Bank. On December 3, 2010, Heritage and Central Valley Bank entered into an employment agreement with Mr. Broadhead to continue as President of Central Valley Bank.

The agreements have initial terms from July 1, 2012 through June 30, 2015 for Mr. Vance and through June 30, 2014 for Messrs. Deuel and Hinson. The term of the agreements will be automatically extended for an additional year beginning on July 1, 2014 for Mr. Vance and July 1, 2013 for Messrs. Deuel and Hinson, and on each July 1 thereafter, unless either party gives at least 90 days prior notice of non-renewal. Mr. Broadhead s agreement had an initial term from December 3, 2010 through March 31, 2012, and the term of the agreement automatically extended for an additional year beginning on April 1, 2012 and will automatically extend on each April 1 thereafter, unless either party gives at least 90 days prior notice of non-renewal.

The employment agreements provide for annual base salaries of $412,000, $256,000, $244,000 and $200,004 for Messrs. Vance, Deuel, Hinson and Broadhead, respectively. The base salaries will be reviewed annually and may be increased at the discretion of the Board. The agreements provide that the executives will be eligible to receive performance-based annual incentive bonuses, in accordance with Heritage s annual incentive plan, and also to receive employee benefits on as favorable a basis as other similarly situated and performing senior executives of Heritage. Messrs. Vance, Deuel and Broadhead will also each be provided an automobile for business use or a car allowance, at Heritage s prerogative.

The agreements for Messrs. Vance, Deuel and Hinson provide for severance benefits in the event the executive s employment is terminated by Heritage other than for cause or as a result of the executive s death or disability, or if the employment is terminated by the executive for good reason (Termination). For a Termination during the term of the employment agreement that does not occur within six months before or within 24 months after a change in control of Heritage (Covered Period), Mr. Vance would be entitled to receive an amount equal to 200% of his base salary plus annual bonus (Base Compensation) and Messrs. Deuel and Hinson would each be entitled to receive an amount equal to 100% of their Base Compensation, all payable in monthly installments over a 24-month period. For a Termination that occurs during a Covered Period, Mr. Vance would be entitled to receive a lump sum equal to 300% of his Base Compensation and Messrs. Deuel and Hinson would each be entitled to receive a lump sum equal to 200% of their Base Compensation. The executives and their eligible dependents would also be entitled to continued coverage under the medical and dental plans of Heritage (18 months coverage for Mr. Vance for any Termination; for Messrs. Deuel and Hinson, 12 months coverage for Termination that does not occur during a Covered Period and 18 months coverage for Termination during a Covered Period). The employment agreements also provide that any equity award granted to an executive and subject to vesting, performance or target requirements will be treated as having satisfied the applicable requirements in the case of any Termination.

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All severance benefits under the employment agreements for Messrs. Vance, Deuel and Hinson are contingent upon the executive s execution and non-revocation of a general release and waiver of claims against Heritage. The agreements are subject to certain banking regulatory provisions and include a clawback provision should any severance payment require recapture under any applicable statute, law, regulation or regulatory interpretation or guidance. Further, the agreements provide for an automatic reduction of severance payments if the reduction would result in a better net-after-tax result for the respective executive after taking into account the impact of the golden parachute payment restrictions of Section 280G of the Internal Revenue Code.

Under Mr. Broadhead s employment agreement, upon a Termination, Heritage would be required to: (1) pay Mr. Broadhead his salary at the rate in effect at the time of Termination, over a one-year period commencing on the date of Termination; (2) continue to provide to Mr. Broadhead and his eligible dependents and beneficiaries, for one year, substantially the same group life insurance, hospitalization, medical, dental, prescription drug and other health benefits, and long-term disability insurance (if any) had he not experienced a Termination (except that any such coverage would cease if and when he is no longer covered under an insurance program made available by Central Valley Bank to employees generally); and (3) pay to Mr. Broadhead any bonus or incentive compensation to which he has a legally binding right on the date of his Termination. In addition, any equity awards granted to Mr. Broadhead by Heritage that are subject to vesting, performance or target requirements would be treated as if Mr. Broadhead satisfied such vesting, performance or target requirements as of the date of his Termination.

Mr. Broadhead s employment agreement also provides for a lump sum severance payment of two times base salary if Mr. Broadhead experiences a Termination within 12 months following a change in control of Heritage. Mr. Broadhead and his eligible dependents and beneficiaries also would receive, for one year, substantially the same group life insurance, hospitalization, medical, dental, prescription drug and other health benefits, and long-term disability insurance (if any) as he would have received had he not experienced a Termination. In addition, any equity awards granted to Mr. Broadhead by Heritage that are subject to vesting, performance or target requirements would be treated as if Mr. Broadhead satisfied such vesting, performance or target requirements as of the date of his Termination. Mr. Broadhead s agreement provides for a benefit cutback in the event any amounts are non-deductible due to the golden parachute payment restrictions of Section 280G of the Internal Revenue Code.

The employment agreements for all the executives contain restrictive covenants prohibiting the unauthorized disclosure of confidential information of Heritage by the executives during and after their employment with the Heritage, and prohibiting the executives from competing with Heritage and from soliciting its employees or customers during employment and after termination of employment for any reason. The non-solicitation and non-competition provisions apply to Mr. Vance for a period of 24 months following any termination not in connection with a change in control. For Messrs. Deuel and Hinson, the non-competition provisions apply for a period of 12 months following any termination not in connection with a change in control and the non-solicitation provisions apply for a period for 24 months following any termination not in connection with a change in control. The non-competition and non-solicitation provisions apply to Messrs. Vance, Deuel and Hinson for a period of 12 months following any termination in connection with a change in control. For Mr. Broadhead, all of the restrictive covenants apply for a period of 12 months following any termination of employment.

Change in Control Agreement Mr. Spurling. On September 7, 2012, Heritage entered into a change in control agreement with Mr. Spurling. The initial term of the agreement begins on September 7, 2012 and continues through June 24, 2014. The agreement will automatically extend for additional 12-month periods unless terminated by Heritage upon 90 days prior written notice. If a change in control occurs during the term of the agreement, the agreement will remain in effect for the two-year period immediately following the change in control and will then terminate.

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The agreement provides for severance benefits in the event of Mr. Spurling s termination by Heritage not for cause or by Mr. Spurling for good reason, in each case within 24 months after a change in control of Heritage. Mr. Spurling would be entitled to receive an amount equal to 150% of his annual salary, payable in monthly installments over a 12-month period. Mr. Spurling and his eligible dependents would also be entitled to continued coverage under the medical and dental plans of Heritage for a period of 12 months following termination.

All severance benefits under Mr. Spurling s agreement are contingent upon his execution and non-revocation of a general release and waiver of claims against Heritage. The agreement is subject to certain banking regulatory provisions and includes a clawback provision should any severance payment require recapture under any applicable statute, law, regulation or regulatory interpretation or guidance. The agreement also provides for a benefit cutback in the event any amounts are non-deductible due to the golden parachute payment restrictions of Section 280G of the Internal Revenue Code.

The agreement contains restrictive covenants prohibiting the unauthorized disclosure of confidential information of Heritage by Mr. Spurling during and after his employment with Heritage, and prohibiting him from competing with Heritage and from soliciting its employees or customers during employment and after termination of employment for any reason. The non-solicitation provisions apply for a period of 12 months following any termination. The non-competition provisions apply for a period of 12 months following any termination in connection with a change in control.

Equity Plans

Our Restricted Stock Plan of 2002 and Restricted Stock Plan of 2006 provide for accelerated vesting of awards upon disability, death or retirement (at or after age 65). The 2010 Omnibus Equity Plan provides for accelerated vesting of awards upon disability, death or retirement (at or after age 65 and 10 years of service). During 2012, the Heritage Board approved an amendment to all of the above named Equity Plans, which allows for the vesting of shares upon the attainment of retirement eligibility to provide administrative alignment of tax and book reporting for these transactions. The 2010 Omnibus Equity Plan further provides that in the event of a change in control, if Heritage is not the surviving corporation and the acquirer does not assume outstanding awards or provide substitute equivalent awards, or if the award recipient is terminated without cause or if the award recipient terminates his or her own employment for good reason within 24 months following a change in control, then all outstanding awards will become immediately exercisable or vested. Our 1998 Stock Option and Restricted Stock Award Plan, Restricted Stock Plan of 2002, Restricted Stock Plan of 2006 and Incentive Stock Option Plan of 2006 provide for immediate vesting of all outstanding awards in connection with a change in control.

Compensation Committee Interlocks and Insider Participation

The members of the Compensation Committee as of December 31, 2012 and as of the mailing date of this proxy statement were Directors Ellwanger, Christensen, Fluetsch, Lyon, Watson and Weigand. No members of this Committee were officers or employees of Heritage or any of its subsidiaries during the year ended December 31, 2012, nor were they formerly officers or had any relationships otherwise requiring disclosure.

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PROPOSAL 2 ADVISORY VOTE ON EXECUTIVE COMPENSATION

Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), we are required to include in this Proxy Statement and present at the meeting a non-binding shareholder vote to approve the compensation of our named executive officers, as disclosed in this Proxy Statement pursuant to the compensation disclosure rules of the SEC. This proposal, commonly known as a say-on-pay proposal, gives shareholders the opportunity to endorse or not endorse the compensation of Heritage s executives as disclosed in this Proxy Statement. We currently hold our say-on-pay vote every year. The proposal will be presented at the annual meeting in the form of the following resolution:

RESOLVED, that the shareholders approve the compensation of Heritage Financial Corporation s named executive officers, as disclosed in the Compensation Discussion and Analysis, the compensation tables and related material in Heritage s Proxy Statement for the 2013 annual meeting of shareholders.

This vote will not be binding on our Board of Directors or Compensation Committee and may not be construed as overruling a decision by the Board or create or imply any additional fiduciary duty on the Board. It will also not affect any compensation paid or awarded to any executive. The Compensation Committee and the Board may, however, take into account the outcome of the vote when considering future executive compensation arrangements.

The purpose of our compensation policies and procedures is to attract and retain experienced, highly qualified executives critical to our long-term success and enhancement of shareholder value. We believe that our compensation policies and procedures are strongly aligned with the long-term interests of our shareholders. As discussed in the Compensation Discussion and Analysis, the Compensation Committee of the Board of Directors believes that the executive compensation for 2012 is reasonable and appropriate, is justified by Heritage s performance in a difficult environment and is the result of a carefully considered approach. In considering how to vote on this proposal, the Board requests that you consider the following factors:

- Heritage s improved one-year and three-year total shareholder returns of 23.7% and 16.5%, respectively. Although slightly below our peer group s respective returns during the same periods, our one-year return is 43 basis points stronger than the SNL U.S. Bank Index, which includes banks with totals assets between $1 and $5 billion.

- Heritage s earnings improved by 103% over the prior year s earnings with $13.3 million in net income for the year ended December 31, 2012 compared to $6.5 million for the year ended December 31, 2011. As a result, diluted earnings per common share increased to $0.87 for the year ended December 31, 2012 from $0.42 for the year ended December 31, 2011.

- Heritage s capital management strategies which included the ongoing stock repurchase program and the annual cash dividend payment of $0.80 per share while maintaining solid capital levels in excess of regulatory requirements. Heritage s performance when measured by credit quality and capital ratios are above the median of its peer group with most metrics above the 75th percentile of the peer group.

- Heritage s leadership team strives to fairly compensate and retain quality management while managing and balancing risks and rewards. The management team achieved some key growth initiatives during 2012 which included the acquisition of Northwest Commercial Bank and the continued focus on strong core business operations.

The Board of Directors recommends that you vote FOR approval of the compensation of our named executive officers as disclosed in this Proxy Statement.

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REPORT OF THE AUDIT AND FINANCE COMMITTEE

The following Report of the Audit and Finance Committee of the Board of Directors shall not be deemed to be soliciting material or to be incorporated by reference by any general statement incorporating by reference this Proxy Statement into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent Heritage specifically incorporates this report therein, and shall not otherwise be deemed filed under these Acts.

Management is responsible for: (1) preparing Heritage s financial statements so that they comply with generally accepted accounting principles and fairly present Heritage s financial condition, results of operations and cash flows; (2) issuing financial reports that comply with the requirements of the SEC; and (3) establishing and maintaining adequate internal control structures and procedures for financial reporting. The Audit Committee s responsibility is to monitor and oversee these processes. In furtherance of its role, the Audit and Finance Committee undertakes periodic reviews of Heritage s internal controls and areas of potential exposure, such as litigation matters. The Committee meets at least quarterly and reviews the interim financial results and earnings releases prior to their publication.

The Audit and Finance Committee reports as follows with respect to Heritage s audited financial statements for the year ended December 31, 2012:

The Audit and Finance Committee has reviewed and discussed the audited financial statements with management;

The Audit and Finance Committee has discussed with the independent registered public accounting firm, Crowe Horwath LLP, the matters required to be discussed by Statement on Auditing Standards No. 61, *Communication with Audit Committees*, as amended, as adopted by the Public Company Accounting Oversight Board in Rule 3200T;

The Audit and Finance Committee has received the written disclosures and the letter from the independent registered public accounting firm required by applicable requirements of the Public Company Accounting Oversight Board regarding the independent registered public accounting firm s communications with the Audit and Finance Committee concerning independence, and has discussed with the independent registered public accounting firm the independent registered public accounting firm s independence; and

The Audit and Finance Committee has, based on its review and discussions with management of the 2012 audited financial statements and discussions with the independent registered public accounting firm, recommended to the Board of Directors that Heritage s audited financial statements for the year ended December 31, 2012 be included in its Annual Report on Form 10-K.

The foregoing report is provided by the following directors, who constitute the Audit and Finance Committee:

Respectfully submitted by :	Daryl D. Jensen (Chairman)
	Brian S. Charneski
	Gary B. Christensen
	John A. Clees
	Jeffrey S. Lyon
	Donald V. Rhodes
	Ann Watson

Philip S. Weigand

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PROPOSAL 3 RATIFICATION OF THE APPOINTMENT

OF REGISTERED PUBLIC ACCOUNTING FIRM

Appointment of Independent Registered Public Accounting Firm

The Audit and Finance Committee of the Board of Directors has appointed Crowe Horwath LLP as its independent registered public accounting firm for the December 31, 2013 and 2012 fiscal years. KPMG LLP served as Heritage s independent auditor for the fiscal year ended December 31, 2011. Heritage terminated its engagement of KPMG LLP as its independent registered public accounting firm upon the completion of the audit for fiscal year ended December 31, 2011. In connection with the audit as of and for the years ended December 31, 2011 and 2010, and the subsequent interim period through March 2, 2012, (1) there were no disagreements with KPMG LLP on any matter of accounting principle or practice, financial statement disclosure, auditing scope or procedure, whereby such disagreements, if not resolved to the satisfaction of KPMG LLP, would have caused them to make reference thereto in their report on the financial statements for such years; and (2) there have been no reportable events (as defined in Item 304(a)(1)(v) of Regulation S-K). You are asked to ratify the appointment of Crowe Horwath LLP at the annual meeting. Although shareholder ratification of the appointment of Crowe Horwath LLP is not required by our bylaws or otherwise, our Board of Directors is submitting this appointment to shareholders for their ratification at the annual meeting as a matter of good corporate practice. If the appointment of Crowe Horwath LLP is not ratified by our shareholders, the Audit and Finance Committee may appoint another independent registered public accounting firm or may decide to maintain its appointment of Crowe Horwath LLP. Even if the appointment of Crowe Horwath LLP is ratified by the shareholders at the annual meeting, the Audit and Finance Committee, in its discretion, may select a different independent registered public accounting firm at any time during the year.

The Audit and Finance Committee operates under a written charter adopted by the Board of Directors. In fulfilling its oversight responsibility of reviewing the services performed by Heritage s independent registered public accounting firm, the Committee carefully reviews the policies and procedures for the engagement of the independent registered public accounting firm. The Audit and Finance Committee discussed with Crowe Horwath LLP the overall scope and plans for the audit, and the results of the audit for the year ended December 31, 2012. Heritage also reviewed and discussed with Crowe Horwath LLP and KPMG LLP the fees paid, as described below, and determined the fees billed for services was compatible with Crowe Horwath LLP and KPMG LLP maintaining their independence.

A representative of Crowe Horwath LLP is expected to attend the meeting to respond to appropriate questions and will have an opportunity to make a statement if he or she so desires.

The Board of Directors unanimously recommends that you vote FOR the ratification of the appointment of Crowe Horwath LLP as the independent registered public accounting firm for Heritage for the year ending December 31, 2013.

Audit Fees

The following table sets forth the aggregate fees billed or expected to be billed to Heritage by its principal accountant during the years indicated. Crowe Horwath LLP audited Heritage s financial statements for the year ended December 31, 2012 and KPMG LLP audited Heritage s financial statements for the year ended December 31, 2011.

	Year Ended December 31,	
	2012(3)	2011
Audit Fees(1)	$ 281,175	$ 396,500
Audit-Related Fees	-	30,000(2)
Tax Fees	-	81,901
Total	$ 281,175	$ 508,401

(1) Audit fees consists of fees paid for the audit of Heritage s consolidated financial statements in the Form 10-K, audit of Heritage s statements of assets acquired and liabilities assumed in the Form 8-K/As, and review of financial statements included in the Form 10-Qs, including services normally provided by an accountant in connection with statutory and regulatory filings or engagements, and the review of registration statements filed with the SEC and the issuance of consents and comfort letters.
(2) Includes costs incurred in relation to the audit of the employee benefit plan performed by KPMG LLP.
(3) The Company paid fees to KPMG LLP for the employee benefit plan and tax services during 2012; however these fees were not included because KPMG LLP was not our principal accountants for this audit period.

Pre-approval Policy

It is the policy of the Audit and Finance Committee to pre-approve all audit and permissible non-audit services to be provided by the registered public accounting firm and the estimated fees for these services. Pre-approval is typically granted by the full Audit and Finance Committee. In considering non-audit services, the Audit and Finance Committee will consider various factors, including but not limited to, whether it would be beneficial to have the service provided by the independent registered public accounting firm and whether the service could compromise the independence of the independent registered public accounting firm. For the year ended December 31, 2012, the Audit and Finance Committee approved all, or 100%, of the services provided by Crowe Horwath LLP that were designated as audit fees, audit-related fees, tax fees and all other fees as set forth in the table above.

SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act requires our directors and executive officers, and persons who own more than 10% of Heritage s common stock to report their initial ownership of the common stock and any subsequent changes in that ownership to the SEC. Specific due dates for these reports have been established by the SEC and we are required to disclose in this Proxy Statement any late filings or failures to file. Based solely on our review of the copies of such forms we have received and written representations provided to us by the above referenced persons, we believe that, during the year ended December 31, 2012, all filing requirements applicable to our reporting officers, directors and greater than 10% shareholders were properly and timely complied with.

SHAREHOLDER PROPOSALS

In order to be eligible for inclusion in the proxy materials for next year s annual meeting of shareholders, any shareholder proposal to take action at such meeting must be received at the executive office at 201 Fifth Avenue S.W., Olympia, Washington 98501, no later than November 18, 2013. Any such proposals shall be subject to the requirements of the proxy rules adopted under the Securities Exchange Act, and as with any shareholder proposal (regardless of whether included in our proxy materials), our Articles of Incorporation and Bylaws.

Our Articles of Incorporation generally provide that shareholders will have the opportunity to nominate Heritage directors if the nominations are made in writing and delivered to our Chairman not less than 14 days nor more than 50 days before such annual meeting of shareholders; provided, however, if less than 21 days notice of the meeting is given, the shareholder s notice shall be delivered to the Chairman no later than the close of the seventh day following the date on which notice of the meeting was mailed to shareholders. As specified in the Articles of Incorporation, the notice with respect to nominations for election of directors must set forth certain information regarding each nominee for election as a director, including the name and address of each proposed nominee, the principal occupation of each proposed nominee, the total number of shares of Heritage common stock that will be voted for each shareholder proposed nominee, the name and address of the nominating shareholder, and the number of shares of Heritage common stock owned by the nominating

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shareholder. Heritage s Board Governance and Nominating Committee, in its discretion, may disregard any nominations that do not comply with the above-listed requirements. Upon the Board Governance and Nominating Committee s instructions, the vote teller may disregard all votes cast for a nominee if the nomination does not comply with the above-listed requirements.

MISCELLANEOUS

The Board of Directors is not aware of any business to come before the annual meeting other than the matters described in this Proxy Statement. However, if any other matters should properly come before the meeting, it is intended that proxies in the accompanying form will be voted in respect thereof in accordance with the judgment of the person or persons voting the proxies.

We will pay the cost of soliciting proxies. In addition to this mailing, our directors, officers and employees may also solicit proxies personally, electronically or by telephone without additional compensation. We will also reimburse brokers and other nominees for their expenses in sending these materials to you and obtaining your voting instructions.

Our annual report for the year ended December 31, 2012 (including consolidated financial statements) has been mailed along with this Proxy Statement to all shareholders of record as of March 4, 2013. The annual report is not to be treated as part of the proxy solicitation material or having been incorporated by reference in this Proxy Statement.

A copy of Heritage s Form 10-K that was filed with the Securities and Exchange Commission on March 6, 2013 will be provided to you without charge if you were a shareholder of Heritage as of March 4, 2013. Please make your written request to:

Heritage Financial Corporation

Attention: Kaylene M. Lahn

Corporate Secretary

201 Fifth Avenue S.W.

Olympia, Washington 98501

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REVOCABLE PROXY

HERITAGE FINANCIAL CORPORATION

ANNUAL MEETING OF SHAREHOLDERS

MAY 1, 2013

The undersigned hereby appoints Daryl D. Jensen and Donald V. Rhodes, and each of them, with full powers of substitution to act as attorneys and proxies for the undersigned, to vote all shares of common stock of Heritage Financial Corporation (the Company or Heritage) which the undersigned is entitled to vote at the annual meeting of shareholders, to be held at the Phoenix Inn Suites, 417 Capitol Way N., Olympia, Washington, on Wednesday, May 1, 2013, at 10:30 a.m., Pacific time, and at any and all adjournments thereof, as follows:

		FOR	WITHHELD	FOR ALL EXCEPT
	The Heritage Board of Directors recommends that you vote **FOR** the following nominees:			
1.	Election as director of the nominees listed below for a one-year term (except as marked to the contrary below).	¨	¨	¨

Brian S. Charneski

Gary B. Christensen
John A. Clees
Kimberly T. Ellwanger
Brian L. Vance

Ann Watson

INSTRUCTION: To withhold authority to vote for any individual nominee, mark For All Except and write that nominee s name in the space provided below.

The Heritage Board of Directors recommends that you vote **FOR** the following proposals:

		FOR	AGAINST	ABSTAIN
2.	Advisory (non-binding) approval of the compensation paid to named executive officers as disclosed in the Proxy Statement.	¨	¨	¨

		FOR	AGAINST	ABSTAIN
3.	Ratification of the appointment of Crowe Horwath LLP as Heritage s independent registered public accounting firm for the fiscal year ending December 31, 2013.	¨	¨	¨

In their discretion, upon such other matters as may properly come before the meeting.

This proxy also provides voting instructions to the trustees of the Heritage Financial Corporation 401(k) Employee Stock Ownership Plan for participants with shares allocated to their accounts.

This proxy will be voted as directed, but if no instructions are specified, this proxy will be voted FOR the election of the nominees listed in Proposal 1 and FOR Proposals 2 and 3. If any other business is presented at such meeting, this proxy will be voted by the proxies named above in their best judgment. At the present time, the Board of Directors knows of no other business to be presented at the

annual meeting. This proxy also confers discretionary authority on the proxies named above to vote with respect to the election of any person as director where the nominees are unable to serve or for good cause will not serve and matters incident to the conduct of the annual meeting.

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THIS PROXY IS SOLICITED BY THE BOARD OF DIRECTORS

Should the undersigned be present and elect to vote at the annual meeting or at any adjournment thereof and after notification to the Secretary of the Company at the annual meeting of the shareholder s decision to terminate this proxy, then the power of said attorneys and proxies shall be deemed terminated and of no further force and effect.

The undersigned acknowledges receipt from the Company prior to the execution of this proxy of the Notice of Annual Meeting of Shareholders, a Proxy Statement dated March 19, 2013, and the 2012 Annual Report to Shareholders.

Dated: , 2013

PRINT NAME OF SHAREHOLDER

PRINT NAME OF SHAREHOLDER

SIGNATURE OF SHAREHOLDER

SIGNATURE OF SHAREHOLDER

Please sign exactly as your name appears on the enclosed card. When signing as attorney, executor, administrator, trustee or guardian, please give your full title. If shares are held jointly, each holder should sign.

PLEASE COMPLETE, DATE, SIGN AND MAIL THIS PROXY PROMPTLY IN THE ENCLOSED POSTAGE-PREPAID ENVELOPE.