

HERITAGE FINANCIAL CORP /WA/
Form 11-K
June 28, 2006
Table of Contents

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 11-K

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

x **ANNUAL REPORT PURSUANT TO SECTION 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 (NO FEE
REQUIRED)**

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2005

.. **TRANSITION REPORT PURSUANT TO SECTION 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 (NO FEE
REQUIRED)**

COMMISSION FILE NUMBER 000-29480

A. Full title of the plan and address, if different from that of the issuer named below:

HERITAGE FINANCIAL CORPORATION

401(k) EMPLOYEE STOCK OWNERSHIP PLAN AND TRUST

B. Name of issuer of the securities held pursuant to the plan and the address of its principal executive office:

HERITAGE FINANCIAL CORPORATION

201 5TH AVENUE S.W.

OLYMPIA, WASHINGTON 98501-1114

REQUIRED INFORMATION

The Heritage Financial Corporation 401(k) Employee Stock Ownership Plan and Trust is subject to ERISA and elects to file Plan Financial Statements and Schedules prepared in accordance with the Financial Reporting Statements of ERISA.

The Heritage Financial Corporation 401(k) Employee Stock Ownership Plan and Trust Financial Statements and Additional Information as of December 31, 2005 annexed as Exhibit A hereto are hereby incorporated by reference herein, and are included as a part of this Annual Report.

Table of Contents

INDEX TO EXHIBITS

EXHIBIT

| NUMBER | DESCRIPTION |
|---------------|-----------------------------|
| 23.1 | Consent of KPMG, LLP |
| 23.2 | Consent of BDO Seidman, LLP |

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the administrator has duly caused the annual report to be signed by the undersigned hereunto duly authorized.

HERITAGE FINANCIAL CORPORATION 401(k)

EMPLOYEE STOCK OWNERSHIP PLAN AND
TRUST

BY: HERITAGE BANK

Administrator

BY: /s/ Donald V. Rhodes

NAME: Donald V. Rhodes

TITLE: Chairman

Table of Contents

**Heritage Financial
Corporation
401(k) Employee
Stock Ownership Plan and Trust
Financial Statements and
Supplemental Schedules
December 31, 2005 and 2004
(With Report of Independent Registered Public Accounting Firm)**

Table of Contents

Heritage Financial Corporation
401(k) Employee Stock Ownership Plan and Trust

| | Contents |
|---|-----------------|
| <u>Reports of Independent Registered Public Accounting Firms</u> | 3-4 |
| Financial Statements | |
| <u>Statements of Net Assets Available for Benefits</u> | 5 |
| <u>Statement of Changes in Net Assets Available for Benefits</u> | 6 |
| <u>Notes to Financial Statements</u> | 7-18 |
| Supplemental Schedules | |
| <u>Schedule of Assets (Held at End of Year)</u> | 19 |
| <u>Schedule of Reportable Transactions</u> | 20 |

Table of Contents

Report of Independent Registered Public Accounting Firm

To the Board of Trustees

Heritage Financial Corporation 401(k)

Employee Stock Ownership Plan and Trust

Olympia, Washington

We have audited the accompanying statement of net assets available for benefits of the Heritage Financial Corporation 401 (k) Employee Stock Ownership Plan and Trust (the Plan) as of December 31, 2005 and the related statement of changes in net assets available for benefits for the year then ended. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 2005, and the changes in net assets available for benefits for the year then ended in conformity with U.S. generally accepted accounting principles.

Our audit was performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules H, line 4i schedule of assets (held at end of year) and line 4j schedule of reportable transactions, are presented for the purpose of additional analysis and are not a required part of the basic financial statements but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. The supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in our audit of the basic financial statements and in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

KPMG LLP

Seattle, WA

June 26, 2006

Table of Contents

Report of Independent Registered Public Accounting Firm

To the Board of Trustees

Heritage Financial Corporation 401(k)

Employee Stock Ownership Plan and Trust

Olympia, Washington

We have audited the accompanying statement of net assets available for benefits of Heritage Financial Corporation 401 (k) Employee Stock Ownership Plan and Trust (the Plan) as of December 31, 2004. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of Heritage Financial Corporation 401(k) Employee Stock Ownership Plan and Trust as of December 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

BDO Seidman, LLP

Seattle, Washington

June 3, 2005

Table of Contents

| Heritage Financial Corporation | | |
|--|----------------------|----------------------|
| 401(k) Employee Stock Ownership Plan and Trust | | |
| Statements of Net Assets Available for Benefits | | |
| <i>December 31,</i> | 2005 | 2004 |
| Assets | | |
| Investments at fair value: | | |
| Participant directed: | | |
| Registered investment company funds | \$ 7,196,854 | \$ 6,536,331 |
| Heritage Financial Corporation common stock | 904,086 | 717,168 |
| Money market funds | 800,839 | 816,475 |
| Participant loans | 69,226 | 37,459 |
| | 8,971,005 | 8,107,433 |
| Non-participant directed: | | |
| Heritage Financial Corporation common stock | 8,982,111 | 7,536,822 |
| Money market funds | 1,335 | 18,530 |
| | 8,983,446 | 7,555,352 |
| Total investments | 17,954,451 | 15,662,785 |
| Cash | | 37,965 |
| Receivables: | | |
| Employer contributions | 423,750 | 322,615 |
| Participant contributions | 27,741 | 117 |
| Accrued investment income | 2,548 | 1,220 |
| Total receivables | 454,039 | 323,952 |
| Total assets | 18,408,490 | 16,024,702 |
| Liabilities | | |
| Loan payable to Heritage Financial Corporation | 829,501 | 911,449 |
| Excess deferrals | 9,052 | |
| Accounts payable and other | 9,063 | 229 |
| Total liabilities | 847,616 | 911,678 |
| Net assets available for benefits | \$ 17,560,874 | \$ 15,113,024 |

See accompanying notes to financial statements.

Table of Contents**Heritage Financial Corporation****401(k) Employee Stock Ownership Plan and Trust****Statement of Changes in Net Assets Available for Benefits**

| <i>Year ended December 31, 2005</i> | Participant Directed | Non-Participant Directed | Total |
|---|---------------------------------|-------------------------------------|----------------------|
| Additions | | | |
| Investment income: | | | |
| Net appreciation in fair value of investments | \$ 573,763 | \$ 1,209,871 | \$ 1,783,634 |
| Interest and dividends | 149,240 | 251,806 | 401,046 |
| | 723,003 | 1,461,677 | 2,184,680 |
| Contributions: | | | |
| Participant salary deferrals | 707,512 | | 707,512 |
| Participant rollovers | 84,626 | | 84,626 |
| Employer | | 606,304 | 606,304 |
| ESOP loan payments | | 105,533 | 105,533 |
| Fund transfers | 12,428 | (12,428) | |
| | 804,566 | 699,409 | 1,503,975 |
| Total additions | 1,527,569 | 2,161,086 | 3,688,655 |
| Deductions | | | |
| Benefits paid to participants | 609,132 | 449,184 | 1,058,316 |
| Excess deferrals | 9,052 | | 9,052 |
| Administrative expenses | 65,562 | 33,546 | 99,108 |
| Interest expense | | 74,329 | 74,329 |
| Total deductions | 683,746 | 557,059 | 1,240,805 |
| Net increase | 843,823 | 1,604,027 | 2,447,850 |
| Net assets available for benefits, beginning of year | 8,142,038 | 6,970,986 | 15,113,024 |
| Net assets available for benefits, end of year | \$ 8,985,861 | \$ 8,575,013 | \$ 17,560,874 |

See accompanying notes to financial statements.

Table of Contents

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

December 31, 2005 and 2004

- 1. Description of Plan** The following description of the Heritage Financial Corporation 401(k) Employee Stock Ownership Plan and Trust (the Plan) provides only general information. Participants should refer to the Plan agreement for a more complete description of the Plan's provisions.

General

Heritage Financial Corporation (the Company) is a bank holding company with headquarters in Olympia, Washington.

The Plan is a qualified defined contribution plan established by the Company under the provisions of Section 401(a) and Section 4975(e)(7) of the Internal Revenue Code (IRC) with salary reduction and employer stock ownership features for the benefit of eligible employees of the Company. The Plan is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA), as amended. The Plan is administered by the KSOP Committee, which consists of certain officers and employees of the Company. U.S. Bank serves as the trustee.

Eligibility

Employees of the Company are generally eligible to participate in the Plan after three months of service, providing they worked at least 250 hours during a three-month period and have reached the age of twenty-one.

Contributions

Participants may elect to contribute up to the lesser of 75% of their eligible compensation or \$14,000 (in 2005), subject to certain eliminations under the IRC. Additionally, participants over age 50 may make catch-up contributions up to \$4,000 (in 2005). Participants may also contribute amounts representing distributions from other qualified plans.

Table of Contents

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

December 31, 2005 and 2004

**1. Description of Plan
(Continued)**

The Company makes contributions to participant accounts as follows:

- 1) a matching contribution equal to 50% of the participant's contribution up to 6% of the participant's eligible compensation.
- 2) required contribution of 2% of the participant's eligible compensation.
- 3) discretionary contributions beyond the required 2% contribution.
- 4) Employee Stock Ownership Plan (ESOP) allocation calculated based on the current year ESOP loan principal and interest payment. See note 3.

During 2005, the Company's discretionary contribution totaled 3% of eligible compensation. Company contributions are made in the form of Heritage Financial Corporation common stock. Participants who do not have at least 1,000 hours of service during the Plan year are not eligible for the matching contributions. Participants who do not have at least 1,000 hours of service during the Plan year and are not employed on the last working day of a Plan year, are not eligible for an allocation of non-matching Company contributions for that year except in the event of the participant's death, disability or retirement. Employer contributions to the Plan are invested primarily in shares of Company stock. In 2005 the Company met the minimum funding requirements as defined by ERISA.

Participants' Accounts

Each participant's account is credited with the participant's contribution and allocations of the Company's contributions and Plan earnings net of expenses. Allocations are made on a quarterly basis and based on participant earnings or account balances as defined. The benefit to which a participant is entitled is the benefit that can be provided from the participant's account.

Vesting

Vesting in the Company's contributions plus earnings thereon is based on years of continuous service. A participant's matching contribution is 100% vested after six years of credited service or upon death, disability or retirement with 20% vesting at two years of service increasing by an additional 20% with each additional year of service. All other employer contributions are 100% vested after seven years of credited service or upon death, disability or retirement with 20% vesting at three years of service increasing by an additional 20% with each additional year of service. The vesting schedule applicable to the prior plans merged into the Plan will continue to apply to existing accounts and on an ongoing basis to accounts after October 1, 1999. However, no credit for service prior to

Table of Contents

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

December 31, 2005 and 2004

1. Description of Plan July 1, 1993 will be given for any such account.

(Continued)

Investment Options

The Plan's ESOP component is designed to invest primarily in Company common stock in order to comply with Section 4975(e)(7) of the IRC and Income Tax Regulation 54.4975-11. The Plan's assets are maintained in funds and Company stock held in a trust account at U.S. Bank. Upon enrollment in the Plan, a participant may direct his or her employee contributions in 1% increments among five registered investment company funds, a money market fund, and Company stock.

Participants may make changes to their deferral amounts and investment options for new deferrals and may reallocate their account at the beginning of each quarter. Contributions may be temporarily held as cash balances prior to the execution of the investment according to the participant's direction.

Because investments in Company stock are not diversified, this investment may present higher than average volatility. Therefore, the Plan states that a participant is limited to investing no more than 20% of his or her 401(k) deferrals into Company stock.

Payment of Benefits

No distributions from the Plan will be made until a participant retires, dies (in which case, payment shall be made to his or her beneficiary or, if none, to his or her legal representatives), becomes disabled or otherwise terminates employment with the Company. Distributions are made in cash, Company stock, or both.

Benefit distributions are based on the participant's vested account balance and may be distributed in a lump sum, installments over a period of not more than the participant's life expectancy, or through the purchase of an annuity if the participant's vested account balance is greater than \$5,000.

Table of Contents

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

December 31, 2005 and 2004

1. Description of Plan

(Continued)

Under certain conditions, participants, while still employed by the Company, are permitted to withdraw in a single sum, the employee contribution portion of their account balance. These conditions include unreimbursed medical expenses, the purchase of the participant's principal residence, the payment of postsecondary education tuition or to prevent eviction or foreclosure from the participant's principal residence. A participant's right to make deferrals to the Plan will be suspended for 6 months after the receipt of a hardship withdrawal.

The Plan has the right to automatically distribute participant accounts upon termination of service for participants with balances not exceeding \$1,000 as a lump sum distribution.

Diversification

Participants who are at least age 55 with 10 years of participation in the Plan may elect to diversify a portion of their account invested in Company stock. The qualified election period is the six-year period commencing with the Plan year in which the participant becomes a qualified participant. In each of the first five years, a participant may diversify up to 25 percent of the number of post-1986 shares allocated to his or her account, less any shares previously diversified. In the sixth year, the diversification percentage changes to 50 percent.

Voting and Dividend Rights

No participant shall have any voting or dividend rights or other rights of a stockholder prior to the time that shares are allocated to the participant.

Each participant is entitled to exercise voting rights attributable to the shares of Company stock allocated to his or her account and is notified by the trustee prior to the time that such rights are to be exercised.

Forfeitures

Forfeitures may be used to reduce employer contributions. At December 31, 2005 and 2004, forfeited non-vested accounts totaled \$40,362 and \$51,811. Forfeitures used to reduce employer contributions during 2005 totaled \$55,085.

Table of Contents

Heritage Financial Corporation
401(k) Employee Stock Ownership Plan and Trust
Notes to Financial Statements
December 31, 2005 and 2004

1. Description of Plan Participant Loans

(Continued)

Participants may borrow, upon written application, any amount provided that the aggregate amount of all outstanding loans to the participant from the Plan and from any other qualified plan maintained by the employer, including accrued interest thereon, shall not exceed the lesser of \$50,000 or 50% of the participant's vested account balance. Loan terms shall not exceed five years, except for the purchase of a primary residence. The loans are collateralized by the balance in the participant's account and bear interest at a rate commensurate with local prevailing rates. Principal and interest is paid ratably not less than quarterly through payroll deductions. The interest rate on outstanding loans as of December 31, 2005 ranged from 4.25% to 7.0% and the loans mature through March 2014.

Administrative Expenses

Administrative expenses including trust, recordkeeping, audit, legal and investment fees are paid by the Plan. Some other expenses may be paid by the Company.

**2. Summary of
Significant
Accounting Policies**

Basis of Accounting

The accompanying financial statements have been prepared under the accrual method of accounting.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and changes therein, and the disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

Table of Contents

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

December 31, 2005 and 2004

**2. Summary of
Significant
Accounting Policies
(Continued)**

Risks and Uncertainties

The Plan allows participants to direct contributions into a money market fund, various registered investment company funds, and Company stock. Company contributions are used to purchase Company stock. The underlying investment securities of these funds and Company stock are exposed to various risks, such as interest rate, market and credit risk. Due to the level of risk associated with certain underlying investment securities and the level of uncertainty related to changes in the value of the funds and the Company stock, it is reasonably possible that changes in the value of investment securities will occur in the near term and that such changes could materially affect participants' account balances and the amounts reported in the statement of net assets available for benefits and the statement of changes in net assets available for benefits.

Participants should refer to Heritage Financial Corporation's annual and quarterly financial statements filed with the Securities and Exchange Commission (Form 10K and 10Q) regarding risks associated with Company stock.

Investment Valuation and Income Recognition

The Plan's investments are stated at fair value. Shares of registered investment company funds and the Company stock are valued at quoted market prices. Fair value of the Company stock is based on the closing price of stock on the NASDAQ National Market System on the last trading day of the Plan year. Participant loans and money market funds are valued at cost.

Purchases and sales of securities are recorded on a trade-date basis. Dividend income is accrued on the ex-dividend date. Interest income is recorded on the accrual basis. Realized gains and losses from security transactions are reported on the moving average method. Net appreciation in fair value of investments represents the change in fair value from one period to the next and realized gains and losses.

Payment of Benefits

Benefits are recorded when paid. At December 31, 2005 and 2004, assets allocated to withdrawing participants totaled \$10,453 and \$271,807, respectively.

Table of Contents

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

December 31, 2005 and 2004

Excess Deferrals

Excess deferrals over maximum IRS limits totaled \$9,052 for the year ended December 31, 2005. The excess deferrals were returned to participants in the first quarter of 2006.

3. Leveraged ESOP Feature

The Plan purchased shares of the Company's stock using the proceeds of a borrowing from the Company and holds the stock in a trust established under the Plan. The borrowing is to be repaid over a period of 15 years by deductible Company contributions to the trust fund.

Under the ESOP feature of the Plan, the Company is obligated to make contributions in cash to the Plan which, when aggregated with the Plan's dividends and interest earnings, equal the amount necessary to enable the Plan to make its regularly scheduled payments of principal and interest due on its term indebtedness to the Company. As the Plan makes each payment of principal and interest, an appropriate percentage of stock is allocated to eligible employees' accounts in accordance with applicable regulations under the IRC.

The loan is collateralized by all unallocated shares of Company stock. The lender has no rights against shares once they are allocated under the Plan. Accordingly, the table below presents separately the assets and liabilities and changes therein pertaining to:

(a) accounts of employees with rights in allocated stock and

(b) stock not yet allocated to employees.

The Plan's ESOP assets at year-end are summarized as follows:

| December 31, | 2005 | | 2004 | |
|---|---------------------|-------------------|---------------------|-------------------|
| | Allocated | Unallocated | Allocated | Unallocated |
| Heritage Financial Corporation Common Stock, at fair value: | \$ 3,418,108 | \$ 1,600,613 | \$ 2,940,810 | \$ 1,576,426 |
| Cash | 134 | | 2,764 | |
| Accrued investment income | | 868 | | |
| Loan Payable to Heritage Financial Corporation | | (829,501) | | (911,449) |
| Net ESOP Assets | \$ 3,418,242 | \$ 771,980 | \$ 2,943,574 | \$ 664,977 |

Table of Contents

Heritage Financial Corporation
401(k) Employee Stock Ownership Plan and Trust
Notes to Financial Statements
December 31, 2005 and 2004

3. Leveraged ESOP Feature (Continued) The ESOP component's change in net assets is summarized as follows:

| <i>Year ended December 31,</i> | 2005 | |
|---|-------------------------|-----------------------|
| | Allocated | Unallocated |
| Heritage Financial Corporation Common Stock: | | |
| Net appreciation in fair value | \$ 432,166 | \$ 250,182 |
| Dividends | 91,089 | 53,103 |
| Loan payments | | 105,533 |
| Shares released | 225,988 | (225,988) |
| Dividends on released shares | 1,498 | (1,498) |
| Fund transfers | (7,619) | |
| Distributions to participants | (253,766) | |
| New loans to participants | | |
| Administrative expense | (14,688) | |
| Interest expense | | (74,329) |
| Net increase (decrease) | 474,668 | 107,003 |
| Net assets, beginning of year | 2,943,574 | 664,977 |
| Net assets, end of year | \$ 3,418,242 | \$ 771,980 |

At December 31, 2005, 8,817 shares were pending allocation to participants under the Plan. The Plan purchased 4,089 allocated shares by reinvesting dividends on allocated shares. The Plan sold or distributed 12,468 shares in connection with distributions to participants. In addition, the Plan had a stock dividend resulting in an increase of 9,765 shares.

Table of Contents**Heritage Financial Corporation****401(k) Employee Stock Ownership Plan and Trust****Notes to Financial Statements****December 31, 2005 and 2004**

- 3. Leveraged ESOP Feature (Continued)** In January 1998, the Plan borrowed \$1,323,000 from the Company to purchase shares of the Company's stock. The loan matures January 2013 and will be repaid in monthly installments of \$13,023 primarily from the Company's contributions. Interest is accrued at a rate of 8.5% per annum.

The repayment schedule for principal is as follows:

| <i>Year ending December 31,</i> | |
|---------------------------------|-------------------|
| 2006 | \$ 89,192 |
| 2007 | 97,076 |
| 2008 | 105,657 |
| 2009 | 114,996 |
| Thereafter | 422,580 |
| Total | \$ 829,501 |

- 4. Investments** The following investments represent 5% or more of the Plan's net assets available for benefits at the end of the year:

| <i>December 31,</i> | 2005 | 2004 |
|--|---------------------|--------------|
| Heritage Financial Corporation Common Stock* | \$ 9,886,197 | \$ 8,253,990 |
| First American Prime Obligation Fund | | 835,005 |
| Fidelity Advisory Mid Cap Fund, Class A | 1,239,309 | 1,033,072 |
| Frank Russell Equity I Fund, Class I | 1,023,753 | 858,025 |
| Frank Russell International Fund, Class I | 1,017,094 | 903,057 |
| Frank Russell Equity Q Fund, Class I | 1,024,926 | 850,742 |

* \$8,982,111 and \$7,536,822 are non-participant directed.

The Plan's investments appreciated during the year as follows:

| <i>Year ended December 31, 2005</i> | Participant directed | Nonparticipant directed | Total |
|-------------------------------------|-------------------------|----------------------------|---------------------|
| Registered Investment Company Funds | \$ 453,294 | \$ | \$ 453,294 |
| Common Stock | 120,469 | 1,209,871 | 1,330,340 |
| | \$ 573,763 | \$ 1,209,871 | \$ 1,783,634 |

Table of Contents

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

December 31, 2005 and 2004

- 5. Plan Termination** The Company reserves the right to terminate the Plan at any time, subject to Plan provisions. Upon termination of the Plan, participant accounts become fully vested and will be distributed to the participant or his or her beneficiary at the time prescribed by the Plan terms and the IRC. Upon termination of the Plan, the trustee will direct the Plan administrator to pay all liabilities and expenses of the trust fund and to sell shares of unallocated stock to the extent it determines such sale necessary to repay the loan. Remaining unallocated shares will be allocated to participants.
- 6. Tax Status** The Plan obtained its latest determination letter on October 25, 2002, in which the Internal Revenue Service stated that the Plan, as then designed, was in compliance with the applicable requirements of the IRC. Although the Plan has been amended since receiving the determination letter, the Plan administrator and the Plan's counsel believe that the Plan is designed and is currently being operated in compliance with the applicable requirements of the IRC. Therefore, no provision for income taxes has been included in the Plan's financial statements.
- 7. Related Party and Party in Interest Transactions** The Plan's assets, which consist primarily of shares of Company stock, registered investment company funds, and U.S. Bank money market fund, are held by U.S. Bank, the trustee of the Plan. The Company's contributions are held and managed by the trustee, which invests cash received, interest and dividend income, and makes distributions to participants. The record keeper administers the payment of interest and principal on the loan, which is reimbursed to the trustee through contributions determined by the Company.
- Certain administrative functions are performed by officers or employees of the Company. No officer or employee receives compensation from the Plan.
- For the year ended December 31, 2005, the Plan paid U.S. Bank \$45,672 for services as trustee and asset custodian of the Plan. For the year ended December 31, 2005, the Plan paid \$53,436 to other service providers that are defined as a Party in Interest under ERISA.

Table of Contents

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

December 31, 2005 and 2004

- 8. Subsequent Events** Heritage Financial Corporation acquired Washington State Bank, N.A. effective June 1, 2006 (date of merger). As a result, all eligible employees of Washington State Bank, N.A. at the date of merger shall become participants of the Plan.
- 9. Reconciliation of Financial Statements to Schedule H of Form 5500** The following is a reconciliation of net assets available for benefits per the financial statements to Schedule H of Form 5500:

| <i>December 31,</i> | 2005 | 2004 |
|--|----------------------|----------------------|
| Net assets available for benefits per the financial statements | \$ 17,560,874 | \$ 15,113,024 |
| Amounts allocated to withdrawing participants | (10,453) | (271,807) |
| Net assets available for benefits per Schedule H of Form 5500 | \$ 17,550,421 | \$ 14,841,217 |

The following is a reconciliation of benefits paid to participants per the financial statements to Schedule H of Form 5500:

| <i>Year ended December 31,</i> | 2005 |
|--|-------------------|
| Benefits paid to participants per the financial statements | \$ 1,058,316 |
| Less: Amounts allocated to withdrawing participants at end of prior year | (271,807) |
| Add: Amounts allocated to withdrawing participants at year-end | 10,453 |
| Benefits paid to participants per Schedule H of Form 5500 | \$ 796,962 |

Table of Contents

Heritage Financial Corporation
401(k) Employee Stock Ownership Plan and Trust
Notes to Financial Statements
December 31, 2005 and 2004

The following is a reconciliation of investment income per the financial statements to Schedule H of Form 5500:

| <i>Year ended December 31,</i> | 2005 |
|--|---------------------|
| Per financial statements: | |
| Net appreciation in fair value of investments | \$ 1,783,634 |
| Interest and dividends | 401,046 |
| | \$ 2,184,680 |
| | |
| <i>Year ended December 31,</i> | 2005 |
| Per Schedule H of Form 5500: | |
| Interest | \$ 24,626 |
| Dividends | 275,150 |
| Net gain on sale of assets | 61,028 |
| Unrealized appreciation of assets | 1,269,541 |
| Net investment income from registered investment companies | 554,335 |
| | \$ 2,184,680 |

Table of Contents

Supplemental Schedules

Table of Contents**Heritage Financial Corporation****401(k) Employee Stock Ownership Plan and Trust****Schedule of Assets (Held at End of Year)**

Form 5500, Schedule H, Line 4(i)

EIN: 91-1618099

Plan Number: 003

December 31, 2005

| | | (c) | | |
|---|--|---|---------------|---------------|
| | | Description of Investment | | |
| (b) | | including Maturity Date, | | |
| Identity of Issue, Borrower, | | Rate of Interest, Collateral, | | (e) |
| (a) | Lessor, or Similar Party | Par or Maturity Value | (d) Cost | Current Value |
| Participant Directed Investments | | | | |
| Registered Investment Company Funds: | | | | |
| | Frank Russell Fixed Income I Fund, Class I | 27,715 shares | \$ 598,234 | \$ 575,634 |
| | Frank Russell Fixed Income III Fund, Class I | 52,567 shares | 543,764 | 547,227 |
| | Frank Russell Equity I Fund, Class I | 33,951 shares | 923,337 | 1,023,753 |
| | Frank Russell Equity II Fund, Class I | 7,591 shares | 248,909 | 232,275 |
| | Frank Russell International Fund, Class I | 23,664 shares | 785,845 | 1,017,094 |
| | Frank Russell Emerging Markets Fund, Class S | 11,524 shares | 121,046 | 214,233 |
| | Frank Russell Real Estate Securities Fund, Class S | 6,185 shares | 228,952 | 274,932 |
| | Frank Russell Equity Q Fund, Class I | 28,637 shares | 911,845 | 1,024,926 |
| | Fidelity Advisory Mid Cap Fund, Class A | 51,552 shares | 1,102,356 | 1,239,309 |
| * | First American Equity Index Fund | 32,808 shares | 666,810 | 766,063 |
| | T. Rowe Price Blue Chip Growth Fund | 8,611 shares | 251,863 | 281,408 |
| * | U.S. Bank - First American Prime Obligation Fund | 800,839 units | 800,839 | 800,839 |
| * | Heritage Financial Corporation of Washington | 37,038 shares | 505,141 | 904,086 |
| * | Participant Loans | Interest rates of 4.25%-7%, maturing through March 2014 | | 69,226 |
| | | | 7,688,941 | 8,971,005 |
| Non-Participant Directed Investments | | | | |
| * | Heritage Financial Corporation of Washington | 367,968 shares | 3,963,046 | 8,982,111 |
| * | U.S. Bank - First American Prime Obligation Fund | 1,335 units | 1,335 | 1,335 |
| | | | 3,964,381 | 8,983,446 |
| | | | \$ 11,653,322 | \$ 17,954,451 |

* A party-in-interest as defined by ERISA.

See accompanying report of independent registered public accounting firm.

Table of Contents

Heritage Financial Corporation
401(k) Employee Stock Ownership Plan and Trust

Schedule of Reportable Transactions

Form 5500, Schedule H, Line 4(j)

EIN: 91-1618099

Plan Number: 003

December 31, 2005

| (a) | (b) | (c) | (d) | (e) | (f) | (g) | (h) |
|--|-----------------------|---------------------|----------------|----------------------------------|---------------|--------------------|-----------------|
| Identity of party involved | Description of assets | Number of Purchases | Purchase Price | Number of sales or disbursements | Selling Price | Book value at sale | Net gain (loss) |
| Category (iii) Series of transactions in excess of 5% of plan assets at January 1, 2005: | | | | | | | |
| First American Prime Obligation | Money Market Fund | 153 | \$ 1,030,029 | 123 | \$ 1,047,348 | \$ 1,047,348 | \$ |
| Heritage Financial Corporation | Company Stock | 63 | \$ 829,308 | 45 | \$ 145,933 | \$ 84,905 | \$ 61,028 |

Note: Participant and non-participant directed transactions are included in both the money market fund and the company stock as it is not possible to segregate the transactions.

There were no category (i), (ii) or (iv) transactions.

See accompanying report of independent registered public accounting firm.