

HERITAGE FINANCIAL CORP /WA/
Form 11-K
June 27, 2005

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, 2004

**.. 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, 2004 annexed as Exhibit A hereto are hereby incorporated by reference herein, and are included as a part of this Annual Report.

INDEX TO EXHIBITS

EXHIBIT

| NUMBER | DESCRIPTION |
|---------------|-----------------------------|
| 23 | 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 thereunto 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**

Heritage Financial

Corporation

401(k) Employee

Stock Ownership Plan and Trust

Financial Statements and

Supplemental Schedule

December 31, 2004 and 2003

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

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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 statements 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 and 2003 and the related statement of changes in net assets available for benefits for the year ended 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 audits.

We conducted our audits 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 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 audits provide 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 and 2003, and the changes in net assets available for benefits for the year ended December 31, 2004, in conformity with US generally accepted accounting principles.

Our audits were performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedule of assets (held at year end) as of December 31, 2004 is presented for the purpose of additional analysis and is not a required part of the basic financial statements but is 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 schedule is the responsibility of the Plan's management. The supplemental schedule has been subjected to the auditing procedures applied in our audits of the basic financial statements and in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

/s/ BDO Seidman, LLP

Kirkland, Washington

June 3, 2005

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Statements of Net Assets Available for Benefits

| <i>December 31,</i> | <u>2004</u> | <u>2003</u> |
|------------------------------------------------|----------------------|----------------------|
| Assets | | |
| Investments at fair value: | | |
| Participant directed: | | |
| Mutual funds | \$ 6,536,331 | \$ 5,094,991 |
| Heritage Financial Corporation common stock | 717,168 | 738,179 |
| Money funds | 816,475 | 1,418,434 |
| Participant loans | 37,459 | 6,776 |
| | <u>8,107,433</u> | <u>7,258,380</u> |
| Non-participant directed: | | |
| Heritage Financial Corporation common stock | 7,536,822 | 7,326,902 |
| Money funds | 18,530 | 23,006 |
| | <u>7,555,352</u> | <u>7,349,908</u> |
| Total investments | 15,662,785 | 14,608,288 |
| Cash | 37,965 | |
| Receivables: | | |
| Employer contributions | 322,615 | 453,109 |
| Participant contributions | 117 | 21,404 |
| Accrued interest | 1,220 | 830 |
| Total receivables | 323,952 | 475,343 |
| Total assets | 16,024,702 | 15,083,631 |
| Liabilities | | |
| Loan payable to Heritage Financial Corporation | 911,449 | 986,743 |
| Accounts payable and other | 229 | |
| Total liabilities | 911,678 | 986,743 |
| Net assets available for benefits | \$ 15,113,024 | \$ 14,096,888 |

See accompanying notes to financial statements.

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, 2004</i> | Participant Directed | Non-Participant Directed | Total |
|-----------------------------------------------------------------|---------------------------------|-------------------------------------|----------------------|
| Additions | | | |
| Investment income: | | | |
| Net appreciation in fair value of investments | \$ 633,742 | \$ 123,820 | \$ 757,562 |
| Interest and dividends | 111,842 | 227,225 | 339,067 |
| | <u>745,584</u> | <u>351,045</u> | <u>1,096,629</u> |
| Contributions: | | | |
| Participant salary deferrals | 673,114 | | 673,114 |
| Participant rollovers | 75,728 | | 75,728 |
| Employer | | 519,622 | 519,622 |
| ESOP loan payments | | 104,444 | 104,444 |
| Fund transfers | 154,271 | (154,271) | |
| Shares released | | (33) | (33) |
| Loan payments | (1,828) | 1,829 | 1 |
| Forfeitures reallocated | (180) | 180 | |
| | <u>901,105</u> | <u>471,771</u> | <u>1,372,876</u> |
| Total additions | <u>1,646,689</u> | <u>822,816</u> | <u>2,469,505</u> |
| Deductions | | | |
| Benefits paid to participants | 731,336 | 558,154 | 1,289,490 |
| New loans to participants | (2,248) | 2,248 | |
| Administrative expenses | 56,161 | 26,733 | 82,894 |
| Interest expense | | 80,985 | 80,985 |
| | <u>785,249</u> | <u>668,120</u> | <u>1,453,369</u> |
| Total deductions | <u>785,249</u> | <u>668,120</u> | <u>1,453,369</u> |
| Net increase | 861,440 | 154,696 | 1,016,136 |
| Net assets available for benefits, beginning of year | <u>7,280,598</u> | <u>6,816,290</u> | <u>14,096,888</u> |
| Net assets available for benefits, end of year | <u>\$ 8,142,038</u> | <u>\$ 6,970,986</u> | <u>\$ 15,113,024</u> |

See accompanying notes to financial statements.

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

- 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 Company formed the Plan effective October 1, 1999 by combining all the assets of Heritage Bank Money Purchase Pension Plan, the Heritage Bank 401(k) Profit Sharing Plan and the North Pacific Bank Employee Stock Ownership Plan with the Heritage Bank Employee Stock Ownership Plan, established July 1, 1993.

The Plan is a qualified stock ownership plan with a salary reduction feature. 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.

The Plan purchased shares of the Company's common 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. As the Plan makes each payment of principal, an appropriate percentage of stock is allocated to eligible employees' accounts in accordance with applicable regulations under the Internal Revenue Code (IRC).

Contributions

Participants may elect to contribute up to the lesser of 50% (in 2004) of their total compensation or \$13,000 (in 2004), or a maximum amount that will not cause the Plan to violate the provisions of the IRC. Additionally, participants over age 50 may make catch-up contributions of \$3,000 (in 2004).

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

1. Description of Plan

(Continued)

The Company makes a matching contribution equal to 50% of the participant's contribution up to 6% of the participant's compensation. In addition, the Company is required to make contributions of 2% of the participant's eligible compensation. The Company may elect to make discretionary contributions beyond the required 2% contribution. The Company contributed 2.5% of eligible compensation during 2004. Company contributions are made in the form of Heritage Financial Corporation common stock. Except for matching contributions, which are made as participants make salary deferrals, participants who do not have at least 1,000 hours of service during the Plan year, or are not employed on the last working day of a Plan year, are not eligible for an allocation of Company contributions for that year.

Participants Accounts

Each participant's account is credited with the participant's contribution and allocations of the Company's contributions and Plan earnings. Allocations are 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. All other employer contributions are 100% vested after seven years of credited service or upon death, disability or retirement. 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 July 1, 1993 will be given for any such account.

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

1. Description of Plan Investment Options

(Continued)

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 common 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 mutual funds, a money market fund, and Company stock.

Participants can make changes to their deferral amounts and investment options for new deferrals and may reallocate their entire Plan balance at the beginning of each quarter.

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, Heritage Financial Corporation common stock, or both.

Benefit distributions are based on the balance of a participant's account 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 account balance is greater than \$5,000. Active participants may elect to withdraw funds from their account under certain financial hardship situations, although earnings of tax-deferred contributions cannot be withdrawn during employment.

The Plan has the right to automatically distribute participant accounts upon termination of service for participants with balances not exceeding \$5,000.

1. Description of Plan Diversification

(Continued)

Participants who are at least age 55 with 10 years of participation in the plan may elect to diversify a portion of their account. 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.

In relation to the ESOP portion of the Plan, each participant is entitled to exercise voting rights attributable to the shares 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, 2004 and 2003, forfeited non-vested accounts totaled \$51,811 and \$22,761. Forfeitures used to reduce employer contributions during 2004 totaled \$37,262.

Participant Loans

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. There were \$37,459 and \$6,776 in participant loans outstanding at December 31, 2004 and 2003, respectively.

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

1. Description of Plan Administrative Expenses

(Continued)

Administrative expenses and investment fees are paid by the Plan or the Company.

Plan Amendment

The Plan was amended in 2003 to clarify certain definitions within the Plan agreement.

**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.

Risks and Uncertainties

The Plan allows participants to direct contributions into cash equivalents, various mutual funds, and Heritage Financial Corporation common stock. Company contributions are used to purchase Heritage Financial Corporation common stock. The underlying investment securities of these funds 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, it is reasonably possible that changes in risks in the near term would materially affect participants' account balances and the amounts reported in the statement of net assets available for benefits and the statements of changes in net assets available for benefits.

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

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

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 Heritage Financial Corporation's common stock.

Investment Valuation and Income Recognition

The Plan's investments are stated at fair value. Shares of registered investment companies and the common shares of Heritage Financial Corporation are valued at quoted market prices. Fair value of the Company common stock is based on the closing price of stock on the NASDAQ National Market System on the last trading day of the Plan year.

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 specific identification method.

Payment of Benefits

Benefits are recorded when paid. At December 31, 2004 and 2003, assets allocated to withdrawing participants totaled \$271,807 and \$12,801.

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

3. Investments

The following presents investments that represent 5% or more of the Plan's net assets available for benefits at the end of the year:

| <u>December 31,</u> | <u>2004</u> | <u>2003</u> |
|-------------------------------------------------|----------------------|----------------------|
| Heritage Financial Corporation Common Stock* | \$ 8,253,990 | \$ 8,065,081 |
| First American Prime Obligation Cash Equivalent | 835,005 | 1,441,440 |
| Fidelity Advisory Mid Cap, Class A** | 1,033,072 | |
| Frank Russell Equity I Fund, Class I | 858,025 | 733,741 |
| Frank Russell International Fund, Class I | 903,057 | 755,014 |
| Frank Russell Equity Q Fund, Class I | 850,742 | 734,815 |
| Others *** | 2,379,133 | 2,366,797 |
| | <u>\$ 15,113,024</u> | <u>\$ 14,096,888</u> |

* \$7,536,822 and \$7,326,902 are non-participant directed.

** Investment is less than 5% of net assets in 2003 and is included in Others.

*** Comprised of individual investments that are less than 5% of net assets at year-end.

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

| <u>Year ended December 31,</u> | <u>2004</u> |
|--------------------------------|-------------------|
| Mutual Funds | \$ 621,438 |
| Common Stock | 136,124 |
| | <u>\$ 757,562</u> |

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

| <u>December 31,</u> | <u>2004</u> | | <u>2003</u> | |
|---------------------|------------------|--------------------|------------------|--------------------|
| | <u>Allocated</u> | <u>Unallocated</u> | <u>Allocated</u> | <u>Unallocated</u> |
| | \$ 2,940,810 | \$ 1,576,426 | \$ 3,013,651 | \$ 1,724,288 |

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| | | | | |
|-------------------------------------------------------------|---------------------|-------------------|--------------|------------|
| Heritage Financial Corporation Common Stock, at fair value: | | | | |
| Cash | 2,764 | | 13,333 | |
| Loan Payable to Heritage Financial Corporation | | (911,449) | | (986,743) |
| Total ESOP Assets | \$ 2,943,574 | \$ 664,977 | \$ 3,026,984 | \$ 737,545 |

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

3. Investments
(Continued)

The ESOP component's change in net assets is summarized as follows:

| Year ended December 31, | 2004 | | 2003 | |
|-----------------------------------------------------|--------------|-------------|--------------|-------------|
| | Allocated | Unallocated | Allocated | Unallocated |
| Heritage Financial Corporation Common Stock: | | | | |
| Net appreciation in fair value | \$ 34,932 | \$ 47,172 | \$ 502,245 | \$ 330,801 |
| Dividends | 83,380 | 51,834 | 72,646 | 50,065 |
| Forfeitures | 2,652 | | (444) | |
| Loan payments | 1 | 104,444 | 1 | 107,358 |
| Shares released | 195,000 | (195,033) | 189,839 | (189,839) |
| Dividends on released shares | | | 1,146 | (1,146) |
| Fund transfers | (76,505) | | | |
| Distributions to participants | (309,182) | | (213,915) | |
| New loans to participants | | | (2) | |
| Administrative expense | (13,688) | | (14,821) | |
| Interest expense | | (80,985) | | (87,099) |
| Net increase (decrease) | (83,410) | (72,568) | 536,695 | 210,140 |
| Net assets, beginning of year | 3,026,984 | 737,545 | 2,490,289 | 527,405 |
| Net assets, end of year | \$ 2,943,574 | \$ 664,977 | \$ 3,026,984 | \$ 737,545 |

At December 31, 2004, 8,817 shares were pending allocation to participants under the Plan. The Plan purchased 2,843 allocated shares by reinvesting dividends on allocated shares. The Plan sold or distributed 3,766 shares in connection with distributions to participants.

4. 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 Code. 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.

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

- 5. 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.
- 6. Related Party and Party in Interest Transactions** The Plan's assets, which consist primarily of shares of Heritage Financial Corporation common stock, mutual funds, and U.S. Bank money market funds, 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 trustee also 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, employee, or trustee receives compensation from the Plan.
- The Plan paid U.S. Bank \$44,112 for services as trustee and asset custodian of the Plan. The Plan paid \$38,782 to other service providers that are defined as a Party in Interest under ERISA.
- 7. Loan Payable** In January 1998, the Plan borrowed \$1,323,000 from the Company to purchase shares of the Company's common 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 loan is collateralized by all unallocated shares of the Plan. The lender has no rights against shares once they are allocated under the Plan.

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

**7. Loan Payable
(Continued)**

The repayment schedule for principal is as follows:

Year ending December 31,

| | |
|--------------|-------------------|
| 2005 | \$ 81,949 |
| 2006 | 89,192 |
| 2007 | 97,076 |
| 2008 | 105,657 |
| Thereafter | 537,575 |
| Total | \$ 911,449 |

**8. Employer
Contributions**

Employer contributions to the Plan are invested primarily in common shares of Company stock. In relation to the ESOP version 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. The Company met the minimum funding requirements as defined by ERISA in 2004.

**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> | 2004 | 2003 |
|----------------------------------------------------------------------|----------------------|---------------|
| Net assets available for benefits per the financial statements | \$ 15,113,024 | \$ 14,096,888 |
| Amounts allocated to withdrawing participants | (271,807) | (12,801) |
| Net assets available for benefits per Schedule H of Form 5500 | \$ 14,841,217 | \$ 14,084,087 |

Heritage Financial Corporation

401(k) Employee Stock Ownership Plan and Trust

Notes to Financial Statements

9. **Reconciliation of Financial Statements to Schedule H of Form 5500 (Continued)** 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> | 2004 |
|--------------------------------------------------------------------------|--------------|
| Benefits paid to participants per the financial statements | \$ 1,289,490 |
| Less: Corrective distributions for 2003 | (2,233) |
| Less: Amounts allocated to withdrawing participants at end of prior year | (12,801) |
| Add: Amounts allocated to withdrawing participants at year-end | 271,807 |
| Benefits paid to participants per Schedule H of Form 5500 | \$ 1,546,263 |

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

| <i>Year ended December 31,</i> | 2004 |
|-----------------------------------------------|--------------|
| Per financial statements: | |
| Net appreciation in fair value of investments | \$ 757,562 |
| Interest and dividends | 339,067 |
| | \$ 1,096,629 |

| <i>Year ended December 31,</i> | 2004 |
|------------------------------------------------------------|--------------|
| Per Schedule H of Form 5500: | |
| Interest | \$ 10,150 |
| Dividends | 241,276 |
| Net gain on sale of assets | 97,324 |
| Unrealized appreciation of assets | 38,804 |
| Net investment income from registered investment companies | 709,075 |
| | \$ 1,096,629 |

Supplemental Schedule

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, 2004

| (a) | (b) | (c) | (d) | (e) |
|-----------------------------------------|----------------------------------------------------|-----------------------------------------------------------------------------------------------------------------|------------|------------------|
| Lessor, or Similar Party | Identity of Issue, Borrower, | Description of Investment including Maturity Date, Rate of Interest, Collateral, Par or Maturity Value | Cost | Current Value |
| Participant Directed Investments | | | | |
| Mutual Funds: | | | | |
| | Frank Russell Fixed Income I Fund, Class I | 32,056 shares | \$ 692,802 | \$ 677,350 |
| | Frank Russell Fixed Income III Fund, Class I | 39,841 shares | 408,940 | 420,719 |
| | Frank Russell Equity I Fund, Class I | 28,706 shares | 779,726 | 858,025 |
| | Frank Russell Equity II Fund, Class I | 11,909 shares | 388,199 | 455,751 |
| | Frank Russell International Fund, Class I | 23,696 shares | 766,309 | 903,057 |
| | Frank Russell Emerging Markets Fund, Class S | 17,377 shares | 174,248 | 259,259 |
| | Frank Russell Real Estate Securities Fund, Class S | 3,868 shares | 117,885 | 172,009 |
| | Frank Russell Equity Q Fund, Class I | 24,474 shares | 764,338 | 850,742 |
| | Fidelity Adv. Mid Cap Fund, Class A | 41,224 shares | 843,940 | 1,033,072 |
| * | First American Equity Index Fund, Class 4 | 30,186 shares | 600,295 | 684,308 |
| | T. Rowe Price Blue Chip Growth Fund | 7,181 shares | 207,688 | 222,039 |
| | | | 5,744,370 | 6,536,331 |
| * | U.S. Bank - First American Prime Obligation | 816,475 units | 816,475 | 816,475 |
| * | Heritage Financial Corporation of Washington | 32,422 shares | 413,848 | 717,168 |
| * | Participant Loans | Interest rates of 4.25%, maturing through March 2014 | | 37,459 |
| | | | 1,230,323 | 1,571,102 |

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| | | | |
|------------------------------------------------|----------------|---------------|---------------|
| | | 6,974,693 | 8,107,433 |
| Non-Participant Directed Investments | | | |
| * Heritage Financial Corporation of Washington | 340,724 shares | 3,490,864 | 7,536,822 |
| * U.S. Bank - First American Prime Obligation | 18,530 units | 18,530 | 18,530 |
| | | 3,509,394 | 7,555,352 |
| | | \$ 10,484,087 | \$ 15,662,785 |

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