HERITAGE FINANCIAL CORP /WA/
Form 10-K
March 05, 2007
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SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-K

x Annual Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the fiscal year ended December 31, 2006

¨ Transition Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
Commission File No. 0-29480

HERITAGE FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Washington	**91-1857900**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**

201 Fifth Avenue SW, Olympia, Washington 98501

(Address of principal executive offices, including zip code)

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

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, no par value per share

(Title of class)

Indicate by check mark if the registrant is a well-seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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 x Non-accelerated filer ¨

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

The aggregate market value of the voting stock held by non-affiliates of the registrant was $138,585,618 and was based upon the last sales price as quoted on the NASDAQ Stock Market for June 30, 2006.

The Registrant had 6,566,755 shares of common stock outstanding as of February 9, 2007.

DOCUMENTS TO BE INCORPORATED BY REFERENCE

Portions of the Registrant s definitive Proxy Statement expected to be dated March 22, 2007 for the 2007 Annual Meeting of Stockholders will be incorporated by reference into Part III of this Form 10-K.

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HERITAGE FINANCIAL CORPORATION

FORM 10-K

December 31, 2006

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PART I

ITEM 1. BUSINESS

General

Heritage Financial Corporation (Company) is a bank holding company incorporated in the State of Washington in August 1997. We were organized for the purpose of acquiring all of the capital stock of Heritage Savings Bank upon our reorganization from a mutual holding company form of organization to a stock holding company form of organization (Conversion).

We are primarily engaged in the business of planning, directing and coordinating the business activities of our wholly owned subsidiaries: Heritage Bank and Central Valley Bank. Heritage Bank is a Washington state-chartered commercial bank whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC) under the Deposit Insurance Fund (DIF). During 2004, Heritage Bank changed its charter from a savings bank to a commercial bank. Heritage Bank conducts business from its main office in Olympia, Washington and its thirteen branch offices located in Thurston, Pierce, Mason and south King Counties. Central Valley Bank is a Washington state-chartered commercial bank whose deposits are insured by the FDIC under the DIF. During 2005, Central Valley Bank changed its charter from a nationally-chartered commercial bank to a state-chartered commercial bank. Central Valley Bank conducts business from its main office in Toppenish, Washington, and its five branch offices located in Yakima and Kittitas Counties. In June 2006, the Company completed the acquisition of Western Washington Bancorp (WWB) and its wholly owned subsidiary, Washington State Bank, N.A. Washington State Bank, N.A. was mergered into Heritage Bank on the date of acquisition.

Our business consists primarily of lending and deposit relationships with small businesses including agribusiness and their owners in our market area, attracting deposits from the general public and originating for sale or investment purposes first mortgage loans on residential properties located in western and central Washington State. We also make residential construction, income property, and consumer loans.

Market Areas

We offer financial services to meet the needs of the communities we serve through our community-oriented financial institutions. Headquartered in Olympia, Thurston County, Washington, we conduct business through Heritage Bank and Central Valley Bank. Heritage Bank has fourteen full service offices, with seven in Pierce County, five in Thurston County, one in Mason County and one in south King County. Heritage Bank has mortgage origination offices in Thurston County, Mason County and Pierce County, which all operate within banking offices. The mortgage loan operations are performed in one office located in Thurston County. Central Valley Bank operates six full service offices, with five in Yakima County and one in Kittitas County.

Lending Activities

General. Our lending activities are conducted through Heritage Bank and Central Valley Bank. We offer commercial, real estate, income property, agricultural, and consumer loans. Our focus is on commercial lending with commercial loans increasing in the recent year to $440.5 million, or 58.8% of total loans, as of December 31, 2006 from $359.8 million, or 55.2% of total loans, as of December 31, 2005. We continue to provide real estate mortgages, both single and multifamily residential and commercial. Real estate mortgages increased to $231.8 million, or 30.9% of total loans, at December 31, 2006, from $217.9 million, or 33.4% of total loans, at December 31, 2005.

Our overall lending operations are guided by loan policies, which are reviewed and approved annually by our board of directors. These policies outline the basic policies and procedures by which lending operations are conducted. The policies address the types of loans, underwriting and collateral requirements, terms, interest rate and yield considerations, compliance with laws and regulations, and compliance with internal lending limits. We

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supplement our own supervision of the loan underwriting and approval process with periodic loan audits by experienced external loan specialists who review credit quality, loan documentation, and compliance with laws and regulations.

The following table provides information about our loan portfolio by type of loan for the dates indicated. These balances are prior to deduction for the allowance for loan losses.

	At December 31,									
	2006		2005		2004		2003		2002	
	Balance (3)	% of Total	Balance	% of Total	Balance	% of Total	Balance	% of Total	Balance	% of Total
	(Dollars in thousands)									
Commercial	$ 440,450	58.75%	$ 359,808	55.16%	$ 336,227	56.06%	$ 266,252	51.06%	$ 243,872	51.86%
Real Estate Mortgages										
One-four family residential(1)	58,911	7.86	53,098	8.14	58,903	9.82	57,377	11.00	72,846	15.49
Five or more family residential and commercial properties	172,937	23.07	164,788	25.26	152,958	25.50	149,728	28.72	114,750	24.40
Total real estate mortgages	231,848	30.93	217,886	33.40	211,861	35.32	207,105	39.72	187,596	39.89
Real estate construction										
One-four family residential	53,298	7.11	42,245	6.48	23,266	3.88	19,881	3.81	29,201	6.21
Five or more family residential and commercial properties	13,532	1.80	21,355	3.27	17,121	2.85	19,570	3.75	3,169	0.67
Total real estate construction(2)	66,830	8.91	63,600	9.75	40,387	6.73	39,451	7.56	32,370	6.88
Consumer	12,976	1.73	12,855	1.97	13,045	2.18	10,043	1.93	7,616	1.62
Gross loans	752,104	100.32%	654,149	100.28%	601,520	100.29%	522,851	100.27%	471,454	100.25%
Less deferred loan fees and other	(2,403)	(0.32)	(1,852)	(0.28)	(1,759)	(0.29)	(1,438)	(0.27)	(1,190)	(0.25)
Total loans receivable and loans held for sale	$ 749,701	100.00%	$ 652,297	100.00%	$ 599,761	100.00%	$ 521,413	100.00%	$ 470,264	100.00%

(1) Includes loans held for sale of $0, $263, $381, $1,018, and $8,113 as of December 31, 2006, 2005, 2004, 2003, and 2002, respectively.
(2) Balances are net of undisbursed loan proceeds.
(3) The June 2006 acquisition of WWB included $41.5 million in total loans.

The following table presents at December 31, 2006 (i) the aggregate maturities of loans in the named categories of our loan portfolio and (ii) the aggregate amounts of fixed rate and variable or adjustable rate loans in the named categories that mature after one year.

	Maturing			
	Within	After		
	1 year	1-5 years	5 years	Total
	(Dollars in thousands)			
Commercial	$ 164,517	$ 119,533	$ 156,400	$ 440,450
Real estate construction	55,111	10,250	1,469	66,830
Total	$ 219,628	$ 129,783	$ 157,869	$ 507,280
Fixed rate loans		$ 60,539	$ 48,114	$ 108,653
Variable or adjustable rate loans		69,244	109,754	178,998
Total		$ 129,783	$ 157,868	$ 287,651

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Real Estate Lending

Single-Family Residential Real Estate Lending. The majority of our one to four family residential loans are secured by single-family residences located in our primary market areas. Our underwriting standards require that single-family portfolio loans generally are owner-occupied and do not exceed 80% (90% with private mortgage insurance) of the appraised value at origination or cost, whichever is lower, of the underlying collateral. Terms typically range from 15 to 30 years. We offer both fixed rate mortgages and adjustable rate mortgages (ARMs) with repricing based on a Treasury Bill or other index. However, our ability to generate volume in ARMs is largely a function of consumer preference and the interest rate environment. Under our current policy we do not originate ARMs with discounted initial interest rates (*i.e.*, teasers). We generally sell all government guaranteed mortgages, both fixed rate and adjustable rate. Management determines to what extent we will retain or sell other ARMs and other fixed rate mortgages in their strategy to control our interest rate sensitivity position. See Management s Discussion and Analysis of Financial Condition and Results of Operations Asset/Liability Management .

Multifamily and Commercial Real Estate Lending. We originate, on a selective basis, multifamily and commercial real estate loans in our primary market areas. Commercial real estate loans are made for small shopping centers, warehouses, and professional offices. Cash flow coverage to debt servicing requirements is generally 1.2 times or more. Our underwriting standards generally require that the loan-to-value ratio for multifamily and commercial real estate loans not exceed 80% of appraised value at origination or cost, whichever is lower.

Multifamily and commercial real estate mortgage lending affords our banks an opportunity to receive interest at rates higher than those generally available from single-family residential lending. However, loans secured by such properties usually are greater in amount, more difficult to evaluate and monitor and, therefore, involve a greater degree of risk than single-family residential mortgage loans. Because payments on loans secured by multifamily and commercial real estate properties are often dependent on the successful operation and management of the properties, repayment of these loans may be affected by adverse conditions in the real estate market or the economy. We seek to minimize these risks by strictly scrutinizing the financial condition of the borrower, the quality of the collateral, and the management of the property securing the loan. We also generally obtain personal guarantees from financially capable borrowers based on a review of personal financial statements.

Construction Loans. We originate single-family residential construction loans for the construction of custom homes (where the home buyer is the borrower) and provide financing to builders for the construction of pre-sold homes and speculative residential construction (i.e. built before a buyer is identified). We lend to builders who have demonstrated a favorable record of performance and profitable operations and who are building in markets that management understands and is comfortable with existing economic conditions. We further endeavor to limit our construction lending risk through adherence to strict underwriting procedures. Loans to one builder are generally limited on a case-by-case basis with unsold home limits based on builder strengths. Our underwriting standards require that the loan-to-value ratio for pre-sold homes and speculative residential construction generally not exceed 80% of appraised value or builder s cost, whichever is less. Speculative construction and land development loans are short term in nature and priced with a variable rate of interest using the prime rate as the index. We generally require builders to have some tangible form of equity in each construction project. Also, we require prompt and thorough documentation of all draw requests and we inspect the project prior to paying any draw requests from builders.

Construction lending affords us the opportunity to achieve higher interest rates and fees with shorter terms to maturity than does our single-family permanent mortgage lending. However, construction lending is considered to involve a higher degree of risk than single-family permanent mortgage lending because of the inherent difficulty in estimating both a property s value at completion of the project and the estimated costs of the project. As a result, these loans are generally more difficult to evaluate and monitor. If the estimate of construction cost proves to be inaccurate, we may be required to advance funds beyond the amount originally

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committed to permit completion of the project. If the estimate of value upon completion proves to be inaccurate, we may be confronted with a project whose value is insufficient to ensure full repayment. Projects may also be jeopardized by disagreements between buyers and builders, and the failure of builders to pay subcontractors. Loans to builders to construct homes for which no purchaser has been identified carry more risk because the liquidation of the loan depends on the builder s ability to sell the property.

Commercial Business Lending

We offer commercial loans to sole proprietorships, partnerships, and corporations with an emphasis on real estate related industries and businesses in agricultural, health care, legal, and other professions. The types of commercial loans offered are business lines of credit secured primarily by real estate, accounts receivable and inventory financing, business term loans secured by real estate for either working capital or lot acquisition, Small Business Administration (SBA) loans, and unsecured business loans.

Commercial business lending generally involves greater risk than residential mortgage lending and these risks differ from those associated with residential and commercial real estate lending. Commercial real estate lending is considered to be collateral based lending with loan amounts based on predetermined loan to collateral values, where liquidation of the underlying real estate collateral is viewed as the primary source of repayment if the borrower defaults. Although our commercial business loans are often collateralized by real estate, the decision to grant a commercial business loan depends primarily on the creditworthiness and cash flow of the borrower (and any guarantors), while liquidation of collateral is a secondary source of repayment.

As of December 31, 2006, we had $440.5 million, or 58.8% of our total loans receivable, in commercial loans. The average loan size is approximately $330,000 with loans generally in amounts of $1,000,000 or less.

Origination and Sales of Loans

We originate real estate and other loans with the majority of the residential mortgage volumes generated from our mortgage loan origination offices. Walk-in customers and referrals from real estate brokers are important sources of loan originations.

Consistent with our asset/liability management strategy, we sell a significant portion of our fixed rate and ARM residential mortgage loans to the secondary market. Commitments to sell mortgage loans generally are made during the period between the taking of the loan application and the closing of the mortgage loan. The timing for making these sale commitments is dependent upon the timing of the borrower s election to lock-in the mortgage interest rate and fees prior to loan closing. Most of these sale commitments are made on a best efforts basis whereby we are only obligated to sell the mortgage if the mortgage loan is approved and closed. As a result, management believes that market risk is minimal. In addition, we have mortgage loan production which is brokered to other lenders prior to funding.

When we sell mortgage loans, we typically sell the servicing of the loans (i.e., collection of principal and interest payments). However, we serviced $0.5 million, $0.7 million, and $0.9 million in mortgage loans for others as of December 31, 2006, 2005, and 2004, respectively. We received fee income for servicing activities on mortgage loans of $2,000, $4,000, and $10,000 for the years ended December 31, 2006, 2005, and 2004, respectively.

The following table presents summary information concerning our origination and sale of residential mortgage loans and the gains achieved on such activities.

	Years ended December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Residential mortgage loans:					
Originated	$ 19,600	$ 25,097	$ 52,188	$ 125,438	$ 91,614
Sold	8,856	13,632	35,822	105,790	74,318
Gains on sales of loans, net	$ 133	$ 277	$ 640	$ 1,907	$ 1,404

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Commitments and Contingent Liabilities

In the ordinary course of business, we enter into various types of transactions that include commitments to extend credit that are not included in our consolidated financial statements. We apply the same credit standards to these commitments as we use in all our lending activities and have included these commitments in our lending risk evaluations. Our exposure to credit loss under commitments to extend credit is represented by the amount of these commitments. At December 31, 2006, we had outstanding commitments to extend credit, including letters of credit, in the amount of $209.9 million.

Delinquencies and Nonperforming Assets

Delinquency Procedures. We send a borrower a delinquency notice 15 days after the due date when the borrower fails to make a required payment on a loan. If the delinquency is not brought current, additional delinquency notices are mailed at 30 and 45 days for commercial loans. Additional written and oral contacts are made with the borrower between 60 and 90 days after the due date.

If a real estate loan payment is past due for 45 days or more, the collection manager may perform a review of the condition of the property if suspect. We may negotiate and accept a repayment program with the borrower, accept a voluntary deed in lieu of foreclosure or, when considered necessary, begin foreclosure proceedings. If foreclosed on, real property is sold at a public sale and we bid on the property to protect our interest. A decision as to whether and when to begin foreclosure proceedings is based on such factors as the amount of the outstanding loan in relation to the value of the property securing the original indebtedness, the extent of the delinquency, and the borrower s ability and willingness to cooperate in resolving the delinquency.

Real estate acquired by us is classified as real estate owned until it is sold. When property is acquired, it is recorded at the lower of cost or estimated fair value at the date of acquisition, not to exceed net realizable value, and any resulting write-down is charged to the allowance for loan losses. Upon acquisition, all costs incurred in maintaining the property are expensed. Costs relating to the development and improvement of the property, however, are capitalized to the extent of the property s net realizable value.

We consider loans as an in-substance foreclosure if the borrower has little or no equity in the property based upon its estimated fair value, repayment can be expected only from operation or sale of the collateral, the borrower has effectively abandoned control of the collateral, or it is doubtful the borrower will be able to repay the loan in the foreseeable future because of the borrower s current financial status. In-substance foreclosures are accounted for as if the properties were held as real estate owned .

Delinquencies in the commercial business loan portfolio are handled on a case-by-case basis. Generally, notices are sent and personal contact is made with the borrower when the loan is 15 days past due. Loan officers are responsible for collecting loans they originate or which are assigned to them. Depending on the nature of the loan and the type of collateral securing the loan, we may negotiate and accept a modified payment program or take other actions as circumstances warrant.

Classification of Assets. Federal regulations require that our banks periodically evaluate the risk inherent in their loan portfolio. In addition, the Division of Banks of the Washington State Department of Financial Institutions (Division) and the FDIC have authority to identify problem assets and, if appropriate, require them to be classified by risk. There are three classifications for problem assets: Substandard, Doubtful, and Loss. Substandard assets have one or more defined weaknesses and are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. Doubtful assets have the weaknesses of Substandard assets, with the additional characteristics that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values questionable. There is a high possibility of loss in assets classified as Doubtful. An asset classified as Loss is considered uncollectible and of such little value that continuance as an asset of the institution is not warranted. If an asset or a portion of the asset is classified as Loss, the institution must charge off this amount. We also have assets we classify as Watch and other assets especially

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mentioned (OAEM). Assets classified as watch are performing assets but have elements of risk that require more monitoring than other performing assets. Assets classified as OAEM are assets that continue to perform but have shown deterioration in credit quality and require close monitoring.

Nonperforming Assets. Nonperforming assets consist of nonaccrual loans, restructured loans, and real estate owned. The following table provides information about our nonaccrual loans, restructured loans, and real estate owned for the indicated dates.

	At December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Nonaccrual loans	$ 2,807	$ 836	$ 319	$ 297	$ 1,987
Real estate and other assets owned	225	371		389	296
Total nonperforming assets	$ 3,032	$ 1,207	$ 319	$ 686	$ 2,283
Accruing loans past due 90 days or more	$	$	$	$ 19	$ 19
Potential problem loans	$ 5,509	$ 9,882	$ 12,184	$ 10,502	$ 11,261
Allowance for loan losses	$ 10,105	$ 8,496	$ 8,295	$ 7,748	$ 6,874
Nonperforming loans to loans	0.37%	0.13%	0.05%	0.06%	0.42%
Allowance for loan losses to loans	1.35%	1.30%	1.38%	1.49%	1.46%
Allowance for loan losses to nonperforming loans	360.05%	1,016.27%	2,603.60%	2,611.97%	346.05%
Nonperforming assets to total assets	0.36%	0.16%	0.05%	0.11%	0.38%

Nonaccrual Loans. Our financial statements are prepared on the accrual basis of accounting, including the recognition of interest income on our loan portfolio, unless a loan is placed on nonaccrual. Loans are considered to be impaired and are placed on nonaccrual when there are serious doubts about the collectibility of principal or interest. Our policy is to place a loan on nonaccrual when the loan becomes past due for 90 days or more, is less than fully collateralized, and is not in the process of collection. Amounts received on nonaccrual loans generally are applied first to principal and then to interest only after all principal has been collected.

Potential Problem Loans. Potential problem loans are those loans that are currently accruing interest, but which are considered possible credit problems because financial information of the borrowers causes us concerns as to their ability to comply with the present repayment program and could result in placing the loan on nonaccrual. As of December 31, 2006, potential problem loans decreased by $4.4 million to $5.5 million from $9.9 million at December 31, 2005.

Analysis of Allowance for Loan Losses

Management maintains an allowance for loan losses to absorb estimated credit losses associated with the loan portfolio, including all binding commitments to lend. We determine an adequate allowance through our ongoing quarterly loan quality assessments.

We assess the estimated credit losses inherent in our non-classified loan portfolio by considering a number of elements including:

Risk rating of the credit portfolio;

Levels and trends in delinquencies and nonaccruals;

Trends in loan demand and structure including terms and interest rates;

National and local economic trends;

Specific industry conditions such as commercial and residential construction;

Concentrations of credits in specific industries;

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Bank regulatory examination results and our own credit examinations; and

Recent loss experience in the portfolio.

We calculate an adequate allowance for the non-classified portion of our loan portfolio based on an appropriate percentage lossfactor that is calculated based on the above-noted elements and trends. We may add specific provisions for each classified loan after a careful analysis of that loan s credit and collateral factors. Our analysis of an adequate allowance combines the provisions made for both our non-classified loans and the specific provisions made for each classified loan.

While we believe we use the best information available to determine the allowance for loan losses, net income could be significantly affected if circumstances differ substantially from the assumptions used in determining the allowance, unforeseen market conditions arise or if we are directed to make adjustments to the allowance for loan losses by our regulators.

The following table provides information regarding changes in our allowance for loan losses for the indicated periods:

	Years Ended December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Total loans outstanding at end of period(1)	$ 749,701	$ 652,297	$ 599,761	$ 521,413	$ 470,264
Average loans outstanding during period	$ 690,287	$ 613,655	$ 549,445	$ 481,404	$ 472,785
Allowance balance at beginning of period	$ 8,496	$ 8,295	$ 7,748	$ 6,874	$ 5,751
Provision for loan losses	720	810	645	1,125	1,835
Allowance acquired through acquisition	749				
Charge-offs:					
Real estate	(3)		(41)	(138)	(69)
Commercial	(78)	(630)	(55)	(102)	(657)
Agriculture			(10)		
Consumer	(83)	(61)	(3)	(19)	(7)
Total charge-offs	(164)	(691)	(109)	(259)	(733)
Recoveries:					
Real estate	24	7	8	3	1
Commercial	255	55		4	20
Agriculture		10	3		
Consumer	25	10		1	
Total recoveries	304	82	11	8	21
Net (charge-offs) recoveries	140	(609)	(98)	(251)	(712)
Allowance balance at end of period	$ 10,105	$ 8,496	$ 8,295	$ 7,748	$ 6,874
Ratio of net (charge-offs) recoveries during period to average loans outstanding	.02%	(0.10)%	(0.02)%	(0.05)%	(0.15)%

(1) Includes loans held for sale

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The following table shows the allocation of the allowance for loan losses for the indicated periods. The allocation is based upon an evaluation of defined loan problems, historical loan loss ratios, and industry wide and other factors that affect loan losses in the categories shown below:

	At December 31,									
	2006		2005		2004		2003		2002	
	Amount	% of Total Loans (1)	Amount	% of Total Loans (1)	Amount	% of Total Loans (1)	Amount	% of Total Loans (1)	Amount	% of Total Loans (1)
	(Dollars in thousands)									
Commercial	$ 7,276	58.6%	$ 6,117	55.0%	$ 5,971	55.9%	$ 5,578	51.0%	$ 4,949	51.8%
Real Estate Mortgage										
One-four family residential	398	7.8%	335	8.1%	327	9.8%	305	11.0%	271	15.4%
Five or more family residential and commercial properties	1,708	23.0%	1,435	25.2%	1,402	25.4%	1,310	28.7%	1,162	24.4%
Real Estate Construction:										
One-four family residential	547	7.1%	460	6.4%	449	3.9%	419	3.7%	370	6.2%
Five or more family residential and commercial properties	41	1.8%	34	3.3%	34	2.8%	31	3.8%	28	0.6%
Consumer	138	1.7%	115	2.0%	112	2.2%	105	1.8%	94	1.6%
Total loans	$ 10,105	100.0%	$ 8,496	100.0%	$ 8,295	100.0%	$ 7,748	100.0%	$ 6,874	100.0%

(1) Represents the total of all outstanding loans in each category as a percent of total loans outstanding.

Investment Activities

At December 31, 2006, our investment securities portfolio totaled $43.0 million, which consisted of $39.1 million of securities available for sale and $3.9 million of securities held to maturity. This compares with a total portfolio of $45.8 million at December 31, 2005, which was comprised of $41.9 million of securities available for sale and $4.0 million of securities held to maturity. The composition of the two investment portfolios by type of security, at each respective date, is presented in financial statement Notes 4 and 5.

Our investment policy is established by the board of directors and monitored by the Audit and Finance Committee of the Board of Directors. It is designed primarily to provide and maintain liquidity, generate a favorable return on investments without incurring undue interest rate and credit risk, and compliments our bank s lending activities. The policy dictates the criteria for classifying securities as either available for sale or held to maturity. The policy permits investment in various types of liquid assets permissible under applicable regulations, which include U.S. Treasury obligations, U.S. Government agency obligations, some certificates of deposit of insured banks, mortgage backed and mortgage related securities, some corporate notes, municipal bonds, and federal funds. Investment in non-investment grade bonds and stripped mortgage backed securities are not permitted under the policy.

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The following table provides information regarding our investment securities available for sale, by contractual maturity, at December 31, 2006.

	Book Value	Fair Value	Weighted Average Yield(1)
	(Dollars in thousands)		
Obligations of US Government agencies			
Due within one year	$ 5,157	$ 5,140	4.40%
Due after 1 year but within 5 years	12,382	12,194	4.40
Due after 5 years but within 10 years	1,000	1,008	5.49
	18,539	18,342	
Mortgage backed securities			
Due within one year	11,043	10,744	3.81
Due after 1 year but within 5 years	214	212	4.12
Due after 5 years but within 10 years	20	20	5.75
Due after 10 years	2,238	2,226	5.25
	13,515	13,202	
Collateralized mortgage obligations			
Due after 1 year but within 5 years	109	109	4.75
Due after 5 years but within 10 years	1,499	1,455	3.08
Due after 10 years	6,270	6,016	4.26
	7,878	7,580	
Total all investments available for sale	$ 39,932	$ 39,124	

The following table provides information regarding our investment securities held to maturity, by contractual maturity, at December 31, 2006.

	Book Value	Fair Value	Weighted Average Yield(1)
	(Dollars in thousands)		
Obligations of US Government agencies			
Due after 5 years but within 10 years	$ 905	$ 896	4.78%
Municipal bonds			
Due within one year	100	101	6.44
Due after 1 year but within 5 years	335	339	5.98
Due after 5 years but within 10 years	1,265	1,279	5.51
	1,700	1,718	
Mortgage backed securities			
Due within one year	25	26	7.42
Due after 1 year but within 5 years	1,228	1,221	5.35
	1,253	1,247	

Total all investments held to maturity	$ 3,858	$ 3,861

(1) Taxable equivalent weighted average yield.

We held $3.2 million of FHLB stock at December 31, 2006. The stock has no contractual maturity and amounts in excess of the required minimum for FHLB membership may be redeemed at par subject to certain restrictions. At December 31, 2006, we were required to maintain an investment in the stock of the FHLB of Seattle of at least $1.5 million.

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Deposit Activities and Other Sources of Funds

General. Our primary sources of funds are deposits, loan repayments and borrowings. Scheduled loan repayments are a relatively stable source of funds, while deposits and unscheduled loan prepayments, which are influenced significantly by general interest rate levels, interest rates available on other investments, competition, economic conditions, and other factors are not. Our deposit balances increased by $89.4 million in 2006 over the prior year, with certificates of deposit accounts increasing slightly as a percentage of total deposits. The June 2006 acquisition of WWB included $44.3 million in deposit balances. Customer deposits remain an important source of funding, but these balances have been influenced in the past by adverse market conditions in the industry and may be affected by future developments such as interest rate fluctuations and new competitive pressures. Borrowings may be used on a short-term basis to compensate for reductions in other sources of funds (such as deposit inflows at less than projected levels). Borrowings may also be used on a longer-term basis to support expanded lending activities and match the maturity of repricing intervals of assets.

Deposit Activities. We offer a variety of deposit accounts designed to attract both short-term and long-term deposits. These accounts include certificates of deposit (CDs), regular savings accounts, money market accounts, checking and negotiable order of withdrawal (NOW) accounts, and individual retirement accounts (IRAs). These accounts generally earn interest at rates established by management based on competitive market factors and management s desire to increase or decrease certain types or maturities of deposits. At December 31, 2006, we had no brokered deposits. The more significant deposit accounts are described below.

Certificates of Deposit. We offer several types of CDs with maturities ranging from one to five years, which require a minimum deposit of $100. In addition, we offer a CD that has a maturity of three to eleven months and a minimum deposit of $2,500, and permits additional deposits at the initial rate throughout the CD term. At Heritage Bank, interest is compounded daily and credited quarterly or at maturity. At Central Valley Bank, interest is accrued daily and compounded quarterly or at maturity. Finally, negotiable CDs are offered in amounts of $100,000 or more for terms of 30 days to 12 months. The negotiable CDs pay simple interest credited at maturity.

Regular Savings Accounts. We offer savings accounts that allow for unlimited deposits and withdrawals, provided that a $100 minimum balance is maintained. At Heritage Bank, interest is compounded daily and credited quarterly. At Central Valley Bank, interest is accrued daily and compounded quarterly.

Money Market Accounts. Money market accounts pay a variable interest rate that is tiered depending on the balance maintained in the account. Minimum opening balances vary. At Heritage Bank, interest is compounded daily and paid monthly. At Central Valley Bank, interest is accrued daily and compounded monthly.

Checking and NOW Accounts. Checking and NOW accounts are non-interest and interest bearing, and may be charged service fees based on activity and balances. NOW accounts pay interest, but require a higher minimum balance to avoid service charges.

Individual Retirement Accounts. IRAs permit annual contributions regulated by law and pay interest at fixed rates. Maturities are available from one to five years. At Heritage Bank, interest is compounded daily and credited quarterly. At Central Valley Bank, interest is accrued daily and compounded quarterly.

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Sources of Funds

Deposit Activities. The following table provides the average balances outstanding and the weighted average interest rates for each major category of deposits for the years ended December 31:

	2006		2005		2004	
	Average Balance	Average Rate Paid	Average Balance	Average Rate Paid	Average Balance	Average Rate Paid
	(Dollars in Thousands)					
Interest bearing demand and money market accounts	$ 189,458	1.93%	$ 170,399	1.08%	$ 165,486	0.73%
Savings	95,075	1.76	96,425	1.03	104,271	1.00
Certificates of deposit	307,902	4.19	264,078	2.94	222,279	2.01
Total interest bearing deposits	592,435	3.08	530,902	2.00	492,036	1.37
Demand and other noninterest bearing deposits	98,567		85,732		76,994	
Total deposits	$ 691,002	2.64%	$ 616,634	1.73%	$ 569,030	1.18%

The following table shows the amount and maturity of certificates of deposits of $100,000 or more as of December 31, 2006:

	(Dollars in thousands)
Remaining maturity:	
Three months or less	$ 89,928
Over three months through six months	34,085
Over six months through twelve months	42,802
Over twelve months	10,077
Total	$ 176,892

Borrowings. Deposits are the primary source of funds for our lending and investment activities, and our general business purposes. We rely upon advances from the Federal Home Loan Bank of Seattle (FHLB) to supplement our supply of lendable funds and meet deposit withdrawal requirements. The FHLB of Seattle serves as one of our secondary sources of liquidity. Advances from the FHLB of Seattle are typically secured by our first mortgage loans and stock issued by the FHLB, which is owned by us. Our subsidiary banks also have lines to purchase federal funds up to $29.8 million. In addition, Heritage Bank maintains a $5.0 million line to support letters of credit. We also maintain a line of credit of $5.0 million with Key Bank to supplement any cash needs not covered by dividends from the banks or earnings from investments. At December 31, 2006, our banks maintained credit facilities with the FHLB of Seattle for $155.3 million with an outstanding balance of $37.2 million.

The FHLB functions as a central reserve bank providing credit for member financial institutions. As members, we are required to own capital stock in the FHLB and are authorized to apply for advances on the security of such stock and certain of our mortgage loans and other assets (principally securities which are obligations of, or guaranteed by, the United States) provided certain standards related to creditworthiness have been met. Advances are made pursuant to several different programs. Each credit program has its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based either on a fixed percentage of an institution s net worth or on the FHLB s assessment of the institution s creditworthiness. Under its current credit policies, the FHLB of Seattle limits advances to 20% of assets for Heritage Bank and 10% of assets for Central Valley Bank.

The following table is a summary of FHLB advances for the years ended December 31:

	2006	2005	2004
		(Dollars in thousands)	
Balance at period end	$ 37,167	$ 39,900	$ 40,900
Average balance during the period	20,682	28,269	30,352
Maximum amount outstanding at any month end	47,145	48,800	48,900
Average interest rate:			
During the period	5.19%	3.29%	1.49%
At period end	5.63%	4.33%	2.35%

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We maintain a line of credit with Key Bank for short-term corporate funding needs. The following table is a summary of usage on the Key Bank line of credit for the years ended December 31:

	2006	2005	2004
	(Dollars in thousands)		
Balance at period end	$ 225	$	$
Average balance during the period	5		554
Maximum amount outstanding at any month end	225		2,194
Average interest rate:			
During the period	7.75%		4.38%
At period end	7.75%		

There were no fed funds purchased for the years ended December 31, 2006, 2005 and 2004.

During 2006, we entered into a loan agreement with Key Bank in the amount of $3,700. The terms of the loan include quarterly payments of $345, interest at 6.8% and maturing July 2009. Principal reductions due for future years ending December 31 are as follows:

2007	$ 888
2008	1,257
2009	1,001
	$ 3,146

Supervision and Regulation

We are subject to extensive federal and Washington state legislation, regulation, and supervision. These laws and regulations are primarily intended to protect depositors, the FDIC and shareholders. The laws and regulations affecting banks and bank holding companies have changed significantly over recent years, and it is reasonable to expect that similar changes will continue in the future. Any change in applicable laws, regulations, or regulatory policies may have a material effect on our business, operations, and prospects. We cannot predict the nature or the extent of the effects on our business and earnings that any fiscal or monetary policies or new federal or state legislation may have in the future.

The following information is qualified in its entirety by reference to the particular statutory and regulatory provisions described.

Heritage Financial. We are subject to regulation as a bank holding company within the meaning of the Bank Holding Company Act of 1956, as amended, and are supervised by the Federal Reserve. The Federal Reserve has the authority to order bank holding companies to cease and desist from unsound practices and violations of conditions imposed on it. The Federal Reserve is also empowered to assess civil money penalties against companies and individuals who violate the Bank Holding Company Act or orders or regulations thereunder in amounts up to $1.0 million per day. The Federal Reserve may order termination of non-banking activities by non-banking subsidiaries of bank holding companies, or divestiture of ownership and control of a non-banking subsidiary by a bank holding company. Some violations may also result in criminal penalties. The FDIC is authorized to exercise comparable authority under the Federal Deposit Insurance Act and other statutes for state nonmember banks such as Heritage Bank and Central Valley Bank.

The Federal Reserve has a policy that a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, the Federal Reserve provides that bank holding companies should serve as a source of strength to its subsidiary banks by being prepared to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity, and should maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting its subsidiary banks. A bank holding

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company s failure to meet its obligation to serve as a source of strength to its subsidiary banks will generally be considered by the Federal Reserve to be an unsafe and unsound banking practice or a violation of the Federal Reserve s regulations or both. The Federal Deposit Insurance Act requires an undercapitalized institution to send to the Federal Reserve a capital restoration plan with a guaranty by each company having control of the bank s compliance with the plan.

We are required to file annual and periodic reports with the Federal Reserve and provide additional information as the Federal Reserve may require. The Federal Reserve may examine us, and any of our subsidiaries, and charge us for the cost of the examination.

We, and any subsidiaries which we may control, are considered affiliates within the meaning of the Federal Reserve Act, and transactions between our bank subsidiaries and affiliates are subject to numerous restrictions. With some exceptions, we, and our subsidiaries are prohibited from tying the provision of various services, such as extensions of credit, to other services offered by us, or our affiliates.

Bank regulations require bank holding companies and banks to maintain a minimum leverage ratio of core capital to adjusted quarterly average total assets of at least 3%. In addition, banking regulators have adopted risk-based capital guidelines under which risk percentages are assigned to various categories of assets and off-balance sheet items to calculate a risk-adjusted capital ratio. Tier I capital generally consists of common stockholders equity (which does not include unrealized gains and losses on securities), less goodwill and certain identifiable intangible assets. Tier II capital includes Tier I capital plus the allowance for loan losses and subordinated debt, both subject to some limitations. Regulatory risk-based capital guidelines require Tier I capital of 4% of risk-adjusted assets and minimum total capital ratio (combined Tier I and Tier II) of 8% of risk-adjusted assets.

Subsidiaries. Heritage Bank and Central Valley Bank are Washington state-chartered commercial banks, the deposits of which are insured by the FDIC. Heritage Bank and Central Valley Bank are subject to regulation by the FDIC and the Division of Banks of the Washington Department of Financial Institutions (Division). Although Heritage Bank and Central Valley Bank are not members of the Federal Reserve System, the Federal Reserve has supervisory authority over us and our subsidiary banks.

Among other things, applicable federal and state statutes and regulations which govern a bank s operations relate to minimum capital requirements, required reserves against deposits, investments, loans, legal lending limits, mergers and consolidation, borrowings, issuance of securities, payment of dividends, establishment of branches, and other aspects of its operations. The Division and the FDIC also have authority to prohibit banks under their supervision from engaging in what they consider to be unsafe and unsound practices.

The banks are required to file periodic reports with the FDIC and the Division, and are subject to periodic examinations and evaluations by those regulatory authorities. Based upon these evaluations, the regulators may revalue the assets of an institution and require that it establish specific reserves to compensate for the differences between the regulator-determined value and the book value of such assets. These examinations must be conducted every 12 months, except that well-capitalized banks may be examined every 18 months. The FDIC and the Division may each accept the results of an examination by the other in lieu of conducting an independent examination.

As subsidiaries of a bank holding company, our banks are subject to various restrictions in their dealings with us and other companies that may become affiliated with us.

Dividends paid by our subsidiaries provide substantially all of our cash flow. Applicable federal and Washington state regulations restrict capital distributions by our banks, including dividends. Such restrictions are tied to the institution s capital levels after giving effect to such distributions. The FDIC has established the qualifications necessary for a well-capitalized bank, which affects FDIC risk-based insurance premium rates. To qualify as well-capitalized , banks must have a Tier I risk-adjusted capital ratio of at least 6%, a total risk-adjusted capital ratio of at least 10%, and a leverage ratio of at least 5%. Both Heritage Bank and Central Valley Bank were well-capitalized at December 31, 2006.

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Federal laws generally bar institutions, which are not well capitalized, from accepting brokered deposits. The FDIC has issued rules, which prohibit under-capitalized institutions from soliciting or accepting brokered deposits. Adequately capitalized institutions are allowed to solicit brokered deposits, but only to accept them if a waiver is obtained from the FDIC.

Deposit Insurance. Heritage Bank s and Central Valley Bank s deposit accounts are insured by the FDIC under the DIF to the maximum extent permitted by law. Each bank pays deposit insurance premiums to the FDIC based on a risk-based assessment system established by the FDIC for all member institutions. Under applicable regulations, institutions are assigned to one of three capital groups that are based solely on the level of an institution s capital (well capitalized , adequately capitalized or undercapitalized), which are defined in the same manner as the regulations establishing the prompt corrective action system under the FDIC as described above. The matrix so created results in nine assessment risk classifications.

Other Regulatory Developments. Congress has enacted significant federal banking legislation in recent years. The following summarizes some of the recent significant federal banking legislation.

Financial Services Reform Legislation. On November 12, 1999, the Gramm-Leach-Bliley Act (GLBA) was enacted into law. The GLBA removes various barriers imposed by the Glass-Steagall Act of 1933, specifically those prohibiting banks and bank holding companies from engaging in the securities and insurance business. The GLBA also expands the bank holding company act framework to permit bank holding companies with subsidiary banks meeting certain capital and management requirements to elect to become a financial holding company .

Beginning March 2000, financial holding companies may engage in a full range of financial activities, including not only banking, insurance, and securities activities, but also merchant banking and additional activities determined to be financial in nature or complementary to an activity that is financial in nature. The GLBA also provides that the list of permissible financial activities will be expanded as necessary for a financial holding company to keep abreast of competitive and technological changes.

The GLBA also expands the activities in which insured state banks may engage. Under the GLBA, insured state banks are given the ability to engage in financial activities through a subsidiary, as long as the bank and its bank affiliates meet and comply with certain requirements. First, the state bank and each of its bank affiliates must be well capitalized . Second, the bank must comply with certain capital deduction and financial statement requirements provided under the GLBA. Third, the bank must comply with certain financial and operational safeguards provided under the GLBA. Fourth, the bank must comply with the limits imposed by the GLBA on transactions with affiliates.

USA Patriot Act. On October 26, 2001, President George W. Bush signed into law the USA Patriot Act (Patriot Act). Title III of the Patriot Act concerns money laundering provisions that may affect many community banks. These provisions include:

- The Secretary of the Treasury is authorized to impose special measures, such as recordkeeping or reporting, on domestic financial institutions that are a primary concern;
- Financial institutions with private or correspondent accounts with non-U.S. citizens must establish policies and procedures to detect money laundering through those accounts;
- Financial institutions are barred from maintaining correspondent accounts for foreign shell banks (that is a bank that does not have a physical presence in any country);
- The Secretary of the Treasury is required to prescribe regulations to further encourage cooperation among financial institutions, regulators, and law enforcement agencies and officials to share information about terrorist acts and money laundering activities;
- The Secretary of the Treasury is required to issue regulations to establish minimum procedures for financial institutions to use in verifying customer identity during the account-opening process;

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Depository institutions are permitted to provide information to other institutions concerning the possible involvement in potentially unlawful activity by a current or former employee;

The Secretary of the Treasury is required to establish a secure website to receive suspicious activity reports and currency transaction reports, and provide institutions with alerts and other information regarding suspicious activity that warrant immediate attention; and

The federal bank regulators are required to consider the anti-money laundering record of each depository institution in evaluating applications under the Bank Merger Act.

Sarbanes-Oxley Act. On July 30, 2002, President George W. Bush signed into law the Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act implements a broad range of corporate governance and accounting measures for public companies designed to promote honesty and transparency in corporate America and better protect investors from the type of corporate wrongdoing that occurred in Enron, WorldCom, and similar companies. The Sarbanes-Oxley Act s principal legislation includes:

The creation of an independent accounting oversight board;

Auditor independence provisions that restrict non-audit services accountants may provide to their audit clients;

Additional corporate governance and responsibility measures, including the requirement that the chief executive officer and the chief financial officer certify financial statements and the expansion of powers of audit committees;

Expanded disclosure requirements, including accelerated reporting of stock transactions by insiders;

Mandatory disclosure by analysts of potential conflicts of interest; and

A range of enhanced penalties for fraud and other violations.

Website Access to Company Reports

We post publicly available reports required to be filed with the SEC on our website, www.HF-WA.com, as soon as reasonably practicable after filing such reports with the SEC. The required reports are available free of charge through our website. We have also adopted a Code of Ethics applicable to all officers, directors, and employees, which is posted on our website.

Executive Officers

We have adopted a code of ethics that applies to our principal executive officer, principal financial officer, controller and assistant controller. We have posted the text of our code of ethics at www.HF-WA.com in the section titled Investor Information: Corporate Governance. Any waivers of the code of the ethics will be publicly disclosed to shareholders.

Audit Committee of the Board of Directors

The audit committee of our board of directors retains our independent auditors, reviews and approves the scope and results of the audits with the auditors and management, monitors the adequacy of our system of internal controls and reviews the annual report, auditors fees and non-audit services to be provided by the independent auditors. The members of our audit committee are Daryl D. Jensen, chair of the committee, Philip S. Weigand, Brian Charneski, Jeffrey Lyon, Peter Fleutsch, John Clees, James Senna, Gary Christensen and Kimberly Ellwanger, all of whom are considered independent as defined by the SEC. Our board of directors has determined that Mr. Jensen meets the definition of an audit committee financial expert, as determined by the requirements of the SEC.

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Competition

We compete for loans and deposits with other commercial banks, credit unions, mortgage bankers, and other institutions in the scope and type of services offered, interest rates paid on deposits, pricing of loans, and number and locations of branches, among other things. Many of our competitors have substantially greater resources than we do. Particularly in times of high or rising interest rates, we also face significant competition for investors funds from short-term money market securities and other corporate and government securities.

We compete for loans principally through the range and quality of the services we provide, interest rates and loan fees, and the locations of our banks branches. We actively solicit deposit-related clients and compete for deposits by offering depositors a variety of savings accounts, checking accounts, cash management and other services.

Employees

We have 233 full-time equivalent employees. We experienced an increase of 22 full-time equivalents during 2006 due to staff increases in the mortgage and lending departments, the opening of the Sumner branch and the acquisition of Western Washington Bancorp. We believe that employees play a vital role in the success of a service company. Employees are provided with a variety of benefits such as medical, vision, dental and life insurance, a generous retirement plan, and paid vacations and sick leave. None of our employees are covered by a collective bargaining agreement.

ITEM 1A. RISK FACTORS

The following are certain risks that management believes are specific to our business. This should not be viewed as an all inclusive list or in any particular order.

Future loan losses may exceed our allowance for loan losses

We are subject to credit risk, which is the risk of losing principal or interest due to borrowers failure to repay loans in accordance with their terms. A downturn in the economy or the real estate market in our market areas or a rapid change in interest rates could have a negative effect on collateral values and borrowers ability to repay. This deterioration in economic conditions could result in losses to the Company in excess of loan loss allowances. To the extent loans are not paid timely by borrowers, the loans are placed on non-accrual, thereby reducing interest income. To the extent loan charge-offs exceed our financial models, increased amounts charged to the provision for loan losses would reduce income.

Rapidly changing interest rate environments could reduce our net interest margin, net interest income, fee income and net income

Interest and fees on loans and securities, net of interest paid on deposits and borrowings, are a large part of our net income. Interest rates are key drivers of our net interest margin and subject to many factors beyond the control of management. As interest rates change, net interest income is affected. Rapid increases in interest rates in the future could result in interest expense increasing faster than interest income because of mismatches in financial instrument maturities. Further, substantially higher interest rates generally reduce loan demand and may result in slower loan growth. Decreases or increases in interest rates could have a negative effect on the spreads between the interest rates earned on assets and the rates of interest paid on liabilities, and therefore decrease net interest income. See Quantitative and Qualitative Disclosures about Market Risk.

Slower than anticipated growth in new branches and new product and service offerings could result in reduced net income

We have placed a strategic emphasis on expanding our branch network and product offerings. Executing this strategy carries risks of slower than anticipated growth both in new branches and new products. New

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branches and products require a significant investment of both financial and personnel resources. Lower than expected loan and deposit growth in new investments can decrease anticipated revenues and net income generated by those investments, and opening new branches and introducing new products could result in more additional expenses than anticipated and divert resources from current core operations.

The financial services industry is very competitive

We face competition in attracting and retaining deposits, making loans, and providing other financial services throughout our market area. Our competitors include other community banks, larger banking institutions, and a wide range of other financial institutions such as credit unions, government-sponsored enterprises, mutual fund companies, insurance companies and other non-bank businesses. Many of these competitors have substantially greater resources than us.

Decreased volumes and lower gains on sales and brokering of mortgage loans sold could adversely impact net income

We originate and sell mortgage loans as well as broker mortgage loans. Changes in interest rates affect demand for our loan products and the revenue realized on the sale of loans. A decrease in the volume of loans sold/brokered can decrease our revenues and net income.

Inability to hire or retain certain key professionals, management and staff could adversely affect our revenues and net income

We rely on key personnel to manage and operate our business, including major revenue generating functions such as our loan and deposit portfolios. The loss of key staff may adversely affect our ability to maintain and manage these portfolios effectively, which could negatively effect our revenues. In addition, loss of key personnel could result in increased recruiting and hiring expenses, which could cause a decrease in our net income.

ITEM 1B. UNRESOLVED STAFF COMMENTS

There are no unresolved staff comments from the Securities and Exchange Commission.

ITEM 2. PROPERTIES

Our executive offices and the main office of Heritage Bank are located in approximately 22,000 square feet of the headquarters building and adjacent office space which are owned by Heritage Bank and located in downtown Olympia. At December 31, 2006, Heritage Bank had seven offices located in Tacoma and surrounding areas of Pierce County (all but two of which are owned), five offices located in Thurston County (all of which are owned with one office located on leased land), one office in south King County (which is leased) and one office in Shelton, Mason County (which is owned). Central Valley Bank had six offices, five located in Yakima County and one in Kittitas County (all of which are owned with two on leased land).

ITEM 3. LEGAL PROCEEDINGS

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

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders in the fourth quarter of 2006.

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PART II

ITEM 5. MARKET FOR THE REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the NASDAQ National Market System® under the symbol HFWA. At December 31, 2006, we had approximately 1,300 stockholders of record (not including the number of persons or entities holding stock in nominee or street name through various brokerage firms) and 6,558,206 outstanding shares of common stock. The last reported sales price on February 9, 2007 was $24.99 per share. The following table provides bid information per share of our common stock as reported on the NASDAQ National Market System® for the indicated quarters.

	2006 Quarter ended:			
	March 31	June 30	September 30	December 31
High	$ 29.13	$ 29.33	$ 27.77	$ 26.50
Low	$ 23.80	$ 24.85	$ 25.40	$ 23.98

	2005 Quarter ended:			
	March 31	June 30	September 30	December 31
High	$ 21.43	$ 21.57	$ 24.20	$ 25.02
Low	$ 19.91	$ 20.22	$ 20.49	$ 22.00

Since our stock offering in January 1998, we have declared quarterly cash dividends. The two most recent fiscal years quarterly cash dividends are listed below:

Declared	Cash Dividend per share	Record Date	Paid
March 24, 2005	$ 0.167	April 15, 2005	April 28, 2005
June 21, 2005	$ 0.171	July 15, 2005	July 29, 2005
September 15, 2005	$ 0.185	October 17, 2005	October 28, 2005
December 15, 2005	$ 0.190	January 16, 2006	January 30, 2006
March 23, 2006	$ 0.195	April 17, 2006	April 28, 2006
June 20, 2006	$ 0.200	July 17, 2006	July 31, 2006
September 21, 2006	$ 0.205	October 16, 2006	October 31, 2006
December 20, 2006	$ 0.210	January 15, 2007	January 31, 2007

In addition to the cash dividends, on September 15, 2005, the board of directors of the Company declared a 5% stock dividend to shareholders of record on September 30, 2005 and distributed October 14, 2005. The stock dividend distributed an additional share of common stock for every 20 shares held on the record date. Cash was paid for any fractional shares. All share and per share amounts have been properly restated to reflect the stock dividend.

Dividends to shareholders depend primarily upon the receipt of dividends from our subsidiary banks. The FDIC and the Division have the authority under their supervisory powers to prohibit the payment of dividends by Heritage Bank and Central Valley Bank to us. For a period of ten years after the conversion from mutual to stock ownership, Heritage Bank may not, without prior approval of the Division, declare or pay a cash dividend in excess of one-half of the greater of the Bank s net income for the current fiscal year or the average of the Bank s net income for the current fiscal year and the retained earnings of the two prior fiscal years. In addition, Heritage Bank may not declare or pay a cash dividend on its common stock if the effect of the dividend would be to reduce the Bank s net worth below the amount required for the liquidation account. Other than the specific restrictions mentioned above, current regulations allow us, and our subsidiary banks to pay dividends on our common stock if our or our banks regulatory capital would not be reduced below the statutory capital requirements set by the Federal Reserve and the FDIC.

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The Company has had various stock repurchase programs since March 1999. In August 2004, the Board of Directors approved a new stock repurchase plan, allowing the Company to repurchase up to 5% of the then outstanding shares, or approximately 309,750 shares over a period of eighteen months. This marked the Company s eighth stock repurchase plan. On January 25, 2006, the Board of Directors authorized an eighteen month extension to this program. During the quarter ended December 31, 2006, the Company repurchased 22,424 shares at an average price of $24.42. In total, the Company has repurchased 111,139 shares at an average price of $21.56 under this plan.

The following table sets forth information about the Company s purchases of its outstanding common stock during the quarter ended December 31, 2006.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
October 1, 2006 October 31, 2006	105	$ 24.24	5,936,786	220,930
November 1, 2006 November 30, 2006	319	24.50	5,937,105	220,611
December 1, 2006 December 31, 2006	22,000	24.41	5.959,105	198,611
Total	22,424	$ 24.42	5,959,105	198,611

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Stock Performance Graph

The chart shown below depicts total return to stockholders during the period beginning December 31, 2001 and ending December 31, 2006. Total return includes appreciation or depreciation in market value of Heritage common stock as well as actual cash and stock dividends paid to stockholders. Indices shown below, for comparison purposes only, are the Total Return Index for the NASDAQ Stock Market (U.S. Companies), which is a broad nationally recognized index of stock performance by publicly traded companies and the SNL Securities Bank Index which is comprised of publicly traded commercial banks with assets of $500 million to $1 billion. The chart assumes that the value of the investment in Heritage s common stock and each of the three indices was $100 on December 31, 2001, and that all dividends were reinvested in Heritage stock.

HERITAGE FINANCIAL CORPORATION

	Period Ending					
Index	**12/31/01**	**12/31/02**	**12/31/03**	**12/31/04**	**12/31/05**	**12/31/06**
Heritage Financial Corporation	100.00	154.33	191.47	202.92	242.67	254.20
NASDAQ Composite	100.00	68.80	103.60	113.10	115.40	127.40
SNL $500M-$1B Bank Index	100.00	127.67	184.09	208.62	217.57	247.44

* Source: SNL Financial LC, Charlottesville, VA

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ITEM 6. SELECTED FINANCIAL DATA

	For the years ended December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands, except per share data)				
Operations Data:					
Net interest income	$ 35,772	$ 33,881	$ 31,727	$ 29,817	$ 30,203
Provision for loan losses	720	810	645	1,125	1,835
Noninterest income	7,954	6,630	6,498	7,164	6,181
Noninterest expense	27,082	24,183	23,270	22,223	20,254
Federal income tax expense	5,377	5,042	4,725	4,729	4,871
Net income	10,547	10,476	9,585	8,904	9,424
Earnings per share					
Basic	1.65	1.69	1.53	1.31	1.25
Diluted	1.60	1.65	1.49	1.26	1.21
Dividend payout ratio(1)	49.1%	42.0%	40.4%	41.6%	37.4%
Performance Ratios:					
Net interest spread	4.30%	4.75%	4.91%	5.14%	5.17%
Net interest margin(2)	4.83%	5.08%	5.13%	5.40%	5.53%
Efficiency ratio(3)	61.94%	59.69%	60.88%	60.09%	55.67%
Return on average assets	1.33%	1.46%	1.44%	1.49%	1.58%
Return on average equity	14.18%	16.13%	15.80%	13.03%	12.18%

	At December 31,				
	2006	2005	2004	2003	2002
Balance Sheet Data:					
Total assets	$ 852,893	$ 751,152	$ 697,267	$ 640,920	$ 594,587
Loans receivable, net	739,596	643,538	591,085	512,647	455,277
Loans held for sale		263	381	1,018	8,113
Deposits	725,921	636,504	587,278	541,832	517,116
Federal Home Loan Bank advances	37,167	39,900	40,900	31,100	
Stockholders equity	78,639	66,120	60,944	62,232	72,397
Book value per share	$ 11.99	$ 10.57	$ 9.76	$ 9.57	$ 10.13
Equity to assets ratio	9.22%	8.80%	8.74%	9.71%	12.18%
Asset Quality Ratios:					
Nonperforming loans to loans	0.37%	0.13%	0.05%	0.06%	0.42%
Allowance for loan losses to loans	1.35%	1.30%	1.38%	1.49%	1.46%
Allowance for loan losses to nonperforming loans	360.05%	1,016.27%	2,603.60%	2,611.97%	346.05%
Nonperforming assets to total assets	0.36%	0.16%	0.05%	0.11%	0.38%
Other Data:					
Number of banking offices	20	18	18	18	18
Number of full-time equivalent employees	233	211	196	206	195

(1) Dividend payout ratio is declared dividends per share (excluding stock dividends) divided by basic earnings per share.
(2) Net interest margin is net interest income divided by average interest earning assets.
(3) The efficiency ratio is recurring noninterest expense divided by the sum of net interest income and noninterest income.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion is intended to assist in understanding the financial condition and results of operations of the Company. The information contained in this section should be read with the December 31, 2006 audited consolidated financial statements and notes to those financial statements included in this Form 10-K.

Statements concerning future performance, developments or events, expectations for growth and market forecasts, and any other guidance on future periods, constitute forward-looking statements and are subject to a number of risks and uncertainties, which might cause actual results to differ materially from stated expectations. Specific factors include, but are not limited to, the effect of interest rate changes, risks associated with acquisition of other banks and opening new branches, the ability to control costs and expenses, and general economic conditions. Additional information on these and other factors, which could affect our financial results are included in our filings with the Securities and Exchange Commission.

Critical Accounting Policies

The Company s consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. Companies may apply certain critical accounting policies requiring management to make subjective or complex judgments, often as a result of the need to estimate the effect of matters that are inherently uncertain.

The Company considers its most critical accounting estimate to be the allowance for loan losses. The allowance for loan losses is established through a provision for loan losses charged against earnings. The balance of the allowance for loan losses is maintained at the amount management believes will be adequate to absorb known and inherent losses in the loan portfolio at the balance sheet date. The allowance for loan losses is determined by applying estimated loss factors to the credit exposure from outstanding loans. Estimated loss factors are based on subjective measurements including management s assessment of the internal risk classifications, historical loss experience, changes in the nature of the loan portfolio, industry concentrations and the impact of current local, regional and national economic factors on the quality of the loan portfolio. Changes in these estimates and assumptions are reasonably possible and may have a material impact on the Company s consolidated financial statements, results of operation or liquidity.

For additional information regarding the allowance for loan losses, its relation to the provision for loans losses, risk related to asset quality and lending activity, see Part I, Item 1 as well as the Management s Discussion and Analysis of Financial Condition and Results of Operation Provision for Loan Losses.

Overview

Heritage Financial Corporation is a bank holding company which primarily engages in the business activities of our wholly owned subsidiaries: Heritage Bank and Central Valley Bank. We provide financial services to our local communities with an ongoing strategic focus in expanding our commercial banking relationships, market expansion and a continual focus on asset quality. During 2006, we acquired Western Washington Bancorp, Inc. and its wholly-owned subsidiary, Washington State Bank, N.A. Washington State Bank, N.A. was merged into Heritage Bank as of the date of acquisition. This merger is consistent with our growth strategy and provides the opportunity to expand into the south King County market in Washington state.

During the period from 2002 through 2006 our total assets have grown $258.3 million, or 43.4%, with net loans growing $284.3 million during the period. Our emphasis in growing our commercial loan portfolio resulted in an increase in commercial loans of $196.6 million, or 80.6%, since 2002. Overall loan increases have benefited from our emphasis in growing our lending in the Pierce county market.

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Deposits increased $208.8 million, or 40.4%, for the period from 2002 through 2006 with an increase in the percentage of non-interest and low interest bearing demand deposits to total deposits. From 2002 to 2006, non-interest demand deposits and NOW accounts increased aggregately from 26.8% of total deposits to 30.3% of total deposits. Our deposit increases are due to our focus on growing our customer base as well as investors continuing to prefer deposit accounts over the stock market. As a whole, while our customers continue to prefer short term deposit products, we are seeing some extension out to two years in certificates. In turn, equity has increased by $6.2 million since December 31, 2002 due to a combination of earnings and issuances of stock partially offset by our stock repurchase programs. Since 1999, we have repurchased 5,959,105 shares totaling $72.7 million. During the period from 2002 through 2006, our annual net income has increased by 11.9% or $1.1 million. The result of these trends have provided our company with an increase in return on average equity from 12.18% for the year ended December 31, 2002 to 14.18% for year ended December 31, 2006.

Our profitability depends primarily on our net interest income, which is the difference between the income we receive on our loan and investment portfolios, and our cost of funds, which consists of interest paid on deposits and borrowed funds. Like most financial institutions, our interest income and cost of funds are affected significantly by general economic conditions, particularly changes in market interest rates and government policies.

Changes in net interest income result from changes in volume, net interest spread, and net interest margin. Volume refers to the average dollar amounts of interest earning assets and interest bearing liabilities. Net interest spread refers to the difference between the average yield on interest earning assets and the average cost of interest bearing liabilities. Net interest margin refers to net interest income divided by average interest earning assets and is influenced by the level and relative mix of interest earning assets and interest bearing and non-interest bearing liabilities.

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The following table provides relevant net interest income information for selected time periods. The average loan balances presented in the table are net of allowances for loan losses. Nonaccrual loans have been included in the tables as loans carrying a zero yield. Yields on tax-exempt securities and loans have not been stated on a tax-equivalent basis.

	Years Ended December 31,								
	2006			2005			2004		
	Average Balance	Interest Earned/ Paid	Average Rate	Average Balance	Interest Earned/ Paid	Average Rate	Average Balance	Interest Earned/ Paid	Average Rate
	(Dollars in thousands)								
Interest Earning Assets:									
Loans	$ 690,287	$ 53,239	7.71%	$ 613,655	$ 43,605	7.11%	$ 549,444	$ 36,938	6.72%
Taxable securities	40,352	1,724	4.27	43,659	1,568	3.59	47,670	1,610	3.38
Nontaxable securities	4,586	167	3.64	4,117	149	3.62	3,779	141	3.74
Interest earning deposits	2,137	104	4.88	2,899	90	3.09	14,945	177	1.18
Federal Home Loan Bank stock	3,163	3	0.10	3,089	16	0.50	3,002	78	2.61
Total interest earning assets	$ 740,525	$ 55,237	7.46%	$ 667,419	$ 45,428	6.81%	$ 618,840	$ 38,944	6.29%
Noninterest earning assets	54,694			48,430			46,478		
Total assets	$ 795,219			$ 715,849			$ 665,318		
Interest Bearing Liabilities:									
Certificates of deposit	$ 307,902	$ 12,902	4.19%	$ 264,078	$ 7,755	2.94%	$ 222,279	$ 4,477	2.01%
Savings accounts	95,075	1,677	1.76	96,425	993	1.03	104,271	1,094	1.05
Interest bearing demand and money market accounts	189,458	3,664	1.93	170,399	1,846	1.08	165,486	1,153	0.70
Total interest bearing deposits	592,435	18,243	3.08	530,902	10,594	2.00	492,036	6,724	1.37
FHLB advances and other borrowings	22,784	1,222	5.36	28,544	953	3.34	30,909	493	1.60
Total interest bearing liabilities	$ 615,219	$ 19,465	3.16%	$ 559,446	$ 11,547	2.06%	$ 522,945	$ 7,217	1.38%
Demand and other noninterest bearing deposits	98,567			85,732			76,994		
Other noninterest bearing liabilities	7,038			5,732			4,708		
Stockholders equity	74,395			64,939			60,671		
Total liabilities and stockholders equity	$ 795,219			$ 715,849			$ 665,318		
Net interest income		$ 35,772			$ 33,881			$ 31,727	
Net interest spread			4.30%			4.75%			4.91%
Net interest margin			4.83%			5.08%			5.13%
Average interest earning assets to average interest bearing liabilities			120.37%			119.30%			118.34%

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The following table provides the amount of change in our net interest income attributable to changes in volume and changes in interest rates. Changes attributable to the combined effect of volume and interest rates have been allocated proportionately for changes due to volume and interest rates.

	Years Ended December 31,					
	2006 Compared to 2005 Increase (Decrease) Due to			2005 Compared to 2004 Increase (Decrease) Due to		
	Volume	Rate	Total	Volume	Rate	Total
	(Dollars in thousands)					
Interest Earning Assets:						
Loans	$ 5,911	$ 3,723	$ 9,634	$ 4,316	$ 2,351	$ 6,667
Taxable securities	(141)	297	156	(135)	94	(41)
Nontaxable securities	17	1	18	13	(5)	8
Interest earning deposits	(38)	52	14	(142)	55	(87)
Federal Home Loan Bank stock		(13)	(13)	2	(65)	(63)
Interest income	$ 5,749	$ 4,060	$ 9,809	$ 4,054	$ 2,430	$ 6,484
Interest bearing liabilities:						
Certificates of deposit	$ 1,836	$ 3,311	$ 5,147	$ 842	$ 2,436	$ 3,278
Savings accounts	(24)	708	684	(82)	(19)	(101)
Interest bearing demand and money market accounts	369	1,449	1,818	34	659	693
Total interest bearing deposits	2,181	5,468	7,649	794	3,076	3,870
FHLB advances and other borrowings	(309)	578	269	(38)	498	460
Interest expense	$ 1,872	$ 6,046	$ 7,918	$ 756	$ 3,574	$ 4,330

Results of Operations for the Years Ended December 31, 2006 and 2005

Net Income. Our net income was $10.55 million or $1.60 per diluted share for the year ended December 31, 2006 compared to $10.48 million or $1.65 per diluted share for the previous year. The 0.7% increase in actual net income was due to a combination of increased net interest income and non-interest income offset by increased non-interest expense.

Net Interest Income. Net interest income increased $1.9 million to $35.8 million for the year ended December 31, 2006 compared with the previous year of $33.9 million. The increase in net interest income resulted primarily from average loans increasing greater than average interest bearing deposits.

Net interest income as a percentage of average earning assets (net interest margin) for the year ended December 31, 2006 decreased to 4.83% from 5.08% for the previous year. Our net interest spread for the year ended December 31, 2006 decreased to 4.30% from 4.75% for the prior year. The average rate of interest earning assets increased to 7.46% for the year ended December 31, 2006 from 6.81% for the same period last year while the average cost of funds increased to 3.16% for the year ended December 31, 2006 from 2.06% for the same period last year. Overall, our net interest margin of 4.83% is in line with the median for West Coast publicly traded commercial banks of 4.81% as reported by D.A. Davidson and Companies for the period ending September 30, 2006.

Provision for Loan Losses. During the year ended December 31, 2006, we provided $720,000 through operations compared to $810,000 for the year ended December 31, 2005. This decrease was due primarily to recoveries in the current year. For the year ended December 31, 2006, we experienced net recoveries of $140,000 compared to net charge-offs of $609,000 for the year ended December 31, 2005. The provision and corresponding net recoveries increased our allowance for loan losses as a percentage of total loans to 1.35% at December 31, 2006 from 1.30% at the end of 2005. Our asset quality has remained solid as demonstrated by the nonperforming assets to total assets ratio of 0.36% at December 31, 2006, though up from 0.16% at December 31, 2005.

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We consider the allowance for loan losses at December 31, 2006 adequate to cover loan losses based on our assessment of various factors affecting the loan portfolio, including the level of problem loans, business conditions, estimated collateral values, loss experience including those related to our courtesy overdraft programs, and credit concentrations. See the previous discussion on the allowance for loan losses in Item 1 for further information about these factors.

Noninterest Income. Total noninterest income increased $1,324,000, or 20.0%, for the year ended December 31, 2006 compared with the prior year. Brokered mortgage income increased $471,000 from the prior year while loan sale gains decreased $144,000 from the prior year. This change is due to an increase in the number of mortgage bankers and an increased focus on brokering mortgages as opposed to funding and selling mortgages. Merchant visa income increased $316,000, or 14.0%, due to increased business volumes. Service charges on deposits also increased by $435,000, or 15.4%, due to our continued focus on growing our deposit relationships and the acquisition of Western Washington Bancorp.

Noninterest Expense. Total noninterest expense increased $2,899,000, or 12.0%, for the year ended 2006 compared to the 2005 period. Salaries and employee benefits increased by $1,780,000 due to an increase in full-time equivalent employees and the effects of stock option compensation as a result of implementing SFAS 123(R) in 2006. The increase in employees was due to the hiring of additional loan officers and additional staff associated with the new Sumner branch and the acquisition of Western Washington Bancorp. The effect of the adoption of SFAS 123(R) on noninterest expense during 2006 was $352,000. Merchant Visa expenses increased by $252,000, or 14.3%. The increase was in line with the increase in business volumes as well as Merchant Visa income. Other operating expenses increased by $866,000, or 8.8%, due to the increases in occupancy costs, data processing, marketing, and state and local taxes relating to the new Sumner branch and the acquisition of Western Washington Bancorp.

Results of Operations for the Years Ended December 31, 2005 and 2004

Net Income. Our net income was $10.5 million or $1.65 per diluted share for the year ended December 31, 2005 compared to $9.6 million or $1.49 per diluted share for the previous year. The 9.3% increase in actual net income was primarily the result of increased loan growth while maintaining a strong net interest margin. 2004 included a fourth quarter after tax gain of $144,000 on the sale of stock held in HCB Bancorp, Inc. Excluding the gain on the sale of HCB Bancorp stock, 2004 net income would have been $9.4 million for an increase this year of 11.0% in actual net income and 12.1% in diluted earnings per share. The net interest margin declined a modest 5 basis points with average earning assets increasing $48.6 million for the year at $667.4 million compared to the previous year s average of $618.8 million.

Net Interest Income. Net interest income increased $2.2 million to $33.9 million for the year ended December 31, 2005 compared with the previous year of $31.7 million. The increase in net interest income resulted primarily from strong loan growth and maintenance of the net interest margin above 5.0%.

Net interest income as a percentage of average earning assets (net interest margin) for the year ended December 31, 2005 decreased to 5.08% from 5.13% for the previous year. Our net interest spread for the year ended December 31, 2005 decreased to 4.75% from 4.91% for the prior year. The average rate of interest earning assets increased to 6.81% for the year ended December 31, 2005 from 6.29% for the same period last year while the average cost of funds increased to 2.06% for the year ended December 31, 2005 from 1.38% for the same period last year. Overall, our net interest margin is strong at 5.08% in comparison to the median for West Coast publicly traded commercial banks of 4.88% as reported by D.A. Davidson and Companies for the period ending September 30, 2005.

Provision for Loan Losses. During the year ended December 31, 2005, we provided $810,000 through operations compared to $645,000 for the year ended December 31, 2004. This increase is necessary due to growth in outstanding loans to maintain our allowance at an adequate level. For the year ended December 31, 2005, we experienced net charge-offs of $609,000 up from $98,000 for the year ended December 31, 2004. The

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provision and corresponding net charge-offs decreased our allowance for loan losses as a percentage of total loans to 1.30% at December 31, 2005 from 1.38% at the end of 2004. Our asset quality has remained solid as demonstrated by the nonperforming assets to total assets ratio of 0.16% at December 31, 2005 even though up from a very low 0.05% at December 31, 2004.

We consider the allowance for loan losses at December 31, 2005 adequate to cover loan losses based on our assessment of various factors affecting the loan portfolio, including the level of problem loans, business conditions, estimated collateral values, loss experience including those related to our courtesy overdraft programs, and credit concentrations. See the previous discussion on the allowance for loan losses in Item 1 for further information about these factors.

Noninterest Income. Total noninterest income increased $132,000, or 2.0%, for the year ended December 31, 2005 compared with the prior year. Gain on loan sales decreased $363,000, or 56.7%, over the prior year. Mortgage loans sold during 2005 were $13.6 million versus $35.8 million sold during 2004, a decrease of 62.0%. Merchant visa income increased $348,000, or 18.2%, due to increased business volumes. Service charges on deposits also increased by $263,000 due to our focus on growing our deposit relationships.

Noninterest Expense. Total noninterest expense increased $913,000, or 3.9%, for the year ended 2005 compared to the 2004 period. Salaries and employee benefits increased by $396,000 primarily due to an increase in full-time equivalent employees. Merchant Visa expenses increased by $261,000, or 17.4%. The increase was in line with the increase in business volumes as well as Merchant Visa income. Other operating expenses increased by $256,000, or 2.7%, primarily due to the increases in occupancy costs.

Liquidity and Capital Resources

Our primary sources of funds are deposits, loan repayments, loan sales, interest earned on and proceeds from investment securities, and advances from the FHLB of Seattle. These funds, together with retained earnings, equity and other borrowed funds, are used to make loans, acquire investment securities and other assets, and fund continuing operations. While maturities and scheduled amortization of loans are a predictable source of funds, deposit flows and prepayments are greatly influenced by the level of interest rates, economic conditions, and competition.

We must maintain an adequate level of liquidity to ensure the availability of sufficient funds to fund loan originations and deposit withdrawals, satisfy other financial commitments, and fund operations. We generally maintain sufficient cash and short-term investments to meet short-term liquidity needs. At December 31, 2006, cash and cash equivalents totaled $26.4 million, or 3.1% of total assets. At December 31, 2006, our banks maintained a credit facility with the FHLB of Seattle for $155.3 million of which we borrowed $37.2 million as of December 31, 2006. In addition, we maintain a credit facility with KeyBank of $5.0 million as well as another $5.0 million line to support letters of credit. Our subsidiary banks also maintain advance lines to purchase federal funds totaling $29.8 million as of December 31, 2006.

During 2006 total assets grew $101.7 million with net loans increasing by $96.1 million over the prior year-end and deposits increasing $89.4 million over the prior year-end. Borrowings from the FHLB of Seattle decreased by $2.7 million over the prior year-end. Our strategy has been to acquire core deposits (which we define to include all deposits except public funds) from our retail accounts, acquire noninterest bearing demand deposits from our commercial customers, and use available borrowing capacity to fund growth in assets. We anticipate that we will continue to rely on the same sources of funds in the future and use those funds primarily to make loans and purchase investment securities.

We, and our banks, are subject to various regulatory capital requirements. As of December 31, 2006, we, and our banks were classified as well capitalized institutions under the criteria established by the Federal Deposit Insurance Act. Our initial public offering in January of 1998 significantly increased our capital to levels well in excess of regulatory requirements and our internal needs. In 1999, we determined that buying our own shares with some of our excess capital was the best use of this capital and we began to buy back our Company s

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outstanding shares. As of December 31, 2006, we have repurchased 5,959,105 shares of our stock representing 52.3% of the total outstanding as of March 31, 1999 at an average price of $12.20 reducing our capital levels by $72.7 million.

Our capital levels are also modestly impacted by our 401(k) Employee Stock Ownership Plan and Trust (KSOP). The Employee Stock Ownership Plan (ESOP) purchased 2% of the common stock issued in a January 1998 stock offering and borrowed from the Company to fund the purchase of the Company s common stock. The loan to the ESOP will be repaid principally from the Bank s contributions to the ESOP. The Bank s contributions will be sufficient to service the debt over the 15 year loan term at the interest rate of 8.5%. As the debt is repaid, shares are released, and allocated to plan participants based on the proportion of debt service paid during the year. As shares are released, compensation expense is recorded equal to the then current market price of the shares, our capital is increased, and the shares become outstanding for earnings per share calculations. For the year ended December 31, 2006, the Company has allocated or committed to be released to the ESOP 9,257 earned shares and has 56,317 unearned, restricted shares remaining to be released. The fair value of unearned, restricted shares held by the ESOP trust was $1.40 million at December 31, 2006.

Contractual Obligations

The following table provides the amounts due under specified contractual obligations for the periods indicated as of December 31, 2006:

	Less than 1 year	1-3 years	4-5 years	More than 5 years	Indeterminate maturity(1)	Total
			(Dollars in thousands)			
Contractual payments by period:						
Deposits	$ 301,219	$ 24,486	$ 2,272	$	$ 397,944	$ 725,921
Long-term debt	888	2,258				3,146
Operating leases	532	715	663	1,325		3,235
Purchase obligations(2)	440					440
Total contractual obligations	$ 303,079	$ 27,459	$ 2,935	$ 1,325	$ 397,944	$ 732,742

(1) Represents interest-bearing and noninterest-bearing checking, money market and checking accounts.
(2) Represents agreements to purchase goods or services.

Asset/Liability Management

Our primary financial objective is to achieve long term profitability while controlling our exposure to fluctuations in market interest rates. To accomplish this objective, we have formulated an interest rate risk management policy that attempts to manage the mismatch between asset and liability maturities while maintaining an acceptable interest rate sensitivity position. The principal strategies which we employ to control our interest rate sensitivity are: selling most long term, fixed rate, single-family residential mortgage loan originations; originating commercial loans and residential construction loans at variable interest rates repricing for terms generally one year or less; and offering noninterest bearing demand deposit accounts to businesses and individuals. The longer-term objective is to increase the proportion of noninterest bearing demand deposits, low interest bearing demand deposits, money market accounts, and savings deposits relative to certificates of deposit to reduce our overall cost of funds.

Our asset and liability management strategies have resulted in a positive 0-3 month gap of 6.83% and a negative 4-12 month gap of 0.68% as of December 31, 2006. These gaps measure the difference between the dollar amount of our interest earning assets and interest bearing liabilities that mature or reprice within the designated period (three months and 4-12 months) as a percentage of total interest earning assets, based on certain estimates and assumptions as discussed below. We believe that the implementation of our operating

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strategies has reduced the potential effects of changes in market interest rates on our results of operations. The positive gap for the 0-3 month period indicates that decreases in market interest rates may adversely affect our results over that period.

The following table provides the estimated maturity or repricing and the resulting interest rate sensitivity gap of our interest earning assets and interest bearing liabilities at December 31, 2006 based upon estimates of expected mortgage prepayment rates and deposit run off rates consistent with national trends. We adjusted mortgage loan maturities for loans held for sale by reflecting these loans in the three-month category, which is consistent with their sale in the secondary mortgage market. The amounts in the table are derived from our internal data. We used certain assumptions in presenting this data so the amounts may not be consistent with other financial information prepared in accordance with generally accepted accounting principles. The amounts in the tables also could be significantly affected by external factors, such as changes in prepayment assumptions, early withdrawal of deposits, and competition.

	Estimated Maturity or Repricing Within					
	0-3 months	4-12 months	1-5 years	5-15 years	More than 15 years	Total
	(Dollars in thousands)					
Interest Earnings Assets:						
Loans	$ 242,411	$ 111,587	$ 318,942	$ 70,643	$ 8,521	$ 752,104
Investment securities	24,394	2,118	4,896	4,488	7,086	42,982
FHLB and Federal Reserve Stock	3,227					3,227
Interest earning deposits	2,673					2,718
Total interest earning assets	$ 272,705	$ 113,750	$ 323,838	$ 75,131	$ 15,607	$ 801,031
Interest Bearing Liabilities:						
Total interest bearing deposits	$ 179,211	$ 173,170	$ 266,062	$	$	$ 618,444
FHLB advances and other borrowings	38,817	737	983			40,538
Total interest bearing liabilities	$ 218,028	$ 173,907	$ 267,045	$	$	$ 658,982
Rate sensitivity gap	$ 54,677	$ (60,157)	$ 56,793	$ 75,131	$ 15,607	$ 142,049
Cumulative rate sensitivity gap:						
Amount	54,677	(5,480)	51,313	126,444	142,057	
As a percentage of total interest earning assets	6.83%	(0.68)%	6.41%	15.79%	17.73%	

Certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on some types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market interest rates. Additionally, some assets, such as adjustable rate mortgages, have features, which restrict changes in the interest rates of those assets both on a short-term basis and over the lives of such assets. Further, if a change in market interest rates occurs, prepayment, and early withdrawal levels could deviate significantly from those assumed in calculating the tables. Finally, the ability of many borrowers to service their adjustable rate debt may decrease if market interest rates increase substantially.

Impact of Inflation and Changing Prices

Inflation affects our operations by increasing operating costs and indirectly by affecting the operations and cash flow of our customers. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, changes in interest rates generally have a more significant impact on a financial institution s performance than the effects of general levels of inflation. Although interest rates do not necessarily move in the same direction or the same extent as the prices of goods and services, increases in inflation generally have resulted in increased interest rates.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to interest rate risk through our lending and deposit gathering activities. For a discussion of how this exposure is managed and the nature of changes in our interest rate risk profile during the past year, see Asset/Liability Management under Management s Discussion and Analysis of Financial Condition and Results of Operation.

Neither we, nor our banks, maintain a trading account for any class of financial instrument, nor do we, or they, engage in hedging activities or purchase high risk derivative instruments. Moreover, neither we, nor our banks, are subject to foreign currency exchange rate risk or commodity price risk.

The table below provides information about our financial instruments that are sensitive to changes in interest rates as of December 31, 2006. The table presents principal cash flows and related weighted average interest rates by expected maturity dates. The expected maturity is the contractual maturity or earlier call date of the instrument. The data in this table may not be consistent with the amounts in the preceding table, which represents amounts by the repricing date or maturity date (whichever occurs sooner) adjusted by estimates such as mortgage prepayments and deposit reduction or early withdrawal rates.

	By Expected Maturity Date Year Ended December 31,						
	2007	2008	2009	2010-2011	After 2011	Total	Fair Value
	(Dollars in thousands)						
Investment Securities							
Amounts maturing:							
Fixed rate	$ 5,279	$ 9,279	$ 2,718	$ 1,352	$ 12,829	$ 31,457	
Weighted average interest rate	4.06%	3.61%	4.34%	3.08%	4.21%		
Adjustable Rate					11,525	11,525	
Weighted average interest rate					5.03%		
Totals	5,279	9,279	2,718	1,352	24,354	$ 42,982	$ 42,985
Loans							
Amounts maturing:							
Fixed rate	$ 47,143	$ 27,497	$ 22,347	$ 36,846	$ 117,137	$ 250,970	
Weighted average interest rate	7.18%	6.99%	6.96%	7.20%	6.55%		
Adjustable rate	196,833	44,174	29,234	32,033	198,860	501,134	
Weighted average interest rate	8.83%	8.19%	7.07%	7.30%	6.81%		
Totals	$ 243,976	$ 71,671	$ 51,581	$ 68,879	$ 315,997	$ 752,104	$ 744,674
Certificates of Deposit							
Amounts maturing:							
Fixed rate	$ 301,219	$ 19,864	$ 4,622	$ 2,272	$	$ 327,977	$ 327,337
Weighted average interest rate	4.79%	4.29%	4.09%	4.19%			

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

For financial statements, see the Index to Consolidated Financial Statements on page F-1.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURES

There were no changes in accountants nor disagreements with our accountants on accounting and financial disclosure.

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ITEM 9A. CONTROLS AND PROCEDURES

(i) Disclosure Controls and Procedures.

Our disclosure controls and procedures are designed to ensure that information the Company must disclose in its reports filed or submitted under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized, and reported on a timely basis. Our management has evaluated, with the participation and under the supervision of our chief executive officer (CEO) and chief financial officer (CFO), the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act) as of the end of the period covered by this report. Based on this evaluation, our CEO and CFO have concluded that, as of such date, the Company s disclosure controls and procedures are effective in ensuring that information relating to the Company, including its consolidated subsidiaries, required to be disclosed in reports that it files under the Exchange Act is (1) recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and (2) accumulated and communicated to our management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

(ii) Internal Control Over Financial Reporting.

(a) Management s report on internal control over financial reporting.

The Company s management is responsible for establishing and maintaining adequate internal control over financial reporting. The Company s internal control system is designed to provide reasonable assurance to our management and the board of directors regarding the preparation and fair presentation of published financial statements. Nonetheless, all internal control systems, no matter how well designed, have inherent limitations. Even systems determined to be effective as of a particular date can provide only reasonable assurance with respect to financial statement preparation and presentation and may not eliminate the need for restatements.

The Company s management assessed the effectiveness of the Company s internal control over financial reporting as of December 31, 2006. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control Integrated Framework*. Based on our assessment, we believe that, as of December 31, 2006, the Company s internal control over financial reporting is effective based on those criteria.

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The Company s independent registered public accounting firm has audited management s assessment of the effectiveness of the Company s internal control over financial reporting as of December 31, 2006, as stated in their report following.

(b) Attestation report of the registered public accounting firm.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Heritage Financial Corporation:

We have audited management s assessment, included in the accompanying *Management s Report on Internal Control over Financial Reporting* that Heritage Financial Corporation and subsidiaries (the Company) maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the Company s internal control over financial reporting 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 effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management s assessment that the Company maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated statements of financial condition of Heritage Financial Corporation and subsidiaries as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholders equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2006, and our report dated March 5, 2007 expressed an unqualified opinion on those consolidated financial statements. Our report refers to the Company s adoption of Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*, effective January 1, 2006.

/s/ KPMG LLP

Seattle, Washington

March 5, 2007

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(c) Changes in internal control over financial reporting.

There were no significant changes in the Company s internal control over financial reporting during the Company s most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company s internal control over financial reporting.

ITEM 9B. OTHER INFORMATION.

None.

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PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Information concerning directors of the registrant is incorporated by reference to the section entitled Election of Directors of our definitive Proxy Statement expected to be dated March 22, 2007 (Proxy Statement) for the annual meeting of shareholders to be held April 26, 2007.

The required information with respect to our executive officers is incorporated by reference to the section entitled Executive Officers of the Proxy Statement.

The required information with respect to compliance with Section 16(a) of the Exchange Act is incorporated by reference to the section entitled Section 16(a) Beneficial Ownership Reporting Compliance of the Proxy Statement.

ITEM 11. EXECUTIVE COMPENSATION

Information concerning executive and director compensation and certain matters regarding participation in the Company s compensation committee required by this item is set forth under the headings Executive Compensation , Director Compensation , and Compensation Committee Report of the Proxy Statement, which is incorporated as part of this document by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table summarizes the consolidated activity within stock option plans 1994, 1997, 1998, 2002 and 2006 as of December 31, 2006, all of which were approved by stockholders.

Number of securities to be issued upon exercise of outstanding options and awards	717,936
Weighted average exercise price of outstanding options	$ 18.79
Number of securities remaining available for future issuance	508,375

For information concerning security ownership of certain beneficial owners and management, see Stock Ownership of the Proxy Statement, which is incorporated as part of this document by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

For information concerning certain relationships and related transactions, see Interest of Management in Certain Transactions of the Proxy Statement, which is incorporated as part of this document by reference.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

For information concerning principal accounting fees and services, see Relationship with Independent Public Accountants of the Proxy Statement, which is incorporated as part of this document by reference.

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PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1) The consolidated financial statements are contained as listed on the Index to Consolidated Financial Statements on page F-1.

(2) All schedules are omitted because they are not required or applicable, or the required information is shown in the consolidated financial statements or notes.

(3) *Exhibits*

Exhibit No.	
3.1	Articles of Incorporation(1)
3.2	Bylaws of the Company(1)
10.1	1998 Stock Option and Restricted Stock Award Plan(2)
10.5	Form of Severance Agreement entered into between the Company and seven additional executives, effective as of October 1, 1997(1)
10.6	1997 Stock Option and Restricted Stock Award Plan(3)
10.7	Employment Agreement between the Company and Michael Broadhead, effective September 28, 1998(4)
10.8	Employment Agreement between the Company and Brian L. Vance, effective October 1, 2006(9)
10.10	2002 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan(5)
10.11	Revised Employment Agreement between the Company and Donald V. Rhodes, effective January 1, 2005(7)
10.12	2006 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan(8)
14.0	Code of Ethics(6)
21.0	Subsidiaries of the Company
23.0	Consent of Independent Registered Public Accounting Firm
24.0	Power of Attorney
31.0	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.0	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Incorporated by reference to the Registration Statement on Form S-1 (Reg. No. 333-35573) declared effective on November 12, 1997.

(2) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-71415).

(3) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-57513).

(4) Incorporated by reference to the Registration Statement on Form S-4 dated January 20, 1999.(5) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-88980; 333-88982; 333-88976).

(6) Incorporated by reference to the Annual Report on Form 10-K dated March 8, 2004.

(7) Incorporated by reference to the Quarterly Report on Form 10-Q dated November 2, 2004.

(8) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-134473; 333-134474; 333-134475).

(9) Incorporated by reference to the Current Report on Form 8-K dated October 4, 2006.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 5th day of March, 2007.

HERITAGE FINANCIAL CORPORATION

(Registrant)

By /s/ BRIAN L. VANCE
Brian L. Vance
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on the 5th day of March, 2007.

Principal Executive Officer:

/s/ BRIAN L. VANCE — President and Chief Executive Officer

Brian L. Vance

Principal Financial Officer:

/s/ EDWARD D. CAMERON — Executive Vice President and Chief Financial Officer

Edward D. Cameron

Remaining Directors:

*Brian S. Charneski

*Gary B. Christensen

*John A. Clees

*Kimberly T. Ellwanger

*Peter N. Fluetsch

*Daryl D. Jensen

*Jeffrey S. Lyon

*Donald V. Rhodes

*James P. Senna

*Philip S. Weigand

*By /s/ BRIAN L. VANCE
Brian L. Vance
Attorney-in-Fact

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006, 2005, and 2004

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders

Heritage Financial Corporation:

We have audited the accompanying consolidated statements of financial condition of Heritage Financial Corporation and subsidiaries (the Company) as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholders equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 2006. These consolidated financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated 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 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 audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Heritage Financial Corporation and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 of the consolidated financial statements, effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Heritage Financial Corporation and subsidiaries internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)*, and our report dated March 5, 2007 expressed an unqualified opinion on management s assessment of, and the effective operation of, internal control over financial reporting.

/s/ KPMG LLP

Seattle, Washington

March 5, 2007

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

December 31, 2006 and 2005

(Dollars in thousands)

	2006	2005
ASSETS		
Cash on hand and in banks	$ 23,713	$ 24,972
Interest earning deposits	2,718	3,030
Investment securities available for sale	39,124	41,856
Investment securities held to maturity (market value of $3,861 and $3,962)	3,858	3,966
Loans held for sale		263
Loans receivable	749,701	652,034
Less: Allowance for loan losses	(10,105)	(8,496)
Loans receivable, net	739,596	643,538
Real estate owned	225	371
Premises and equipment, net	15,681	15,801
Federal Home Loan Bank and Federal Reserve stock, at cost	3,227	3,072
Accrued interest receivable	4,298	3,566
Prepaid expenses and other assets	4,550	2,811
Deferred Federal income taxes, net	2,242	1,266
Intangible assets, net	580	
Goodwill	13,081	6,640
	$ 852,893	$ 751,152
LIABILITIES AND STOCKHOLDERS EQUITY		
Deposits	$ 725,921	$ 636,504
Advances from Federal Home Loan Bank	37,167	39,900
Other borrowings	3,371	
Accrued expenses and other liabilities	7,795	8,628
Total liabilties	774,254	685,032
Stockholders equity:		
Common stock, no par, 15,000,000 shares authorized; 6,558,206 and 6,252,689 shares outstanding at December 31, 2006 and 2005, respectively	24,053	17,606
Unearned compensation ESOP and other	(535)	(1,151)
Retained earnings, substantially restricted	55,647	50,347
Accumulated other comprehensive loss, net	(526)	(682)
Total stockholders equity	78,639	66,120
Commitments and Contingencies		
	$ 852,893	$ 751,152

See accompanying notes to consolidated financial statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

For the years ended December 31, 2006, 2005 and 2004

(Dollars in thousands, except per share amounts)

	2006	2005	2004
Interest income:			
Interest and fees on loans	$ 53,239	$ 43,605	$ 36,938
Taxable interest on investment securities	1,724	1,568	1,610
Nontaxable interest on investment securities	167	149	141
Interest on federal funds sold and interest earning deposits	104	90	177
Dividends on Federal Home Loan Bank stock	3	16	78
Total interest income	55,237	45,428	38,944
Interest expense:			
Deposits	18,243	10,594	6,724
Other borrowings	1,222	953	493
Total interest expense	19,465	11,547	7,217
Net interest income	35,772	33,881	31,727
Provision for loan losses	720	810	645
Net interest income after provision for loan losses	35,052	33,071	31,082
Noninterest income:			
Gains on sales of loans, net	133	277	640
Brokered mortgage income	661	190	96
Service charges on deposits	3,254	2,819	2,556
Rental income	321	309	294
Merchant visa income	2,579	2,263	1,915
Other income	1,006	772	997
Total noninterest income	7,954	6,630	6,498
Noninterest expense:			
Salaries and employee benefits	14,398	12,618	12,222
Occupancy and equipment	4,063	3,906	3,746
Data processing	1,386	1,204	1,252
Marketing	604	494	423
Office supplies and printing	452	410	383
Merchant visa	2,015	1,763	1,502
Professional Services	722	662	645
State and Local Taxes	810	699	641
Other	2,632	2,427	2,456
Total noninterest expense	27,082	24,183	23,270
Income before Federal income tax expense	15,924	15,518	14,310

Federal income tax expense	5,377	5,042	4,725
Net income	$ 10,547	$ 10,476	$ 9,585
Basic earnings per common share	$ 1.65	$ 1.69	$ 1.53
Basic weighted average shares outstanding	6,375,059	6,189,497	6,248,418
Diluted earnings per common share	$ 1.60	$ 1.65	$ 1.49
Diluted weighted average shares outstanding	6,589,381	6,363,002	6,429,532

See accompanying notes to consolidated financial statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME

For the years ended December 31, 2006, 2005 and 2004

(Dollars and shares in thousands)

	Number of common shares	Common stock	Unearned compensation ESOP and Restricted Stock Awards	Retained earnings	Accumulated other comprehensive income (loss), net	Total stock-holders equity
Balance at December 31, 2003	6,193	$ 18,430	$ (1,087)	$ 44,849	$ 40	$ 62,232
Restricted stock awards granted	25	598	(598)			
Earned ESOP, incentive stock options and restricted stock shares	9	93	306			399
Exercise of stock options (including tax benefits from nonqualified stock options	123	1,069				1,069
Stock repurchased	(403)	(8,307)				(8,307)
Net income				9,585		9,585
Change in fair value of securities available for sale, net of taxes					(257)	(257)
Cash dividends declared ($.62/share cumulative)				(3,777)		(3,777)
Balance at December 31, 2004	5,947	$ 11,883	$ (1,379)	$ 50,657	$ (217)	$ 60,944
Restricted stock awards granted	2	61	(61)			
Earned ESOP, incentive stock options and restricted stock shares	9	113	289			402
Exercise of stock options (including tax benefits from nonqualified stock options	71	839				839
Stock repurchased	(73)	(1,606)				(1,606)
Net income				10,476		10,476
Change fair value of securities available for sale, net of taxes					(465)	(465)
5% stock dividend	297	6,316		(6,316)		
Cash dividends declared ($.71/share cumulative)				(4,470)		(4,470)
Balance at December 31, 2005	6,253	$ 17,606	$ (1,151)	$ 50,347	$ (682)	$ 66,120
Elimination of unearned compensation restricted stock awards		(527)	527			
Restricted stock awards granted	16					
Restricted stock awards cancelled	(1)					
Stock option compensation expense		352				352
Earned ESOP and restricted stock shares	9	433	89			522
Exercise of stock options (including tax benefits from nonqualified stock options)	74	1,115				1,115
Stock repurchased	(24)	(588)				(588)
Acquisition of Western Washington Bancorp	231	5,662				5,662
Net income				10,547		10,547
Change in fair value of securities available for sale, net of taxes					156	156
Cash dividends declared ($.81/share cumulative)				(5,247)		(5,247)
Balance at December 31, 2006	6,558	$ 24,053	$ (535)	$ 55,647	$ (526)	$ 78,639

Comprehensive Income	2006	2005	2004
Net income	$ 10,547	$ 10,476	$ 9,585
Change in fair value of securities available for sale, net of tax of $84, ($248), and ($132)	156	(465)	(257)
Comprehensive income	$ 10,703	$ 10,011	$ 9,328

See accompanying notes to consolidated financial statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

For the years ended December 31, 2006, 2005 and 2004

(Dollars in thousands)

	2006	2005	2004
Cash flows from operating activities:			
Net income	$ 10,547	$ 10,476	$ 9,585
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,641	1,770	1,708
Deferred loan fees, net of amortization	467	93	324
Provision for loan losses	720	810	645
Federal Home Loan Bank stock dividends		(16)	(79)
Net change in accrued interest receivable, prepaid expenses and other assets, accrued expenses and other liabilities	(2,941)	(212)	2,705
Recognition of compensation related to ESOP shares and restricted stock awards	504	402	399
Stock option compensation expense	352		
Tax benefit realized from stock options exercised and dividends on restricted stock awards	(149)		
Amortization of intangible assets	46		
Gain on sale of investment securities available for sale			(218)
Gain on sale of premises and equipment	(71)	(8)	(7)
Gain on sale of other real estate owned	(14)	(7)	(73)
Gain on sale of loans	(133)	(277)	(640)
Origination of loans held for sale	(8,593)	(13,514)	(35,185)
Proceeds from sale of loans	8,989	13,909	36,462
Deferred Federal income tax benefit	(834)	(207)	(254)
Purchase of Federal Home Loan Bank and Federal Reserve Bank stock		(109)	
Proceeds from sale of Federal Home Loan Bank and Federal Reserve Bank stock		91	3
Net cash provided by operating activities	10,531	13,201	15,375
Cash flows from investing activities:			
Loans originated, net of principal payments	(56,551)	(53,903)	(79,309)
Purchase of Western Washington Bancorp, net of cash acquired	(2,031)		
Proceeds from other real estate owned	430	183	571
Maturities of investment securities available for sale	6,884	6,781	26,829
Sales of investment securities available for sale	2,248		243
Maturities of investment securities held to maturity	503	638	691
Purchase of investment securities available for sale	(1,237)	(3,421)	(17,643)
Purchase of investment securities held to maturity	(415)	(3,146)	
Proceeds from redemption of Federal Reserve Bank stock	141		
Purchase of premises and equipment	(1,516)	(738)	(1,158)
Proceeds from sale of premises and equipment	146	13	11
Net cash used in investing activities	(51,398)	(53,593)	(69,765)
Cash flows from financing activities:			
Net increase in deposits	45,135	49,226	45,446
Net increase (decrease) in borrowed funds	(4,461)	(1,000)	9,800
Proceeds from issuance of long-term debt	3,700		
Repayments of long-term debt	(554)		
Cash dividends paid	(5,069)	(4,291)	(3,744)
Exercise of stock options	984	726	1,008
Tax benefit realized from stock options exercised and dividends on restricted stock awards	149		
Repurchase of common stock	(588)	(1,606)	(8,307)
Net cash provided by financing activities	39,296	43,055	44,203

Net increase (decrease) in cash and cash equivalents	(1,571)	2,663	(10,187)
Cash and cash equivalents at beginning of year	28,002	25,339	35,526
Cash and cash equivalents at end of year	$ 26,431	$ 28,002	$ 25,339
Supplemental disclosures of cash flow information:			
Cash payments for:			
Interest expense	$ 19,119	$ 11,217	$ 6,902
Federal income taxes	6,376	5,126	4,583
Supplemental disclosure of noncash investing and financing activities:			
Loans transferred to real estate owned	$ 45	$ 547	$ 39
Elimination of unearned compensation restricted stock awards	527		
Stock dividend		6,316	
Tax benefit from nonqualified stock options		113	61

See accompanying notes to consolidated financial statements.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Dollars in thousands, except per share amounts)

(1) Summary of Significant Accounting Policies

(a) *Description of Business*

Heritage Financial Corporation (the Company) is a bank holding company incorporated in the State of Washington in August 1997. The Company is primarily engaged in the business of planning, directing and coordinating the business activities of its wholly owned subsidiaries: Heritage Bank and Central Valley Bank. Heritage Bank is a Washington-chartered commercial bank whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC) under the Deposit Insurance Fund (DIF). Heritage Bank conducts business from its main office in Olympia, Washington and its twelve branch offices located in Thurston, Pierce and Mason Counties. Central Valley Bank is a Washington-chartered commercial bank whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC) under the Deposit Insurance Fund (DIF). Central Valley Bank conducts business from its main office in Toppenish, Washington, and its five branch offices located in Yakima and Kittitas Counties.

The Company s business consists primarily of lending and deposit relationships with small businesses including agribusiness and their owners in its market area, attracting deposits from the general public and originating for sale or investment purposes first mortgage loans on residential properties located in western and central Washington. The Company also makes residential construction loans, income property loans and consumer loans.

(b) *Basis of Presentation*

The accounting and reporting policies of the Company and its subsidiaries conform to U.S. generally accepted accounting principles. In preparing the consolidated financial statements, management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of financial statements and the reported amounts of income and expense during the reporting periods. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses. Actual results could differ from these estimates.

The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions among the Company and its subsidiaries have been eliminated in consolidation.

Certain amounts in the consolidated financial statements for prior years have been reclassified to conform to the current consolidated financial statement presentation.

(c) *Cash and Cash Equivalents*

For purposes of reporting cash flows, cash and cash equivalents includes cash on hand and in banks, interest bearing deposits, and federal funds sold.

The Company is required to maintain an average reserve balance with the Federal Reserve Bank in the form of cash. For the years ended December 31, 2006 and 2005 the Company maintained adequate levels of cash to meet the Federal Reserve Bank requirement.

(d) *Investment Securities*

The Company identifies investments as held to maturity or available for sale at the time of acquisition. Securities are classified as held to maturity when the Company has the ability and positive intent to hold them to

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maturity. Securities classified as available for sale are available for future liquidity requirements and may be sold prior to maturity.

Investment securities held to maturity are recorded at cost, adjusted for amortization of premiums or accretion of discounts using the interest method. Securities available for sale are carried at fair value. Unrealized gains and losses on securities available for sale are excluded from earnings and are reported in other comprehensive income. Realized gains and losses on sale are computed on the specific identification method.

A decline in the market value of any available for sale or held to maturity security below cost that is deemed to be other than temporary results in a reduction in carrying amount to fair value, a charge to earnings and an establishment of a new cost basis for the security. Unrealized investment securities losses are evaluated at least quarterly to determine whether such declines in value should be considered other than temporary and therefore be subject to immediate loss recognition in income. Although these evaluations involve significant judgment, an unrealized loss in the fair value of a debt security is generally deemed to be temporary when the fair value of the security is below the carrying value primarily due to changes in interest rates, there has not been significant deterioration in the financial condition of the issuer, and the Company has the intent and ability to hold the security for a sufficient time to recover the carrying value. An unrealized loss in the value of an equity security is generally considered temporary when the fair value of the security is below the carrying value primarily due to current market conditions and not deterioration in the financial condition of the issuer, and the Company has the intent and ability to hold the security for a sufficient time to recover the carrying value. Other factors that may be considered in determining whether a decline in the value of either a debt or an equity security is other than temporary include ratings by recognized rating agencies; actions of commercial banks or other lenders relative to the continued extension of credit facilities to the issuer of the security; the financial condition, capital strength and near-term prospects of the issuer and recommendations of investment advisors or market analysts.

(e) *Loans Receivable and Loans Held for Sale*

Loans are generally recorded at their outstanding principal balance adjusted for charge-offs, the allowance for loan losses and deferred fees or any costs on originated loans. Interest on loans is calculated using the simple interest method based on the daily balance of the principal amount outstanding and is credited to income as earned.

The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the credit is well secured and in the process of collection. Credit card loans and other personal loans are typically charged-off no later than 180 days past due. In all cases, loans are placed on non-accrual or charged-off at an earlier date if collection of principal or interest is doubtful.

All interest accrued but not collected on loans that are placed on non-accrual or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Discounts and premiums on purchased loans are amortized using the effective interest method over the remaining contractual lives, adjusted for actual prepayments. Mortgage loans held for sale are carried at the lower of amortized cost or market value determined on an aggregate basis. Any loan that management determines will not be held to maturity is classified as held for sale at the time of origination, purchase or securitization, or when such decision is made. Unrealized losses on such loans are included in income.

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(f) *Loan Fees*

Loan origination fees and certain direct origination costs are deferred and amortized as an adjustment of the yields of the loans over their contractual lives, adjusted for prepayment of the loans, using the effective interest method. In the event loans are sold, the deferred net loan origination fees or costs are recognized as a component of the gains or losses on the sales of loans.

(g) *Allowance for Loan Losses*

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management s periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, historical loss considerations, adverse situations that may affect the borrower s ability to repay, estimated value of any underlying collateral and prevailing economic conditions. The evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available.

While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank s allowance for loan losses. Such agencies may require the Bank to make adjustments to the allowance based on their judgments about information available to them at the time of their examinations.

(h) *Impaired Loans*

A loan is considered impaired when, based on current information and events, it is probable the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrowers, including length of the delay, the reasons for the delay, the borrower s prior payment record, and the amounts of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan s effective interest rate, the loan s obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment purposes.

(i) *Mortgage Banking Operations*

The Company sells mortgage loans on a servicing released basis and recognizes a cash gain or loss. A cash gain or loss is recognized to the extent that the sales proceeds of the mortgage loans sold exceed or are less than

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the net book value at the time of sale. Income from mortgage loans brokered to other lenders is recognized into income on date of loan closing.

Commitments to sell mortgage loans are made primarily during the period between the taking of the loan application and the closing of the mortgage loan. The timing of making these sale commitments is dependent upon the timing of the borrower s election to lock-in the mortgage interest rate and fees prior to loan closing. Most of these sale commitments are made on a best-efforts basis whereby the Bank is only obligated to sell the mortgage if the mortgage loan is approved and closed by the Bank. As a result, management believes that market risk is minimal.

Loan servicing income is recorded when earned. Loan servicing costs are charged to expense as incurred.

(j) *Real Estate and Other Assets Owned*

Real estate and other assets acquired by the Company in satisfaction of debt are held for sale and recorded at fair value at time of foreclosure and are carried at the lower of the new cost basis or fair value less estimated costs to sell.

(k) *Premises and Equipment*

Premises and equipment, including leasehold improvements, are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets or the lease period, whichever is shorter. The estimated useful lives used to compute depreciation and amortization for buildings and building improvements is 15 to 39 years; and for furniture, fixtures and equipment is 3 to 7 years. The Company reviews buildings, leasehold improvements and equipment for impairment whenever events or changes in the circumstances indicate that the undiscounted cash flows for the property are less than its carrying value. If identified, an impairment loss is recognized through a charge to earnings based on the fair value of the property.

(l) *Goodwill*

Goodwill represents the costs in excess of net assets acquired arising from the purchases of North Pacific Bank and Western Washington Bancorp. Goodwill is not amortized, but is reviewed for impairment and written down and charged to income during the periods in which the recorded value is more than its implied value. The Company evaluates any potential impairment of goodwill on an annual basis at the Heritage Bank level. The Company has evaluated goodwill and concluded there is no goodwill impairment for the years ended December 31, 2006, 2005 or 2004.

(m) *Intangible Assets*

The intangible assets represent the core deposit intangible arising from the purchase of Western Washington Bancorp. The core deposit intangible is being amortized to non-interest expense on a straight-line basis over 8 years. Amortization expense related to the core deposit intangible was $46,000 for the year ended December 31, 2006.

(n) *Federal Income Taxes*

The Company files a consolidated federal income tax return. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying

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amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the periods in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rate is recognized in income in the period that includes the enactment date.

(o) *Employee Stock Ownership Plan*

The Company sponsors an Employee Stock Ownership Plan (ESOP). The ESOP purchased 2% of the common stock issued in a January 1998 stock offering and borrowed from the Company in order to fund the purchase of the Company s common stock. The loan to the ESOP will be repaid principally from the Bank s contributions to the ESOP. The Bank s contributions will be sufficient to service the debt over the 15-year loan term at the interest rate of 8.5%. As the debt is repaid, shares are released and allocated to plan participants based on the proportion of debt service paid during the year. As shares are released, compensation expense is recorded equal to the then current market price of the shares and the shares become outstanding for earnings per share calculations. Cash dividends on allocated shares are recorded as a reduction of retained earnings and paid or distributed directly to participants accounts. Cash dividends on unallocated shares are recorded as a reduction of debt and accrued interest.

(p) *Share Based Payment*

The Company maintains a number of stock-based incentive programs, which are discussed in more detail in Note 13. Prior to 2006, the Company applied the intrinsic value-based method, as outlined in Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, (APB No. 25) and related interpretations, in accounting for stock options granted under these programs. Under the intrinsic value-based method, no compensation expense was recognized if the exercise price of the Company s employee stock options equaled the market price of the underlying stock on the date of the grant. Accordingly, prior to 2006, no compensation cost was recognized in the accompanying consolidated statements of income on stock options granted to employees, since all options granted under the Company s share incentive programs had an exercise price equal to the market value of the underlying common stock on the date of the grant.

Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123R (SFAS No. 123R) Share-based Payment. This statement replaces SFAS No. 123, Accounting for Stock-Based Compensation, and supersedes APB No. 25. SFAS No. 123R requires that all stock-based compensation be recognized as an expense in the financial statements and that such cost be measured at the fair value of the award on the grant date. This statement was adopted using the modified prospective method of application, which requires the Company to recognize compensation expense on a prospective basis. Therefore, prior period financial statements have not been restated. Under this method, in addition to reflecting compensation expense for new share-based awards, expense is also recognized to reflect the remaining service period of awards that had been included in pro forma disclosures in prior periods.

Total stock-based compensation expense (excluding ESOP expense) for the year ended December 31, 2006 was $611,000 ($502,000 after tax), or $0.08 for basic and diluted earnings per share. Included in this expense is $352,000 ($334,000 after tax), or $0.05 for basic and diluted earnings per share attributable to the Company s adoption of SFAS 123R. As of December 31, 2006, the total unrecognized compensation expense related to non-vested stock awards was $686,000 and the related weighted average period over which it is expected to be recognized is approximately 1.8 years.

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The following table illustrates the effect on net income and earnings per share as if SFAS 123R had been applied to all outstanding awards for the years ended December 31 (dollars in thousands, except per share amounts):

	2005	2004
Net income:		
As reported	$ 10,476	$ 9,585
Plus compensation costs recognized under ABP No. 25, net of taxes	135	143
Less SFAS No. 123R compensation costs, net of taxes	(392)	(325)
Pro forma	$ 10,219	$ 9,403
Basic earnings per share:		
As reported	$ 1.69	$ 1.53
Plus compensation costs recognized under ABP No. 25, net of taxes	0.02	0.02
Less SFAS No. 123R compensation costs, net of taxes	(0.06)	(0.05)
Pro forma	$ 1.65	$ 1.50
Diluted earnings per share:		
As reported	$ 1.65	$ 1.49
Plus compensation costs recognized under ABP No. 25, net of taxes	0.02	0.02
Less SFAS No. 123 compensation costs, net of taxes	(0.06)	(0.05)
Pro forma	$ 1.61	$ 1.46

The fair value of options granted during the year ended December 31, 2006, 2005 and 2004 is estimated on the date of grant using the Black-Scholes option pricing model based on the assumptions noted in the following table. The expected term of share options is derived from historical data and represents the period of time that share options granted are expected to be outstanding. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant. Expected volatility is based on historical volatility of Company shares. Expected dividend yield is based on dividends expected to be paid during the expected term of the share options.

Grant period ended	Weighted Average Risk Free Interest Rate	Expected Term in years	Expected Volatility	Expected Dividend Yield	Weighted Average Fair Value
December 31, 2006	4.93%	4.50	20%	3.69%	$ 4.17
December 31, 2005	3.91%	6.00	20%	4.32%	$ 2.87
December 31, 2004	2.99%	6.00	20%	4.31%	$ 2.45

(q) *Recently Issued Accounting Pronouncements*

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainties in Income Taxes, an Interpretation of FASB Statement No. 109* (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on

derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company is currently assessing the impact of adopting the new pronouncement, which will become effective January 1, 2007, but it is not expected to have a material impact.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value under Generally Accepted Accounting Principles (GAAP),

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and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Management is assessing the impact of adoption of SFAS 157 on the Company s consolidated financial statements.

(2) Loans Receivable and Loans Held for Sale

Loans receivable and loans held for sale at December 31, 2006 and 2005 consist of the following:

	2006	2005
Commercial loans	$ 440,450	$ 359,808
Real estate mortgages:		
One to four family residential	58,911	53,098
Five or more family residential and commercial real estate	172,937	164,788
Total real estate mortgage	231,848	217,886
Real estate construction:		
One to four family residential	53,298	42,245
Five or more family residential and commercial real estate	13,532	21,355
Total real estate construction	66,830	63,600
Consumer	12,976	12,855
Subtotal	752,104	654,149
Deferred loan fees and other	(2,403)	(1,852)
Total loans receivable and loans held for sale	$ 749,701	$ 652,297

As of December 31, 2006 and 2005, the Company had loans to persons serving as Directors and Executive Officers, and entities related to such individuals, aggregating $16,401 and $15,620, respectively. All loans were made on essentially the same terms and conditions as comparable transactions with other persons, and did not involve more than the normal risk of collectibility. The Company did not have any borrowings from Directors or Executive Officers at December 31, 2006.

Potential problem loans as of December 31, 2006 and 2005 were $5,509 and $9,882, respectively. Potential problem loans are those loans that are currently accruing interest, but which are considered possible credit problems because financial information of the borrowers causes concern as to their ability to comply with the present repayment program and could result in placing the loan on nonaccrual.

Accrued interest on loans receivable amounted to $4,027 and $3,322 as of December 31, 2006 and 2005, respectively. The Company had $2,807 and $836 of impaired loans, which were nonaccruing as of December 31, 2006 and 2005, respectively. The annual average balance of impaired loans for the years ended December 31, 2006, 2005 and 2004 were $2,226, $658 and $433, respectively. The allowance for loan losses related to impaired loans at December 31, 2006 and 2005 totaled $494 and $125, respectively. There was no interest recognized on impaired loans for the year ended December 31, 2006 and 2005. Interest recognized on impaired loans for the year ended December 31, 2004 totaled $23.

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Details of certain mortgage banking activities at December 31, 2006 and 2005 are as follows:

	2006	2005
Loans held for sale at lower of cost or market	$	$ 263
Loans serviced for others	452	658
Total loans sold	8,856	13,632
Commitments to sell mortgage loans		563
Commitments to fund mortgage loans (at interest rates approximating market rates)		
Fixed rate		92
Variable or adjustable rate		

Servicing fee income from mortgage loans serviced for others amounted to $2, $4 and $10 for the years ended December 31, 2006, 2005 and 2004, respectively.

As of December 31, 2006, the Company had commitments of $102,368 in other commercial lines of credit, $101,287 in real estate commitments (both construction and lines of credit), and $6,275 in other commitments (including consumer credit lines and letters of credit).

(3) Allowance for Loan Losses

Activity in the allowance for loan losses is summarized as follows for the years ended December 31:

	2006	2005	2004
Balance at beginning of period	$ 8,496	$ 8,295	$ 7,748
Provision	720	810	645
Allowance acquired through acquisition	749		
Recoveries	304	82	11
Charge offs	(164)	(691)	(109)
Balance at end of period	$ 10,105	$ 8,496	$ 8,295

The allocation of the allowance for loan losses is summarized as follows for the years ended December 31:

	2006		2005		2004	
	Amount	% of Total Loans (1)	Amount	% of Total Loans (1)	Amount	% of Total Loans (1)
	(Dollars in thousands)					
Commercial	$ 7,273	58.6%	$ 6,117	55.0%	$ 5,971	55.9%
Real Estate Mortgage						
One-four family residential	398	7.8%	335	8.1%	327	9.8%

Five or more family residential and commercial properties	1,708	23.0%	1,435	25.2%	1,402	25.4%
Real Estate Construction:						
One-four family residential	547	7.1%	460	6.4%	449	3.9%
Five or more family residential and commercial properties	41	1.8%	34	3.3%	34	2.8%
Consumer	138	1.7%	115	2.0%	112	2.2%
Total allowance	$ 10,105	100.0%	$ 8,496	100.0%	$ 8,295	100.0%

(1) Represents the total of all outstanding loans in each category as a percent of total loans outstanding.

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(4) Investment Securities Available For Sale

The amortized cost and fair values of investment securities available for sale at the dates indicated are as follows:

	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
December 31, 2006				
U.S. Government agencies	$ 18,539	$ 27	$ (224)	$ 18,342
Mortgage backed and related securities:				
Collateralized mortgage obligations and mortgage backed securities	10,390	12	(325)	10,077
Other related securities	11,003		(298)	10,705
Totals	$ 39,932	$ 39	$ (847)	$ 39,124
December 31, 2005				
U.S. Government agencies	$ 19,797	$ 12	$ (393)	$ 19,416
Mortgage backed and related securities:				
Collateralized mortgage obligations and mortgage backed securities	12,105	22	(414)	11,713
Other related securities	11,003		(276)	10,727
Totals	$ 42,905	$ 34	$ (1,083)	$ 41,856

Investments with unrealized losses as of December 31, 2006 are as follows:

	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Government agencies	$ 815	$ 1	$ 14,170	$ 233	$ 14,985	$ 234
Mortgage backed and related securities	730	8	20,366	630	21,096	638
Total temporarily impaired securities	$ 1,545	$ 9	$ 34,536	$ 863	$ 36,081	$ 872

Investments with unrealized losses as of December 31, 2005 are as follows:

	Less than 12 months	12 months or longer	Total

	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Government agencies	$ 2,900	$ 32	$ 15,870	$ 375	$ 18,770	$ 407
Mortgage backed and related securities	5,268	126	17,594	583	22,862	709
Total temporarily impaired securities	$ 8,168	$ 158	$ 33,464	$ 958	$ 41,632	$ 1,116

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Because the declines in fair value were due to changes in market interest rates, not in estimated cash flows, and because we have the intent and ability to retain our investment in the issuer for a period of time to allow for any anticipated recovery in market value, no other-than-temporary impairment has been recorded.

The amortized cost and fair value of securities available for sale, by contractual maturity, at December 31, 2006 are shown below:

	Amortized cost	Fair value
Due in one year or less	$ 16,201	$ 15,884
Due after one year through three years	11,938	11,758
Due after three through five years	767	757
Due after five years through ten years	2,518	2,483
Due after ten years	8,508	8,242
Totals	$ 39,932	$ 39,124

Sales of investment securities available for sale during the year ended December 31, 2006 did not result in a recognized gain or loss. There were no sales of investment securities available for sale during the year ended December 31, 2005. During the year ended December 31, 2004 there were sales of investment securities available for sale resulting in a $218 gain.

Accrued interest on investment securities available for sale amounted to $219 and $211 as of December 31, 2006 and 2005, respectively.

At December 31, 2006 and 2005, investment securities available for sale with fair values of $13,149 and $13,043, respectively, were pledged to secure public deposits and for other purposes as required or permitted by law.

We had no securities classified as trading at December 31, 2006 or 2005.

(5) Investment Securities Held to Maturity

The amortized cost and fair values of investment securities held to maturity are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair value
December 31, 2006				
U.S. Government agencies	$ 905	$	$ (9)	$ 896
Mortgage backed securities:				
FNMA certificates	1			1
FHLMC certificates	501	1	(7)	495
GNMA certificates	751	8	(8)	751
Municipal bonds	1,700	19	(1)	1,718

	$ 3,858	$ 28	$ (25)	$ 3,861
December 31, 2005				
U.S. Government agencies	$ 980	$	$ (12)	$ 968
Mortgage backed securities:				
FNMA certificates	17	1		18
FHLMC certificates	515	2	(9)	508
GNMA certificates	939	14	(10)	943
Municipal bonds	1,515	12	(2)	1,525
	$ 3,966	$ 29	$ (33)	$ 3,962

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The amortized cost and fair value of investment securities held to maturity, by contractual maturity, at December 31, 2006 are shown below:

	Amortized cost	Fair value
Due in one year or less	$ 100	$ 101
Due after one year through three years	240	243
Due after three years through five years	595	587
Due after five years	2,923	2,930
Totals	$ 3,858	$ 3,861

There were no sales of investment securities held to maturity during the years ended December 31, 2006, 2005 and 2004.

Accrued interest on investment securities held to maturity amounted to $28 and $22 as of December 31, 2006 and 2005, respectively.

At December 31, 2006 and 2005, investment securities held to maturity with amortized cost values of $1,467 and $1,412, respectively, were pledged to secure public deposits and for other purposes as required or permitted by law.

(6) Premises and Equipment

A summary of premises and equipment at December 31, 2006 and 2005 follows:

	2006	2005
Land	$ 4,471	$ 4,527
Buildings and building improvements	19,097	18,182
Furniture, fixtures and equipment	12,250	12,020
	35,818	34,729
Less accumulated depreciation	20,137	18,928
	$ 15,681	$ 15,801

Total depreciation expense on premises and equipment was $1,656, $1,815 and $1,708 for the years ended December 31, 2006, 2005 and 2004, respectively.

The Bank leases premises and equipment under operating leases. Rental expense of leased premises and equipment was $598, $446, and $410 for December 31, 2006, 2005 and 2004, respectively, which is included in premises and equipment expense.

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Minimum net rental commitments under noncancellable leases having an original or remaining term of more than one year for future years ending December 31 are as follows (in thousands):

2007	$ 532
2008	388
2009	327
2010	342
2011	321
Thereafter	1,325
	$ 3,235

Certain leases contain renewal options from five to ten years and escalation clauses based on increases in property taxes and other costs.

(7) Deposits

Deposits consist of the following at December 31:

	2006		2005	
	Amount	Percent	Amount	Percent
Non interest demand deposits	$ 107,477	14.8%	$ 88,015	13.8%
NOW accounts	112,728	15.5	96,538	15.2
Money market accounts	87,649	12.1	80,451	12.6
Savings accounts	90,090	12.4	88,149	13.9
Certificate of deposit accounts	327,977	45.2	283,351	44.5
	$ 725,921	100.0%	$ 636,504	100.0%

Accrued interest payable on deposits was $1,292 and $854 at December 31, 2006 and 2005, respectively and is included in accrued expenses and other liabilities in the consolidated statements of financial condition. Interest expense, by category, is as follows for the years ended December 31:

	2006	2005	2004
NOW accounts	$ 1,423	$ 731	$ 461
Money market accounts	2,831	1,521	1,454
Savings accounts	1,087	587	332
Certificate of deposit accounts	12,902	7,755	4,477
	$ 18,243	$ 10,594	$ 6,724

Scheduled maturities of certificates of deposit for future years ending December 31 are as follows:

2007	$ 301,219
2008	19,864
2009	4,622
2010	1,772
2011	500
	$ 327,977

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Certificates of deposit issued in denominations equal to or in excess of $100 totaled $176,892 and $146,318 at December 31, 2006 and 2005, respectively.

(8) FHLB Advances and Stock

The Federal Home Loan Bank of Seattle (FHLB) functions as a central reserve bank providing credit for member financial institutions. Advances are made pursuant to several different programs. Each credit program has its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based either on a fixed percentage of an institution s net worth or on the FHLB s assessment of the institution s creditworthiness. At December 31, 2006, our banks maintained credit facilities with the FHLB of Seattle for $155,308 with an outstanding balance of $37,167.

Our banks are required to maintain an investment in the stock of the FHLB in an amount equal to at least the greater of $0.5 or 0.75% of residential mortgage loans and pass-through securities plus 3.5% of its outstanding advances from the FHLB and 5.0% of the outstanding balance of mortgage loans sold to the FHLB. At December 31, 2006, the Company was required to maintain an investment in the stock of FHLB of Seattle of at least $1,456. The Company maintained $3,227 in FHLB stock at December 31, 2006. Purchases and sales of stock are transacted directly with the FHLB at par value.

A summary of FHLB Advances is summarized as follows:

	2006	2005
Balance at period end, due less than 12 months	$ 37,167	$ 39,900
Average balance	20,682	28,269
Maximum amount outstanding at any month end	47,145	48,800
Average interest rate:		
During the period	5.19%	3.29%
At period end	5.63%	4.33%

At December 31, 2006 and 2005, the Company had $35,200 and $39,900, respectively, in overnight advances from the FHLB.

Advances from the FHLB are collateralized by a blanket pledge on FHLB stock owned by the Company, deposits at the FHLB and all mortgages or deeds of trust securing such properties. In accordance with the pledge agreement, the Company must maintain unencumbered collateral in an amount equal to varying percentages ranging from 100% to 125% of outstanding advances depending on the type of collateral. At December 31, 2006, the Company was required to maintain $107,410 in collateral to meet the collateral requirements of FHLB.

(9) Federal Funds Purchased

Our subsidiary banks maintain advance lines to purchase federal funds totaling $29,800. The lines generally mature annually with the exception of one of the lines with U.S. Bank in the amount of $2,800, which does not mature. As of December 31, 2006 there were no overnight federal funds purchased.

(10) Borrowings

The Company maintains a line of credit for $5,000 with Key Bank, which is renewed annually, and currently matures in March 2007. As of December 31, 2006, the balance of this line of credit was $225.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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During 2006, the Company entered into a loan agreement with Key Bank in the amount of $3,700. The terms of the loan include quarterly payments of $345, interest at 6.8% and maturing July 2009. The balance outstanding at December 31, 2006 was $3,146. Principal reductions due for future years ending December 31 are as follows:

2007	$ 888
2008	1,257
2009	1,001
	$ 3,146

(11) Federal Income Taxes

Federal income tax expense (benefit) consists of the following for the years ended December 31:

	2006	2005	2004
Current	$ 6,437	$ 5,249	$ 4,979
Deferred	(1,060)	(207)	(254)
	$ 5,377	$ 5,042	$ 4,725

Federal income tax expense differs from that computed by applying the Federal statutory income tax rate of 35% for the years ended December 31:

	2006	2005	2004
Income tax expense at Federal statutory rate	$ 5,573	$ 5,431	$ 5,009
Tax exempt interest	(296)	(300)	(159)
Other, net	100	(89)	(125)
	$ 5,377	$ 5,042	$ 4,725

The following table presents major components of the deferred Federal income tax asset (liability) resulting from differences between financial reporting and tax bases for the years ended December 31:

	2006	2005
Deferred tax assets:		
Allowance for loan losses	$ 3,466	$ 2,974
Accrued compensation	157	210
Other	278	182

Unrealized loss on available for sale securities	283	367
Total deferred tax assets	4,184	3,733
Deferred tax liabilities:		
Deferred loan fees	(669)	(704)
Premises and equipment	(476)	(981)
FHLB stock	(797)	(782)
Total deferred tax liabilities	(1,942)	(2,467)
Deferred Federal income tax asset, net	$ 2,242	$ 1,266

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands, except per share amounts)

The Company has qualified under provisions of the Internal Revenue Code to compute federal income taxes after deductions of additions to the bad debt reserves. At December 31, 2006, the Company had a taxable temporary difference of approximately $2,800 that arose before 1988 (base-year amount). In accordance with Statement of Financial Accounting Standards No. 109, a deferred tax liability has not been recognized for the temporary difference. Management does not expect this temporary difference to reverse in the foreseeable future.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management expects to realize the benefits of these deductible differences.

(12) Stockholders Equity

(a) *Stock Repurchase Program*

The board of directors of the Company has authorized the repurchase in the open market of 309,750 of its outstanding common shares. This is the eighth repurchase program authorized by the board of directors. The current program commenced in July 2004, with 111,139 shares, or 35.9%, repurchased as of December 31, 2006. On January 25, 2006, the Board of Directors authorized an eighteen month extension to this program. Collectively as of December 31, 2006, the Company has repurchased 5,959,105 shares of our stock representing 52.3% of the total outstanding as of March 31, 1999 at an average price of $12.20.

(b) *Earnings Per Common Share*

The following table illustrates the reconciliation of weighted average shares used for earnings per share computations for the years ended December 31:

	2006	2005	2004
Basic:			
Basic weighted average shares outstanding	6,449,967	6,253,084	6,306,680
Less restricted stock awards	(74,908)	(63,587)	(58,262)
Total basic weighted average shares outstanding	6,375,059	6,189,497	6,248,418
Diluted:			
Basic weighted average shares outstanding	6,375,059	6,189,497	6,248,418
Incremental shares from stock options and restricted stock awards	214,322	173,505	181,114
Weighted average shares outstanding	6,589,381	6,363,002	6,429,532

For purposes of calculating basic and diluted EPS, the numerator of net income is the same.

At December 31, 2006, there were 108,000 anti-dilutive outstanding options to purchase common stock. There were no anti-dilutive outstanding options to purchase common stock at December 31, 2005 or 2004.

(c) *Cash Dividend Declared*

On December 20, 2006, the Company announced a quarterly cash dividend of 21.0 cents per share payable on January 31, 2007, to shareholders of record on January 15, 2007.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands, except per share amounts)

(d) *Restrictions on Dividends*

Dividends from the Company depend, in part, upon receipt of dividends from its subsidiary banks because the Company currently has no source of income other than dividends from Heritage Bank and Central Valley Bank.

The FDIC and the Washington State Department of Financial Institutions (DFI) have the authority under their supervisory powers to prohibit the payment of dividends by Heritage Bank and Central Valley Bank to the Company. For a period of ten years after the January 1998 stock conversion (Conversion), Heritage Bank may not, without prior approval of the DFI, declare or pay a cash dividend in an amount in excess of one-half of the greater of (i) the Bank s net income for the current fiscal year or (ii) the average of the Bank s net income for the current fiscal year and the retained earnings of the two prior fiscal years. In addition, Heritage Bank may not declare or pay a cash dividend on its common stock if the effect thereof would be to reduce the net worth of the Bank below the amount required for the liquidation account established at the time of Conversion in an amount equal to the Bank s retained earnings at Conversion. Other than the specific restrictions mentioned above, current regulations allow the Company and its subsidiary banks to pay dividends on their common stock if the Company s or Bank s regulatory capital would not be reduced below the statutory capital requirements set by the Federal Reserve and the FDIC.

(e) *Stock Dividend*

On September 15, 2005, the board of directors of the Company declared a 5% stock dividend to shareholders of record on September 30, 2005 and distributed October 14, 2005. The stock dividend distributed an additional share of common stock for every 20 shares held on the record date. Cash was paid for any fractional shares. All share and per share amounts have been restated to reflect the stock dividend.

(13) Stock Option and Award Plans

In September 1994, Heritage Bank s stockholders approved the adoption of the 1994 stock option plan, providing for the award of a restricted stock award to a key officer, incentive stock options to employees and nonqualified stock options to directors of the Bank at the discretion of the Board of Directors. On September 24, 1996, Heritage Bank s stockholders approved the adoption of the 1997 stock option plan, which is generally similar to the 1994 plan. On October 15, 1998, the Company s stockholders approved the adoption of the 1998 stock option plan, which is similar to the 1994 and 1997 plans. The 1998 plan does not affect any options granted under the 1994 or 1997 plans. On April 25, 2002, the Company s stockholders approved the adoption of the 2002 Incentive Stock Option Plan, the 2002 Director Nonqualified Stock Option Plan and the 2002 Restricted Stock Plan, which are generally similar to the 1994, 1997 and 1998 stock plans. On April 27, 2006, the Company s stockholders approved the adoption of the 2006 Incentive Stock Option Plan, the 2006 Director Nonqualified Stock Option Plan and the 2006 Restricted Stock Plan, which are generally similar to the 1994, 1997, 1998 and 2002 stock plans.

Under these stock option plans, on the date of grant, the exercise price of the option must at least equal the market value per share of the Company s common stock. The 1994 plan provides for the grant of options and stock awards up to 362,246 shares. The 1997 plan provides for the granting of options and stock awards up to 270,333 common shares. The 1998 plan provides for the grant of stock options for up to 414,750 shares and stock awards for up to 69,431 shares. The 2002 and 2006 Incentive Stock Option plans provide for the grant of stock options for up to 451,500 and 400,000 shares, respectively. The 2002 and 2006 Director Nonqualified Stock Option Plans provide for the grant of stock options for up to 73,500 and 75,000 shares, respectively. The 2002 and 2006 Restricted Stock Plans provide for the grant of stock awards for up to 52,500 and 25,000 shares, respectively.

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(Dollars in thousands, except per share amounts)

Stock options generally vest ratably over three years and expire five years after they become exercisable which amounts to an average term of seven years. Restricted Stock awards issued have a five-year cliff vesting. The Company issues new shares to satisfy share option exercises.

The following table summarizes stock option and award activity for the years ended December 31, 2006, 2005 and 2004.

	Outstanding Options		Outstanding Awards	
	Shares	Avg. Price	Shares	Avg. Price
Balance at December 31, 2003	589,656	$ 12.49	37,800	$ 11.93
Options and awards granted	136,752	20.10	28,875	20.10
Less: Options exercised	(128,959)	7.82		
Expired or canceled	(36,654)	17.58	(2,625)	11.67
Balance at December 31, 2004	560,795	15.08	64,050	15.63
Options and awards granted	147,597	20.63	3,050	23.13
Less: Options exercised/Awards vested	(74,236)	9.77	(1,759)	11.67
Expired or canceled	(23,808)	19.80	(866)	11.67
Balance at December 31, 2005	610,348	16.88	64,475	16.15
Options and awards granted	106,500	26.04	16,000	26.05
Less: Options exercised /Awards vested	(74,412)	13.23		
Expired or canceled	(3,975)	24.81	(1,000)	27.73
Balance at December 31, 2006	638,461	$ 18.79	79,475	$ 17.99

Financial data pertaining to outstanding stock options and exercisable stock options at December 31, 2006 follows:

Exercise Price	Number of Outstanding Option Shares	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Number of Exercisable Option Shares	Weighted Average Exercise Price
$7.35 $9.67	73,742	1.1	$ 8.92	73,742	$ 8.92
$11.67	85,354	2.2	11.67	85,354	11.67
$15.19 $18.14	9,519	3.1	18.12	9,519	18.12
$20.11	103,954	4.3	20.11	66,481	20.11
$20.36	120,810	3.3	20.36	120,810	20.36
$20.50	126,042	5.2	20.50	40,110	20.50
$20.71 $24.05	14,940	5.6	21.85	4,980	21.85
$25.94 $27.32	104,100	6.3	26.00		

638,461	4.0	$ 18.79	400,996	$ 16.34

At December 31, 2006, the aggregate intrinsic value of stock options outstanding and stock options exercisable was $4.0 million and $3.4 million, respectively. The total intrinsic value of options exercised during the years ended December 31, 2006, 2005 and 2004, was $1,020,000, $852,000 and $1,574,000, respectively. The weighted average remaining contractual life of exercisable option shares as of December 31, 2006 was

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands, except per share amounts)

3.9 years. The total fair value of shares vested during the years ended December 31, 2006, 2005 and 2004 was $403,000, $339,000 and $298,000, respectively.

(14) Regulatory Capital Requirements

The Company is a bank holding company under the supervision of the Federal Reserve Bank. Bank holding companies are subject to capital adequacy requirements of the Federal Reserve under the Bank Holding Company Act of 1956, as amended, and the regulations of the Federal Reserve. Heritage Bank and Central Valley Bank are federally insured institutions and thereby subject to the capital requirements established by the Federal Deposit Insurance Corporation (FDIC). The Federal Reserve requirements generally parallel the FDIC requirements. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company s financial statements.

Pursuant to minimum capital requirements of the FDIC, Heritage Bank and Central Valley Bank are required to maintain a leverage ratio (capital to assets ratio) of 3% and risk-based capital ratios of Tier 1 capital and total capital (to total risk-weighted assets) of 4% and 8%, respectively. As of December 31, 2006 and December 31, 2005, Heritage Bank and Central Valley Bank were both classified as well capitalized institutions under the criteria established by the FDIC Act. There are no conditions or events since that notification that management believes have changed the Bank s classification as a well capitalized institution.

	Minimum Requirements		Well-capitalized Requirements		Actual	
	$	%	$	%	$	%
As of December 31, 2006:						
The Company consolidated						
Tier 1 leverage capital to average assets	$ 24,480	3%	$ 40,800	5%	$ 65,318	8.0%
Tier 1 capital to risk-weighted assets	28,683	4	43,025	6	65,318	9.1
Total capital to risk-weighted assets	57,367	8	71,709	10	74,296	10.4
Heritage Bank						
Tier 1 leverage capital to average assets	20,958	3	34,930	5	58,148	8.3
Tier 1 capital to risk-weighted assets	25,271	4	37,906	6	58,148	9.2
Total capital to risk-weighted assets	50,542	8	63,177	10	66,060	10.5
Central Valley Bank						
Tier 1 leverage capital to average assets	3,505	3	5,842	5	10,497	9.0
Tier 1 capital to risk-weighted assets	3,432	4	5,147	6	10,497	12.2
Total capital to risk-weighted assets	6,863	8	8,579	10	11,486	13.4
As of December 31, 2005:						
The Company consolidated						
Tier 1 leverage capital to average assets	$ 21,862	3%	$ 36,437	5%	$ 59,983	8.2%
Tier 1 capital to risk-weighted assets	25,252	4	37,878	6	59,983	9.5
Total capital to risk-weighted assets	50,504	8	63,130	10	67,882	10.8
Heritage Bank						
Tier 1 leverage capital to average assets	18,531	3	30,886	5	50,064	8.1
Tier 1 capital to risk-weighted assets	21,946	4	32,919	6	50,064	9.1
Total capital to risk-weighted assets	43,893	8	54,866	10	56,932	10.4
Central Valley Bank						
Tier 1 leverage capital to average assets	3,323	3	5,538	5	9,205	8.3

Tier 1 capital to risk-weighted assets	3,315	4	4,973	6	9,205	11.1
Total capital to risk-weighted assets	6,631	8	8,288	10	10,023	12.1

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands, except per share amounts)

(15) Employee Benefit Plans

Effective October 1, 1999 the Company combined three retirement plans, a money purchase pension plan, a 401k plan, and an employee stock ownership plan (ESOP) at Heritage Bank, and the 401k plan at Central Valley Bank into one plan called the Heritage Financial Corporation 401(k) Employee Stock Ownership Plan (KSOP). Effective April 1, 2002 the Company added three investment funds to the plan as well as changed the eligibility requirements to the plan. At this same time the Company approved an amendment of the plan to reflect certain provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

The pension portion of the KSOP is a defined contribution retirement plan. The plan provides a contribution to all eligible participants upon completion of one year of service, the attainment of 21 years of age, and employment on the last day of the year. It is the Company s policy to fund plan costs as accrued. Employee vesting occurs over a period of seven years, at which time they become fully vested. Charges of $403, $405 and $355 are included in the consolidated statements of income for the years ended December 31, 2006, 2005 and 2004, respectively.

The KSOP also maintains the Company s salary savings 401(k) plan for its employees. All persons employed as of July 1, 1984 automatically participate in the plan. All employees hired after that date who are at least 21 years of age and with three continuous months of service and at least 250 hours of service to the Company may participate in the plan. Employees who participate may contribute a portion of their salary, which is matched by the employer at 50% up to certain specified limits. Employee vesting in employer portions is similar to the retirement plan described above for the period prior to December 31, 2001. Employee vesting in employer portions occurs over a period of six years for those contributions made after January 1, 2003. Employer contributions for the years ended December 31, 2006, 2005 and 2004 were $241, $208 and $205, respectively.

The third portion of the KSOP is the employee stock ownership plan (ESOP). Heritage Bank established for eligible employees the ESOP and related trust effective July 1, 1994, which became active upon the former mutual holding company s conversion to a stock-based holding company in January 1995. The plan provides a contribution to all eligible participants upon completion of one year of service, the attainment of 21 years of age, and employment on the last day of the year. The ESOP is funded by employer contributions in cash or common stock. Employee vesting occurs over a period of seven years.

In January 1998, the ESOP borrowed $1,323 from the Company to purchase additional common stock of the Company. The loan will be repaid principally from the subsidiary bank s contributions to the ESOP over a period of fifteen years. The interest rate on the loan is 8.5% per annum. ESOP compensation expense was $242, $192 and $198 for the years ended December 31, 2006, 2005 and 2004, respectively.

For the year ended December 31, 2006, the Company has allocated or committed to be released to the ESOP 9,257 earned shares and has 56,317 unearned, restricted shares remaining to be released. The fair value of unearned, restricted shares held by the ESOP trust was $1,397 at December 31, 2006.

(a) *Severance Agreements*

The Company has entered into contracts with certain senior officers that provide benefits under certain conditions following termination without cause, and/or following a change of control of the Company.

(16) Fair Value of Financial Instruments

Because broadly traded markets do not exist for most of the Company s financial instruments, the fair value calculations attempt to incorporate the effect of current market conditions at a specific time. Fair valuations are

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

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management s estimates of values. These determinations are subjective in nature, involve uncertainties and matters of significant judgment and do not include tax ramifications; therefore, the results cannot be determined with precision, substantiated by comparison to independent markets and may not be realized in an actual sale or immediate settlement of the instruments. There may be inherent weaknesses in any calculation technique, and changes in the underlying assumptions used, including discount rates and estimates of future cash flows, could significantly affect the results. For all of these reasons, the aggregation of the fair value calculations presented herein do not represent, and should not be construed to represent, the underlying value of the Company.

(a) *Financial Instruments With Book Value Equal to Fair Value*

The fair value of financial instruments that are short-term or reprice frequently and that have little or no risk are considered to have a fair value equal to book value.

(b) *Investment Securities*

The fair value of all investment securities excluding the Federal Home Loan Bank of Seattle (FHLB) and the Federal Reserve stock was based upon quoted market prices. The FHLB and Federal Reserve stock is not publicly traded, however it may be redeemed on a dollar-for-dollar basis for any amount the Bank is not required to hold. The fair value is therefore equal to the book value.

(c) *Loans*

For most loans, fair value is estimated using the Company s lending rates that would have been quoted on December 31, 2006 for loans, which mirror the attributes of the loans with similar rate structures and average maturities. Commercial loans and construction loans, which are variable rate and short-term are reflected with fair values equal to book value.

(d) *Deposits*

For deposits with no contractual maturity, the fair value is equal to the book value. The fair value of fixed maturity deposits is based on discounted cash flows using the difference between the deposit rate and an alternative cost of funds rate.

(e) *FHLB Advances*

The fair value of FHLB advances are estimated based on discounting the future cash flows using the rate currently offered on similar borrowings with similar maturities.

(f) *Commitments to Extend Credit and Standby Letters of Credit*

The majority of our commitments to extend credit and standby letters of credit carry current market interest rates if converted to loans. Because these commitments are generally unassignable by either the borrower or us, they only have value to the borrower and us.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands, except per share amounts)

The table below presents the book value amount of the Bank s financial instruments and their corresponding fair values:

	December 31, 2006		December 31, 2005	
	Book value	Fair value	Book value	Fair value
Financial Assets				
Cash on hand and in banks	$ 23,713	$ 23,713	$ 24,972	$ 24,972
Interest earning deposits	2,718	2,718	3,030	3,030
Investment securities available for sale	39,124	39,124	41,856	41,856
Investment securities held to maturity	3,858	3,861	3,966	3,962
FHLB and Federal Reserve stock	3,227	3,227	3,072	3,072
Loans receivable and loans held for sale	749,701	742,271	652,297	642,769
Financial Liabilities				
Deposits:				
Savings, money market and demand	$ 397,944	$ 397,944	$ 353,153	$ 353,153
Time certificates	327,977	327,337	283,351	282,321
Total deposits	725,921	725,281	636,504	635,474
FHLB advances	37,167	37,049	39,900	39,900
Other borrowings	3,371	3,368		

(17) Contingencies

The Company is involved in numerous business transactions, which, in some cases, depend on regulatory determination as to compliance with rules and regulations. Also, the Company has certain litigation and negotiations in progress. All such matters are attributable to activities arising from normal operations. In the opinion of management, after review with legal counsel, the eventual outcome of the aforementioned matters is unlikely to have a materially adverse effect on the Company s consolidated financial statements or its financial position.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands, except per share amounts)

(18) Heritage Financial Corporation (Parent Company Only)

Following is the condensed financial statements of the Parent Company.

HERITAGE FINANCIAL CORPORATION

(PARENT COMPANY ONLY)

Condensed Statements of Financial Condition

	December 31, 2006	2005
ASSETS		
Cash and interest earning deposits	$ 41	$ 763
Loans receivable ESOP	740	829
Investment in subsidiary banks	81,967	65,406
Other assets	659	361
	$ 83,407	$ 67,359
LIABILITIES AND STOCKHOLDERS EQUITY		
Borrowed funds	$ 3,371	$
Other liabilities	1,397	1,239
Total stockholders equity	78,639	66,120
	$ 83,407	$ 67,359

HERITAGE FINANCIAL CORPORATION

(PARENT COMPANY ONLY)

Condensed Statements of Income

	Years Ended December 31, 2006	2005	2004
Interest income:			
Interest earning deposits	$ 8	$ 9	$ 7
ESOP loan	67	74	81
Other income:			
Gain on sale of investment			218
Dividends from subsidiaries	4,600	5,075	7,900
Equity in undistributed income of subsidiaries	6,978	5,906	2,108

Total income	11,653	11,064	10,314
Interest expense	142	13	40
Other expenses	1,348	839	906
Total expense	1,490	852	946
Income before federal income taxes	10,163	10,212	9,368
Benefit for federal income taxes	(384)	(264)	(217)
Net income	$ 10,547	$ 10,476	$ 9,585

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands, except per share amounts)

HERITAGE FINANCIAL CORPORATION

(PARENT COMPANY ONLY)

Condensed Statements of Cash Flows

	Years Ended December 31,		
	2006	2005	2004
Cash flows from operating activities:			
Net income	$ 10,547	$ 10,476	$ 9,585
Adjustments to reconcile net income to net cash provided by operating activities:			
Equity in undistributed income of subsidiaries	(11,578)	(10,981)	(10,008)
Dividends from subsidiaries	4,600	5,075	7,900
Recognition of compensation related to ESOP and restricted stock shares	504	402	181
Stock option compensation expense	352		
Net change in other assets and liabilities	(169)	(82)	324
Net cash provided by operating activities	4,256	4,890	7,982
Cash flows from investing activities:			
ESOP loan principal repayments	89	82	76
Purchase of Western Washington Bancorp	(3,765)		
Net cash provided by investing activities	(3,676)	82	76
Cash flows from financing activities:			
Net increase in short-term borrowed funds	225		
Proceeds from issuance of long-term debt	3,700		
Repayments of long-term debt	(554)		
Cash dividends paid	(5,069)	(4,291)	(3,744)
Exercise of stock options	984	726	1,008
Stock repurchase	(588)	(1,606)	(8,307)
Net cash used in financing activities	(1,302)	(5,171)	(11,043)
Net increase (decrease) in cash and cash equivalents	(722)	(199)	(2,985)
Cash and cash equivalents at beginning of period	763	962	3,947
Cash and cash equivalents at end of period	$ 41	$ 763	$ 962

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands, except per share amounts)

(19) Selected Quarterly Financial Data (Unaudited)

Results of operations on a quarterly basis were as follows:

	Year ended December 31, 2006			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Interest income	$ 12,370	$ 13,412	$ 14,682	$ 14,773
Interest expense	3,885	4,628	5,291	5,661
Net interest income	8,485	8,784	9,391	9,112
Provision for loan losses	140	100	240	240
Net interest income after provision for loan losses	8,345	8,684	9,151	8,872
Non-interest income	1,771	1,917	2,166	2,100
Non-interest expense	6,285	6,816	6,980	7,001
Income before provision for income taxes	3,831	3,785	4,337	3,971
Provision for income taxes	1,267	1,250	1,447	1,413
Net income	$ 2,564	$ 2,535	$ 2,890	$ 2,558
Basic earnings per share	$ 0.41	$ 0.40	$ 0.45	$ 0.39
Diluted earnings per share	0.40	0.39	0.43	0.38
Cash dividends declared	0.195	0.200	0.205	0.210

	Year ended December 31, 2005			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Interest income	$ 10,628	$ 11,101	$ 11,581	$ 12,118
Interest expense	2,305	2,718	3,026	3,499
Net interest income	8,323	8,383	8,555	8,619
Provision for loan losses	165	210	210	225
Net interest income after provision for loan losses	8,158	8,173	8,345	8,394
Non-interest income	1,476	1,629	1,719	1,805
Non-interest expense	5,826	6,100	6,066	6,190
Income before provision for income taxes	3,808	3,702	3,998	4,009
Provision for income taxes	1,245	1,205	1,275	1,317
Net income	$ 2,563	$ 2,497	$ 2,723	$ 2,692

Basic earnings per share	$ 0.41	$ 0.40	$ 0.44	$ 0.44
Diluted earnings per share	0.40	0.39	0.43	0.42
Cash dividends declared	0.167	0.171	0.185	0.190

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands, except per share amounts)

(20) Business Combination

On June 1, 2006 the Company acquired Western Washington Bancorp, Inc. (WWB) and its wholly-owned subsidiary, Washington State Bank, N.A., in an acquisition accounted for under the purchase method of accounting. The results of WWB have been included in the consolidated financial statements since the date of acquisition. This merger was consistent with the Company s growth strategy and provides the opportunity to expand into the south King County market in Washington State.

The aggregate purchase price was $10.1 million and included cash of $3.8 million, 231,225 shares of common stock valued at $5.7 million and $0.7 million in direct merger costs. The value of the 231,235 shares issued was determined based on the $24.49 average closing market price of the Company s common stock for the two trading days before and after the measurement date of January 24, 2006 when the number of shares to be issued was determined. Total transaction expenses of $1.2 million included $721,000 of direct expenses noted above and $464,000 of merger expenses that were paid by WWB prior to the close of the transaction.

The following table summarizes the estimated fair value of the assets acquired and liabilities assumed at the date of acquisition.

(Dollars in thousands)	
Assets acquired:	
Cash and cash equivalents	$ 2,455
Securities	4,887
Loans, net of allowance for loan losses	40,739
Goodwill	6,441
Core deposit intangible	626
Premises and equipment, net	95
Other assets	1,319
Total assets	$ 56,562
Liabilities assumed:	
Deposits	44,282
FHLB advances and other borrowings	1,953
Other liabilities	179
Total liabilities	$ 46,414
Net assets acquired	$ 10,148

The core deposit intangible of $626,000 is being amortized on a straight-line basis over 8 years. Goodwill of $6.4 million is not amortized but will be reviewed for potential impairment on an annual basis, or more often if events or circumstances indicate a potential impairment.

Additional adjustments to the purchase price allocation may occur as certain items are based on estimates at the time of acquisition, including income taxes, direct costs and compensation adjustments.

The following table presents unaudited pro forma results of operations for the years ended December 31, 2006 and 2005 assuming the acquisition occurred on January 1, 2005. The Company expects to realize cost savings as a result of the WWB merger that are not reflected in the pro forma consolidated condensed statements of income. No assurance can be given with respect to the ultimate level of such cost savings. The pro forma results do not necessarily indicate the results that would have been obtained had the acquisition actually occurred on January 1,

2005.

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HERITAGE FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Dollars in thousands, except per share amounts)

For the year ended December 31, 2006

($ in thousands, except per share amounts)	HFWA	WWB	Pro Forma Adjustments	Pro Forma Combined
Net interest income	$ 35,772	$ 1,131	$ 19(a)	$ 36,922
Provision for loan losses	720	176		896
Noninterest income	7,954	136		8,090
Noninterest expense	27,082	1,648	(431)(b)	28,299
Income before provision for income taxes	15,924	(557)	476	15,817
Provision for income taxes	5,377	(119)	91(c)	5,340
Net Income	$ 10,547	$ (438)	$ 385	$ 10,477
Basic earnings per share	$ 1.65			$ 1.62
Diluted earnings per share	$ 1.60			$ 1.57
Basic weighted average shares outstanding	6,375,059			6,471,407
Diluted weighted average shares outstanding	6,589,381			6,685,729

(a) Amount represents amortization of purchase adjustments.
(b) Amount represents merger related costs of $464 less amortization of intangibles of $33.
(c) Income tax effect of proforma adjustments.

For the year ended December 31, 2005

($ in thousands, except per share amounts)	HFWA	WWB	Pro Forma Adjustments	Pro Forma Combined
Net interest income	$ 33,881	$ 2,807	$ 45(a)	$ 36,733
Provision for loan losses	810	(28)		782
Noninterest income	6,630	195		6,825
Noninterest expense	24,183	2,374	78(b)	26,635
Income before provision for income taxes	15,518	656	(33)	16,141
Provision for income taxes	5,042	225	(12)(c)	5,255
Net Income	$ 10,476	$ 431	$ (21)	$ 10,886
Basic earnings per share	$ 1.69			$ 1.70
Diluted earnings per share	$ 1.65			$ 1.65
Basic weighted average shares outstanding	6,189,497			6,420,732
Diluted weighted average shares outstanding	6,363,002			6,594,237

(a) Amount represents amortization of purchase adjustments.
(b) Amount represents amortization of intangibles.
(c) Income tax effect of proforma adjustments.

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INDEX TO EXHIBITS

Exhibit No.	
3.1	Articles of Incorporation(1)
3.2	Bylaws of the Company(1)
10.1	1998 Stock Option and Restricted Stock Award Plan(2)
10.5	Form of Severance Agreement entered into between the Company and seven additional executives, effective as of October 1, 1997(1)
10.6	1997 Stock Option and Restricted Stock Award Plan(3)
10.7	Employment Agreement between the Company and Michael Broadhead, effective September 28, 1998(4)
10.8	Employment Agreement between the Company and Brian L. Vance, effective October 1, 2006(9)
10.10	2002 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan(5)
10.11	Revised Employment Agreement between the Company and Donald V. Rhodes, effective January 1, 2005(7)
10.12	2006 Incentive Stock Option Plan, Director Nonqualified Stock Option Plan, and Restricted Stock Option Plan (8)
14.0	Code of Ethics(6)
21.0	Subsidiaries of the Company
23.0	Consent of Independent Registered Public Accounting Firm
24.0	Power of Attorney
31.0	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.0	Certification of Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Incorporated by reference to the Registration Statement on Form S-1 (Reg. No. 333-35573) declared effective on November 12, 1997.

(2) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-71415).

(3) Incorporated by reference to the Registration Statement on Form S-8 (Reg. No. 333-57513).

(4) Incorporated by reference to the Registration Statement on Form S-4 dated January 20, 1999.

(5) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-88980; 333-88982; 333-88976).

(6) Incorporated by reference to the Annual Report on Form 10-K dated March 8, 2004.

(7) Incorporated by reference to the Quarterly Report on Form 10-Q dated November 2, 2004.

(8) Incorporated by reference to the Registration Statements on Form S-8 (Reg. No. 333-134473; 333-134474; 333-134475).

(9) Incorporated by reference to the Current Report on Form 8-K dated October 4, 2006.