

HERITAGE FINANCIAL CORP /WA/  
Form DEF 14A  
March 15, 2005

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**SCHEDULE 14A INFORMATION REQUIRED IN PROXY STATEMENT**

**SCHEDULE 14A INFORMATION**

**PROXY STATEMENT PURSUANT TO SECTION 14(a) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

Filed by the Registrant

Filed by a Party other than the Registrant

Check the appropriate box:

- |                                     |   |                          |  |
|-------------------------------------|---|--------------------------|--|
| <input type="checkbox"/>            | Preliminary Proxy Statement   | <input type="checkbox"/> | CONFIDENTIAL FOR USE OF THE<br>COMMISSION ONLY (AS PERMITTED BY<br>RULE 14a-6(e)(2)) |
| <input checked="" type="checkbox"/> | Definitive Proxy Statement  |                          |  |
| <input type="checkbox"/>            | Definitive Additional Materials   |                          |  |
| <input type="checkbox"/>            | Soliciting Material Pursuant to Section 240.14a-11(c) or Section 240.14a-12 |                          |  |

**Heritage Financial Corporation**

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(Name of Registrant as Specified In Its Charter)

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(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

- |                                     |  |
|-------------------------------------|--|
| <input checked="" type="checkbox"/> | No fee required.   |
| <input type="checkbox"/>            | Fee computed on table below per Exchange Act Rules 14a-6(i)(4) and 0-11. |

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(1) Title of each class of securities to which transaction applies:

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(2) Aggregate number of securities to which transaction applies:

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(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (Set forth the amount on which the filing fee is calculated and state how it was determined):

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(4) Proposed maximum aggregate value of transaction:

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(5) Total fee paid:

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Fee paid previously with preliminary materials.

Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

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(2) Form, Schedule or Registration Statement No.:

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(3) Filing Party:

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(4) Date Filed:

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**NOTICE OF ANNUAL MEETING OF STOCKHOLDERS**

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**To be held April 28, 2005**

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To Our Stockholders:

You are invited to attend the 2005 annual meeting of stockholders of Heritage Financial Corporation (Heritage) to be held at the Phoenix Inn, 417 Capitol Way N., Olympia, Washington, on April 28, 2005 at 10:30 a.m., Pacific Time. At the annual meeting, you will be asked to:

1. Elect three (3) persons to serve on the Board of Directors of Heritage until the annual meeting of stockholders in 2008 and one (1) person to serve on the Board of Directors of Heritage until the annual meeting of stockholders in 2006.
2. Approve whatever other business as may properly be brought before the annual meeting or any adjournment thereof.

Stockholders of record at the close of business on March 9, 2005 are entitled to vote at the annual meeting or any adjournment of the annual meeting.

BY ORDER OF THE BOARD OF DIRECTORS

Edward D. Cameron

Secretary

Olympia, Washington

March 22, 2005

**We urge you to complete, sign and return the enclosed proxy card as soon as possible, whether or not you plan to attend the annual meeting in person. If you do attend the annual meeting, you then may withdraw your proxy and vote in person. The proxy may be withdrawn at any time prior to voting.**

201 5<sup>th</sup> Avenue S.W.

OLYMPIA, WASHINGTON 98501

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**PROXY STATEMENT**

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Heritage is sending this proxy statement to you for the solicitation of proxies by the Board of Directors of Heritage to be voted at the annual meeting. This proxy statement and the enclosed proxy card are being mailed to stockholders on or about March 22, 2005.

**INFORMATION ABOUT THE MEETING**

**When and Where is the Annual Meeting?**

The annual meeting will be held at 10:30 a.m., Pacific Time, on Thursday, April 28, 2005 at the Phoenix Inn, 417 Capitol Way N., Olympia, Washington.

**What Matters will be Voted on at the Annual Meeting?**

At the annual meeting, you will be asked to:

Elect three (3) persons to serve on the Board of Directors of Heritage until the annual meeting of stockholders in 2008 and one (1) person to serve on the Board of Directors of Heritage until the annual meeting of stockholders in 2006;

Approve whatever other business may properly come before the annual meeting or any adjournment thereof.

**Who is Entitled to Vote?**

Only stockholders of record at the close of business on the record date, March 9, 2005, are entitled to receive notice of the annual meeting and to vote at the annual meeting. On March 9, 2005, there were 6,050,150 shares of Heritage common stock outstanding, held by approximately 1,415

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holders of record. Each share of Heritage common stock is entitled to one vote on each matter considered at the meeting, including one vote for each director to be elected. Stockholders are not entitled to cumulate their votes in the election of directors.

### **What Constitutes a Quorum?**

The presence at the annual meeting, in person or by proxy, of a majority of the outstanding shares eligible to vote at the annual meeting is required for a quorum to exist at the annual meeting. For this purpose, abstentions and broker non-votes are counted in determining the shares present at the annual meeting.

### **What Vote is Required to Elect the Directors?**

The four nominees for election as directors who receive a simple majority of votes cast will be elected directors. Votes may be cast in favor of some or all of the nominees for election to the Board of Directors or withheld as to some or all of the nominees.

**How Do I Vote?**

If you complete and properly sign the accompanying proxy card and return it to Heritage, it will be voted as you direct. If you give no directions on your proxy, the shares represented by your proxy, if properly signed, will be voted FOR the nominees for directors listed in this proxy statement. If any other matters are properly presented at the annual meeting for consideration, the persons named in the proxy will have discretion to vote on those matters according to their best judgment. Street name stockholders who wish to vote at the annual meeting will need to obtain a proxy form from the institution that holds their shares.

**Can I Change My Vote After I Return My Proxy Card?**

Yes. Even after you have submitted your proxy, your proxy may be withdrawn at any time before it is voted by

delivering written notice to Edward D. Cameron, Heritage's Secretary, at 201 5<sup>th</sup> Avenue S.W., Olympia, Washington 98501, before 5:00 p.m. on April 27, 2005, *or*

completing a later dated proxy, *or*

attending the annual meeting and voting in person.

**Who Pays the Costs of Soliciting Proxies?**

The enclosed proxy is solicited by the Board of Directors of Heritage. Heritage will bear the costs of soliciting proxies for the annual meeting. In addition to soliciting proxies by mail, Heritage's directors, officers and employees may solicit proxies personally or by telephone or fax. No director, officer or employee of Heritage who solicits proxies will receive any compensation for their solicitation other than their regular compensation for the positions they hold. Heritage does not intend to pay any compensation to any other persons for the solicitation of proxies. However, it will reimburse brokerage houses and other custodians, nominees and fiduciaries for reasonable expenses to mail proxy materials for beneficial owners.

**STOCK OWNERSHIP**

**Who are the Largest Owners of Heritage Stock?**

The following table sets forth information concerning the number of shares of Heritage common stock held as of March 9, 2005 by the only stockholders who are known to management to be the beneficial owners of more than five percent (5%) of Heritage's outstanding shares:

Name and Address of Beneficial Owner	Amount and Nature	Percent of Class
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of Beneficial Ownership (1)

Donald V. Rhodes	415,068(2)	6.98%
201 Fifth Avenue, S.W.		
Olympia, WA 98501		

- (1) Of common stock.
- (2) Includes 6,800 options, which are exercisable at \$11.13 per share, 13,600 options exercisable at \$8.44 per share, 15,000 options exercisable at \$9.75 per share, and 12,000 options exercisable at \$12.25 per share. Includes 17,120 vested shares in the Heritage 401(k) ESOP.

**How Much Stock Do Heritage's Directors and Executive Officers Own?**

The following table shows the beneficial ownership of Heritage common stock as of March 9, 2005 by:

Each director and director nominee;

The chief executive officer and those persons who served as executive officers in 2004 and received salaries and bonuses totaling in excess of \$100,000 during 2004; and

All directors and executive officers as a group.



For purposes of this table and according to Rule 13d-3 under the Securities Exchange Act of 1934, a person is the beneficial owner of any shares if he or she has voting and/or investment power over those shares. The table includes shares owned by spouses, other immediate family members in trust, shares held in retirement accounts or funds for the benefit of the named individuals, and other forms of ownership, over which shares the persons named in the table possess voting and/or investment power.

Name	Shares Beneficially Owned at March 9, 2005	
	Number	Percent of Outstanding Common Stock
D. Michael Broadhead (1)	72,684	1.07%
Lynn M. Brunton (2)	126,179	2.12%
Edward D. Cameron (3)	23,028	*
Brian S. Charneski (4)	26,300	*
Gary B. Christensen (5)	29,171	*
Peter N. Fluetsch (6)	25,100	*
Daryl D. Jensen (7)	162,495	2.73%
Melvin R. Lewis (8)	54,428	*
Jeffrey S. Lyon (9)	14,346	*
H. Edward Odegard (10)	14,789	*
Gregory D. Patjens (11)	40,188	*
Donald V. Rhodes (12)	415,068	6.98%
James P. Senna (13)	80,000	1.35%
Brian L. Vance (14)	164,519	2.77%
Philip S. Weigand (15)	128,035	2.15%
Directors and executive officers as a group (15 persons) (16)	1,376,330	19.32%

\* Represents less than 1.0% of Heritage's outstanding common stock.

- (1) Includes 4,100 shares issuable upon exercise of options, which are exercisable at \$9.00 per share, 6,900 options exercisable at \$10.15 per share, 6,900 options exercisable at \$12.25 per share, 4,600 options exercisable at \$21.38 per share and 1,800 options exercisable at \$21.11 per share. Includes 3,904 vested shares in the Heritage 401(k) ESOP.
- (2) Includes 500 shares issuable upon exercise of options, which are exercisable at \$12.25 per share, 1,000 options exercisable at \$21.38 per share and 500 options exercisable at \$21.11 per share.
- (3) Includes 4,050 shares issuable upon exercise of options, which are exercisable at \$12.25 per share, 1,000 options exercisable at \$9.75 per share and 3,000 options exercisable at \$21.38 per share, 1,200 options exercisable at \$21.11 per share. Includes 2,978 vested shares in the Heritage 401(k) ESOP.
- (4) Includes 1,200 shares issuable upon exercise of options, which are exercisable at \$8.00 per share, 1,200 options exercisable at \$10.15 per share, 1,500 options exercisable at \$12.25 per share, 1,000 options exercisable at \$21.38 per share and 500 options exercisable at \$21.11 per share.
- (5) Includes 300 shares issuable upon the exercise of options, which are exercisable at \$7.72 per share, 200 options exercisable at \$9.00 per share, 300 options exercisable at \$10.15 per share, 450 options exercisable at \$12.25 per share, 300 options exercisable at \$21.38 per share and 150 options exercisable at \$21.11 per share.
- (6) Includes 1,200 shares issuable upon the exercise of options, which are exercisable at \$7.81 per share, 1,200 options exercisable at \$10.15 per share, 1,500 options exercisable at \$12.25 per share, 1,000 options exercisable at \$21.38 per share and 500 options exercisable at \$21.11 per share.
- (7) Includes 1,950 shares issuable upon exercise of options, which are exercisable at \$12.25 per share, 1,300 options exercisable at \$21.38 per share and 650 options exercisable at \$21.11 per share.
- (8) Includes 500 shares issuable upon exercise of options, which are exercisable at \$10.15 per share, 1,300 options exercisable at \$12.25 per share, 1,300 options exercisable at \$21.38 per share and 650 options exercisable at \$21.11 per share.

- (9) Includes 1,200 shares issuable upon the exercise of options, which are exercisable at \$10.15 per share, 1,500 options exercisable at \$12.25 per share, 1,000 options exercisable at \$21.38 per share and 500 options exercisable at \$21.11 per share.
- (10) Includes 500 shares issuable upon the exercise of options at \$12.25 per share, 1,000 options exercisable at \$21.38 per share and 500 options exercisable at \$21.11 per share.
- (11) Includes 6,900 shares issuable upon exercise of options, which are exercisable at \$9.75 per share, 4,900 options exercisable at \$8.44 per share, 4,600 options exercisable at \$8.75 per share, 4,050 options exercisable at \$12.25 per share, 3,000 options exercisable at \$21.38 per share and 1,200 options exercisable at \$21.11 per share. Includes 3,538 vested shares in the Heritage 401(k) ESOP.
- (12) Includes 6,800 shares issuable upon exercise of options, which are exercisable at \$11.13 per share, 13,600 options exercisable at \$8.44 per share, 15,000 options exercisable at \$9.75 per share and 12,000 options exercisable at \$12.25 per share. Includes 17,120 vested shares in the Heritage 401(k) ESOP.
- (13) Includes 800 shares issuable upon exercise of options, which are exercisable at \$8.50 per share, 1,200 options exercisable at \$7.81 per share, 1,200 options exercisable at \$10.15 per share, 1,500 options exercisable at \$12.25 per share, 1,000 options exercisable at \$21.38 per share and 500 options exercisable at \$21.11 per share.
- (14) Includes 3,600 shares issuable upon exercise of options, which are exercisable at \$8.44 per share, 8,000 options exercisable at \$9.75 per share, 15,000 options exercisable at \$12.25 per share, 14,000 options exercisable at \$21.38 per share and 4,000 options exercisable at \$21.11 per share. Includes 9,979 vested shares in the Heritage 401(k) ESOP.
- (15) Includes 800 shares issuable upon exercise of options, which are exercisable at \$8.50 per share, 1,200 options exercisable at \$7.81 per share, 1,200 options exercisable at \$10.15 per share, 1,500 options exercisable at \$12.25 per share, 1,000 options exercisable at \$21.38 per share and 500 options exercisable at \$21.11 per share.
- (16) Includes 190,950 shares issuable upon exercise of options. Includes 37,519 vested shares in the Heritage 401(k) ESOP.

#### EXECUTIVE OFFICERS

The following table provides information about the executive officers of Heritage. All officers are appointed by the Board of Directors and serve at the pleasure of the Board for an unspecified term.

<u>Name</u>	<u>Age</u>	<u>Position</u>	<u>Has Served Heritage, Heritage Bank or Central Valley Bank Since</u>
Donald V. Rhodes (1)	69	Chairman and Chief Executive Officer of Heritage; Chairman of Heritage Bank; Chairman and Chief Executive Officer of Central Valley Bank	1986
Brian L. Vance (2)	50	President of Heritage and President and Chief Executive Officer of Heritage Bank	1996
Gregory D. Patjens (3)	55	Executive Vice President, Heritage Bank	1999
Edward D. Cameron (4)	64	Senior Vice President, Treasurer and Corporate Secretary of Heritage and Senior Vice President, Treasurer and Corporate Secretary of Heritage Bank	1999
D. Michael Broadhead (5)	60	President Central Valley Bank, N.A.	1986

- (1) For background information on Mr. Rhodes, see page 7 of the proxy statement.
- (2) For background information on Mr. Vance, see page 8 of the proxy statement.

- (3) Mr. Patjens joined Heritage Bank on March 16, 1999. Mr. Patjens was employed for over 25 years with Key Bank and its predecessor, Puget Sound National Bank in positions with responsibilities for a variety of administrative and bank operations functions. Prior to leaving Key Bank, Mr. Patjens was Senior Vice President for Key Services, National Client Services.
- (4) Mr. Cameron became the Senior Vice President, Treasurer and Corporate Secretary of Heritage in January of 2003. Mr. Cameron was named Corporate Secretary of Heritage in June 2002. Prior to that he was Vice President and Treasurer of Heritage. Mr. Cameron was the Senior Vice President and Treasurer of Heritage Bank in August 1999. Prior to that since April 1999, Mr. Cameron was Vice President, Investment Manager at Heritage Bank. Prior to that, he had over 25 years of banking experience, most recently as Senior Vice President, Investment Manager at Security Pacific Bank.
- (5) Mr. Broadhead joined Central Valley Bank in 1986 and has been President of Central Valley Bank since 1990. Heritage acquired Central Valley Bank in March 1999.

### **ELECTION OF DIRECTORS**

Heritage's Articles of Incorporation call for the Board of Directors to fix the exact number of directors from time to time within a range of no fewer than 5 nor more than 25 persons. The Board of Directors has fixed the number of directors at 11 persons.

Directors are divided into three classes with each class having three year terms that expire in successive years. Approximately one third of the members of the Board of Directors are elected by the stockholders annually. The directors whose terms will expire at the 2005 annual meeting are Daryl D. Jensen, Jeffrey S. Lyon, H. Edward Odegard and Donald V. Rhodes. All with the exception of Mr. Odegard, have been nominated by the Nominating Committee of the Board of Directors for reelection at the 2005 annual meeting. Mr. Odegard has indicated his decision to retire at the expiration of his term. If elected, directors Jensen, Lyon and Rhodes will hold office until the annual meeting of stockholders in the year 2008.

In addition, the Nominating Committee of the Board nominated Mr. Gary B. Christensen for election to the Board. If elected Mr. Christensen will hold office until the annual meeting of stockholders in the year 2006.

Each nominee has indicated that he is able and willing to serve on the Board of Directors. If any nominee becomes unable to serve, the shares represented by all properly completed proxies will be voted for the election of the substitute recommended by the Board of Directors. At this time, the Board of Directors knows of no reason why any nominee might be unavailable to serve.

Information about the nominees for election at the annual meeting as well as information about those directors continuing in office after the annual meeting is as follows:

#### **Nominees for Election at This Annual Meeting for a Term Expiring in 2008**

*Daryl D. Jensen, Director Since 1985.* Mr. Jensen, 66, was the President of Sunset Life Insurance Company of America from 1973 until his retirement in 1999. Currently, Mr. Jensen is Vice President of Western Institutional Review Board, located in Olympia, WA. He serves as a director of Sunset Life Insurance Company and of Kansas City Life Insurance Company. Mr. Jensen is also a director of Generations Bank, located in Missouri, and a director of Panorama City Corporation, a large retirement community located in Lacey, Washington. Mr. Jensen has served as a director of Central Valley Bank since 1989.

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*Jeffrey S. Lyon, Director since 2000.* Mr. Lyon, 52, is the President and Chief Executive Officer of GVA Kidder Mathews, headquartered in Seattle, Washington. Mr. Lyon serves as a director for GVA Worldwide and a director for Kidder Mathews-Segner Inc. Mr. Lyon is a member of the Real Estate Advisory Board of Washington State University and has over 32 years of experience in the commercial real estate industry in the Puget Sound area.

*Donald V. Rhodes, Director Since 1989.* Mr. Rhodes, 69, currently serves as Chairman and Chief Executive Officer of Heritage; Chairman of Heritage Bank; and since 1986, Chairman and Chief Executive Officer of Central Valley Bank, a subsidiary of Heritage which was acquired on March 5, 1999. Mr. Rhodes joined Heritage Bank in 1989 as President and Chief Executive Officer and was elected Chairman in 1990.

**Nominee for Election at This Annual Meeting for a Term Expiring in 2006**

*Gary B. Christensen.* Mr. Christensen, 56, is the owner of R.E. Powell Distributing a fuel, lubricant and propane distributorship headquartered in Yakima, Washington. In 2004 R.E. Powell Distributing was named one of five inductees into the University of Washington sponsored Leadership Circle at the Annual UW Minority Business of the Year Awards dinner. Mr. Christensen serves as a director for Central Valley Bank, N.A. and serves on the Board of Directors for Yakima County Economic Development. Mr. Christensen was recently appointed to the Chevron/Texaco National Distributor Advisory Council.

**The Board of Directors recommends a vote FOR the election of Messrs. Christensen, Jensen, Lyon, and Rhodes.**

**Incumbent Directors Whose Terms Expire in 2006**

*Lynn M. Brunton, Director Since 1990.* Ms. Brunton, 67, is presently a community volunteer and serves as a member of the St. Peter Hospital Community Board and is actively involved in several local community organizations. Ms. Brunton is also a director of Panorama City Corporation, a large retirement community located in Lacey, Washington.

*Melvin R. Lewis, Director Since 1999.* Mr. Lewis, 73, is a Broker and former President of the firm Terril, Lewis, Wilke Insurance. Since 1993, Mr. Lewis has served as a director of Central Valley Bank and, until March 5, 1999 was a director of Washington Independent Bancshares, Inc., the holding company for Central Valley Bank. On March 5, 1999, Heritage acquired Washington Independent Bancshares, Inc., and Central Valley bank then became a subsidiary of Heritage. Mr. Lewis became a director of Heritage on March 25, 1999 to fulfill the requirements of the acquisition agreement between Heritage and Washington Independent Bancshares, Inc. Mr. Lewis is also Vice President of the Yakima Community College Foundation and a member of the Salvation Army Advisory Board.

*Philip S. Weigand, Director Since 1985.* Mr. Weigand, 67, is a retired Lieutenant Colonel of the U.S. Marine Corps with 20 years of active service. Since 1988, Mr. Weigand has been a real estate agent with Virgil Adams Real Estate, located in Olympia, Washington.

**Incumbent Directors Whose Terms Expire in 2007**

*Brian S. Charneski, Director since 2000.* Mr. Charneski, 43, is the President of L&E Bottling Company located in Olympia, Washington. He also serves as Chairman and CEO of Snack Time Foods, headquartered in Tumwater, Washington. Mr. Charneski is a director of Columbia Beverage Company headquartered in Tumwater, Washington, L&E Bottling Company and ET Financial Services, Inc.

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*Peter N. Fluetsch, Director since 1999.* Mr. Fluetsch, 67, is the Chief Executive Officer of Sunset Air, Inc. in Lacey, Washington, a heating and air conditioning contractor that he founded in 1976.

*James P. Senna, Director since 1976.* Mr. Senna, 70, is retired.

*Brian L. Vance, Director since 2003.* Mr. Vance, 50, currently serves as President and Chief Executive Officer of Heritage Bank and President of Heritage. Mr. Vance has been employed by Heritage Bank since 1996. Prior to joining Heritage Bank, Mr. Vance was employed for over 20 years with West One Bank, a bank with offices in Idaho and Washington. Prior to leaving West One, he was Senior Vice President and Regional Manager of Banking Operations for the south Puget Sound region. On February 25, 2005, Mr. Vance was named

President of Heritage. On March 24, 2003, Mr. Vance was named President and Chief Executive Officer of Heritage Bank. On August 17, 1998, the Board of Directors of Heritage Bank approved the appointment of Mr. Vance as President and Chief Operating Officer of Heritage Bank to be effective as of October 1, 1998. Prior to that, Mr. Vance was named Executive Vice President of Heritage Bank.

## INFORMATION ABOUT THE BOARD OF DIRECTORS AND ITS COMMITTEES

### How Often Did the Board Meet During 2004?

During the year ended December 31, 2004, the Board of Directors of Heritage held twelve meetings. No director of Heritage attended fewer than 75% of the total meetings of the Board and committees on which a director served during this period. It is Heritage's policy that its directors attend the annual meeting of stockholders. At the 2004 annual meeting, ten of the eleven Heritage directors were in attendance.

### What Committees Has the Board Established?

The Board of Directors of Heritage has an Executive Committee, an Audit and Finance Committee, a Personnel and Compensation Committee and a Nominating Committee.

*Audit and Finance Committee.* The Audit and Finance Committee:

Reviews and approves the selection of Heritage's independent auditors;

Reviews the plan, scope and audit results of the internal auditors and the independent auditors;

Reviews the reports of bank regulatory authorities; and

Reviews the annual and other reports to the Securities and Exchange Commission and the annual report to Heritage's stockholders.

The Audit and Finance Committee consists of directors Jensen (chair), Weigand, Charneski, Lyon and Fluetsch. Additionally, John A. Clees, a former member of the Heritage Board of Directors and an accountant with the firm of RSM McGladrey, Inc. acts as a non-voting consultant to the Audit and Finance Committee. None of the members of the Audit and Finance Committee are officers or employees of Heritage or any Heritage subsidiary. Our Board has determined that all members of the Audit and Finance Committee are considered independent under the NASDAQ's listing standards. There were seven meetings of the Audit and Finance Committee during the year ended December 31, 2004.

*Personnel and Compensation Committee.* The Personnel and Compensation Committee reviews and recommends compensation arrangements for all officers. The members of the Personnel and Compensation Committee are directors Fluetsch (chair), Jensen and Brunton. None of the members of the Committee are officers or employees of Heritage or any subsidiary of Heritage. Our Board has determined that all members of the Personnel and Compensation Committee are considered independent under the NASDAQ's listing standards. There were five meetings of the

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Personnel and Compensation Committee during the year ended December 31, 2004.

*Nominating Committee.* Heritage's Board has established a Nominating Committee which reviews and recommends nominees to serve as directors and officers of Heritage. Heritage's Nominating Committee consists of directors Daryl D. Jensen (chair), Brunton and Fluetsch. None of the members of the Nominating Committee are officers or employees of Heritage or any Heritage subsidiary. Our Board has determined that all members of the Nominating Committee are considered independent under the NASDAQ's listing standards. The Nominating Committee provides oversight on a broad range of issues surrounding the composition and operation of the Board of Directors of Heritage Financial Corporation. The Nominating Committee has a Charter which is available on Heritage's website at [www.hf-wa.com](http://www.hf-wa.com). There was one meeting of the Nominating Committee during the year ended December 31, 2004.



The Nominating Committee's Charter has established general criteria for considering director candidates. The Nominating Committee considers the following criteria when selecting nominees:

Ability to represent all Heritage stockholders;

Expected period of time available for service;

Independence;

Current knowledge and contacts in Heritage's market area;

Ability to work effectively with the Board group; and

Ability to commit adequate time to serve as a Heritage director.

#### **How Can a Stockholder Nominate Someone for the Board?**

According to Heritage's Articles of Incorporation, any stockholder nominations of candidates for election to the Board of Directors at the 2006 annual meeting must be made in writing to Heritage's chairman not fewer than fourteen days nor more than fifty days prior to the date of the annual meeting. If fewer than twenty-one days notice of the annual meeting is given to stockholders, stockholder nominations must be mailed or delivered to Heritage's chairman by the close of business on the seventh day after the day the notice of the annual meeting is mailed. Stockholder nominations must contain the following information if known to the nominating stockholder:

The name and address of each proposed nominee;

The principal occupation of each proposed nominee;

The total number of shares of Heritage common stock that will be voted for each stockholder proposed nominee;

The name and address of the nominating stockholder; and

The number of shares of Heritage common stock owned by the nominating stockholder.

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

**How Can Stockholders Communicate with the Board of Directors?**

Heritage has implemented a stockholder communication process to facilitate communication with its Board of Directors. All stockholder communications to the Board of Directors should be forwarded to the attention of Edward D. Cameron, Secretary, Heritage Financial Corporation, 201 Fifth Avenue S.W., Olympia, Washington 98501. E-mail address: HFWA@heritagebankwa.com.

**How are Directors Compensated?**

During the year ended December 31, 2004, Heritage's non-officer directors received a monthly retainer of \$500 and a monthly fee of \$750 for each Board meeting attended. For all committees other than the Audit and Finance Committee, non-officer directors also received \$150 for each committee meeting attended with the Chair of the committee receiving \$200 per meeting attended. Non-officer directors of the Audit and Finance Committee received \$500 for each meeting attended with the Chair of the committee receiving an additional \$550 per meeting. Directors who are officers or employees of Heritage or its subsidiaries receive no additional compensation for service as directors or members of Board committees.

Under Heritage's 1997 stock option plan, directors Brunton, Clees, Jensen, Odegard, Senna and Weigand each were granted a Non-Qualified stock option in January 1997 to purchase 6,863 shares of Heritage common

stock at an exercise price of \$3.58 per share (as adjusted for the mutual holding company conversion). Under Heritage's 1998 Stock Option and Restricted Stock Award Plan, in April 1999, directors Brunton, Clees, Odegard, Senna and Weigand each were granted a Non-Qualified stock option to purchase 1,200 shares of Heritage common stock at an exercise price of \$8.50 per share. Also, in 1999, directors Jensen and Lewis each were granted a Non-Qualified stock option to purchase 1,500 shares of Heritage common stock: 1,200 in April 1999 at an exercise price of \$8.50 per share as directors of Heritage and 300 in March 1999 at an exercise price of \$9.00 per share as directors of Central Valley Bank. Under Heritage's 1998 Stock Option and Restricted Stock Award Plan, in April 2000, directors Brunton, Clees, Fluetsch, Odegard, Senna and Weigand each were granted a Non-Qualified stock option to purchase 1,200 shares of Heritage stock at an exercise price of \$7.81 per share. Also, in 2000, directors Jensen and Lewis each were granted a Non-Qualified stock option to purchase 1,500 shares of Heritage common stock: 1,200 in April 2000 at an exercise price of \$7.81 per share as directors of Heritage and 300 in March 2000, at an exercise price of \$7.72 per share as directors of Central Valley Bank. Under Heritage's 1998 Stock Option and Restricted Stock Award Plan, on May 18, 2000, Director Charneski was granted a Non-Qualified stock option to purchase 1,200 shares of Heritage stock at an exercise price of \$8.00 per share. Under Heritage's 1998 Stock Option and Restricted Stock Award Plan, on March 27, 2001, directors Brunton, Charneski, Fluetsch, Lyon, Odegard, Senna and Weigand each were granted a Non-Qualified stock option to purchase 1,200 shares of Heritage common stock at an exercise price of \$10.15 per share. Also in March 2001, directors Jensen and Lewis each were granted a Non-Qualified stock option to purchase 1,500 shares of Heritage common stock at an exercise price of \$10.15 per share: 1,200 as a director of Heritage and 300 shares as a director of Central Valley Bank. In February 2002, directors Brunton, Charneski, Fluetsch, Lyon, Odegard, Senna and Weigand each were granted a Non-Qualified stock option to purchase 1,500 shares of Heritage common stock at an exercise price of \$12.25 per share. 6,009 of those options were granted under Heritage's 1998 Stock Option and Restricted Stock Award Plan and 4,491 options were granted under the Heritage Financial Corporation Non-Qualified Stock Option Plan of 2002. Also in February 2002, directors Jensen and Lewis each were granted a Non-Qualified stock option to purchase 1,950 shares of Heritage common stock at an exercise price of \$12.25 per share: 1,500 as a director of Heritage and 450 shares as a director of Central Valley Bank. 2,232 of those options were granted under Heritage's 1998 Stock Option and Restricted Stock Award Plan and 1,668 options were granted under the Heritage Financial Corporation Non-Qualified Stock Option Plan of 2002. Under Heritage's Non-Qualified Stock Option Plan of 2002, in March 2003, directors Brunton, Charneski, Fluetsch, Lyon, Odegard, Senna and Weigand each were granted a Non-Qualified stock option to purchase 1,500 shares of Heritage common stock at an exercise price of \$21.38 per share. Also in March 2003, directors Jensen and Lewis each were granted a Non-Qualified stock option to purchase 1,950 shares of Heritage common stock at an exercise price of \$21.38 per share: 1,500 as a director of Heritage and 450 shares as a director of Central Valley Bank. Under Heritage's Non-Qualified Stock Option Plan of 2002, in March 2004, directors Brunton, Charneski, Fluetsch, Lyon, Odegard, Senna and Weigand each were granted a Non-Qualified stock option to purchase 1,500 shares of Heritage common stock at an exercise price of \$21.11 per share. Also in March 2004, directors Jensen and Lewis each were granted a Non-Qualified stock option to purchase 1,950 shares of Heritage common stock at an exercise price of \$21.11 per share: 1,500 as a director of Heritage and 450 shares as a director of Central Valley Bank. Under Heritage's Non-Qualified Stock Option Plan of 2002, in February 2005, directors Brunton, Charneski, Fluetsch, Lyon, Senna and Weigand each were granted a Non-Qualified stock option to purchase 1,500 shares of Heritage common stock at an exercise price of \$21.52 per share. Also in February 2005, directors Jensen and Rhodes each were granted a Non-Qualified stock option to purchase 1,950 shares of Heritage common stock at an exercise price of \$21.52 per share: 1,500 as a director of Heritage and 450 shares as a director of Central Valley Bank. All director options vest and become exercisable in annual one-third increments beginning one year after the date of grant. The options are exercisable for a period of five years after they vest.

## AUDIT AND FINANCE COMMITTEE REPORT

### Report of the Audit and Finance Committee

This report of Heritage's Audit and Finance Committee describes the manner in which the committee reviews Heritage's financial reporting process.

**What are the Responsibilities of the Audit and Finance Committee?**

The committee monitors Heritage's internal financial controls and its financial reporting process. The committee:

Reviews and discusses the audited financial statements with management.

Reviews and discusses reports filed with the Securities and Exchange Commission.

Discusses with the independent auditors the matters required to be discussed by Statement on Auditing Standards No. 61 (Communication with Audit Committees).

Receives written disclosures as required by Independent Standards Board Standard No. 1 (Independence Discussions with Audit Committees) and discusses with the independent auditors the auditors' independence.

Recommends to the Board of Directors whether the audited financial statements should be included in Heritage's annual report on Form 10-K.

**Who are the Members of Heritage's Audit and Finance Committee?**

Heritage's Audit and Finance Committee consists of directors Daryl D. Jensen (chair), Philip S. Weigand, Brian S. Charneski, Jeffrey S. Lyon and Peter N. Fluetsch. Additionally, John A. Clees acts as a non-voting consultant to the Audit and Finance Committee. None of the members of the Audit and Finance Committee are officers or employees of Heritage or any Heritage subsidiary. Our board has determined that all members of the Audit and Finance Committee are considered independent under the requirements of the Securities and Exchange Commission and the Nasdaq's listing standards, and further, our board of directors has determined that Mr. Jensen meets the definition of an audit committee financial expert, as set forth in Item 401(h)(2) of Regulation S-K.

**Audit and Finance Committee Report**

The Audit and Finance Committee of the Heritage Board of Directors is composed of five independent directors and one consultant and operates under a written charter adopted by the Board of Directors. The committee is responsible for the selection of Heritage's independent auditors.

Management is responsible for maintaining Heritage's effective internal controls over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. The independent auditors are responsible for performing an independent audit of Heritage's consolidated financial statements, management's assessment, and the effectiveness of Heritage's internal control over financial reporting, in accordance with the standards of the Public Company Accounting Oversight Board (United States) and for issuing reports thereon. The Audit and Finance Committee's responsibility is to monitor and oversee these processes.

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In this context, the Audit and Finance Committee has met and held discussions with management and the independent auditors. Management represented to the Audit and Finance Committee that Heritage's consolidated financial statements were prepared in accordance with auditing principles generally accepted in the United States of America, and the Audit and Finance Committee has reviewed and discussed the consolidated financial statements with management and the independent auditors. The Audit and Finance Committee discussed with the independent auditors matters required to be discussed by the Statement on Auditing Standards No. 61 (Communication with Audit Committees).

Heritage's independent auditors also provided to the Audit and Finance Committee the written disclosures required by Independence Standards Board Standard No. 1 (Independence Discussions with Audit Committees), and the Audit and Finance Committee discussed with the independent auditors that firm's independence.

Based on the Audit and Finance Committee's discussion with management and the independent auditors and the Audit and Finance Committee's review of the representation of management and the report of the independent auditors to the Audit and Finance Committee, the Audit and Finance Committee recommended that the Board of Directors include the audited consolidated financial statements in Heritage's annual report on Form 10-K for the year ended December 31, 2004 filed with the Securities and Exchange Commission.

Respectfully submitted:

Daryl D. Jensen, Chair of the Committee and designated audit committee

financial expert  
Philip S. Weigand, Member  
Brian S. Charneski, Member  
Jeffrey S. Lyon, Member  
Peter N. Fluetsch, Member

## EXECUTIVE COMPENSATION

### Report of the Personnel and Compensation Committee

This report of Heritage's Personnel and Compensation Committee describes in general terms the process the committee undertakes and the factors it considers to determine the appropriate compensation for Heritage's officers.

### What Are The Responsibilities of the Personnel and Compensation Committee?

The committee establishes and monitors compensation programs for executive officers of Heritage and its subsidiaries. The committee:

reviews and approves individual officer salaries, bonus plan allocations, and stock option grants and other equity-based awards; and

establishes the compensation and evaluates the performance of the chief executive officer, while the chief executive officer evaluates the performance of the other executive officers and recommends individual compensation levels for approval by the committee.

None of the members of the committee are officers or employees of Heritage or any Heritage subsidiary.

### What is Heritage's Philosophy of Executive Officer Compensation?

The committee's compensation philosophy is intended to reflect and support the goals and strategies that Heritage has established. The key elements of Heritage's strategy are geographic and product expansion, loan portfolio diversification, development of relationship banking and maintenance of asset quality. The committee believes these goals, which are intended to create long-term stockholder value, must be supported by a compensation program that:

attracts and retains highly qualified executives;

provides levels of compensation that are competitive with those offered by other financial institutions;

motivates executives to enhance long-term stockholder value by helping them to build their own ownership in Heritage; and

integrates Heritage's long-term strategic planning and measurement processes.

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Heritage's compensation program includes competitive salary and benefits, opportunities for employee ownership of Heritage stock through participation in an employee stock ownership plan and, for certain employees, an annual incentive cash bonus based upon attainment of company and individual performance goals and opportunities for stock ownership of Heritage stock through stock option and restricted stock programs.

To determine compensation packages for individual executives, the committee considers various subjective and objective factors, including:

individual job responsibilities and experience;

individual performance in terms of both qualitative and quantitative goals;

Heritage's overall performance, as measured by attainment of strategic and budgeted financial goals and prior performance; and

industry surveys, prepared by an independent consulting firm, of compensation for comparable positions with similar institutions in the State of Washington, the Pacific Northwest and the United States.



The components of Heritage's compensation program are the following:

*Base Salary.* Salary levels of executive officers are designed to be competitive within the banking industry. To set competitive salary ranges, the committee periodically evaluates current salary levels of other financial institutions with size, lines of business, geographic dispersion and market place position similar to Heritage's. Base salaries for Heritage's executive officers other than the chief executive officer are based upon recommendations by the chief executive officer, taking into account the subjective and objective factors described above. The committee reviews and approves or disapproves those recommendations.

*Annual Incentive Bonus.* Executive officers have an annual incentive opportunity with cash bonus awards based on the overall performance of Heritage and on attainment of individual performance targets. The annual awards are determined by formulas established by the committee following each fiscal year and are based upon an assessment of Heritage's performance (for the year ended December 31, 2004, primarily with respect to the Company's return on average equity) as compared to both budgeted and previous fiscal year performance and upon an evaluation by the chief executive officer of an executive's individual performance and contribution to Heritage's overall performance. The committee then reviews and approves the bonus recommendations and presents them to the Board of Directors for approval.

*Stock Option and Other Stock-Based Compensation.* Equity-based compensation is intended to more closely align the financial interests of Heritage's executives with long-term stockholder value, and to assist in the retention of executives who are key to the success of Heritage and its subsidiaries. Equity-based compensation generally has been in the form of incentive stock options and restricted stock awards pursuant to Heritage's existing stock option plans. The committee determines from time to time which executives, if any, will receive stock options or awards and determines the number of shares subject to each option or award. Grants of stock options and awards are based on various subjective factors relating primarily to the responsibilities of individual executives, their expected future contributions to Heritage and prior option grants.

#### **How Is Heritage's Chief Executive Officer Compensated?**

The base compensation for Heritage's chairman and chief executive officer, Donald V. Rhodes, was determined by the committee with final approval by the Board based on the same criteria as the compensation for the other executive officers. In October 1997, Heritage entered into an employment agreement with Mr. Rhodes providing for an annual base salary of \$174,000, which could be increased at the discretion of the Board of Directors or the committee. During the first quarter of 2002, Heritage entered into a new employment agreement with Mr. Rhodes, effective June 1, 2001,