

Edgar Filing: Sound Financial Bancorp, Inc. - Form 10-Q

Sound Financial Bancorp, Inc.
Form 10-Q
August 14, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934

For the quarterly period ended June 30, 2012

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE EXCHANGE ACT

For the transition period from _____ to _____

Commission file number: 333-180385

SOUND FINANCIAL BANCORP, INC.
(Exact name of registrant as specified in its charter)

United States
(State or other jurisdiction of incorporation of
organization)

45-5188530
(IRS Employer Identification No.)

2005 5th Avenue, Second Floor, Seattle, Washington 98121
(Address of principal executive offices)

(206) 448-0884
(Registrant's telephone number)

None
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer	Accelerated filer	Non-accelerated filer	Smaller reporting company
		X	

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES [] NO [X]

Indicate the number of shares outstanding of each issuer's classes of common stock, as of the latest practicable date:

As of August 13, 2012, there were no shares of the registrant's common stock outstanding.

Explanatory Note:

Sound Financial Bancorp, Inc., a Maryland corporation (the “Registrant”), was organized to facilitate the “second-step” conversion of Sound Community Bank (the “Bank”) from the mutual holding company structure to the stock holding company structure (the “Conversion”). The Conversion is expected to be consummated in the third quarter of 2012, at which time the Registrant will become the holding company for the Bank and will own all of the issued and outstanding shares of the Bank’s common stock. As part of the Conversion, shares of the Registrant’s common stock will be issued and sold in an offering to certain depositors of the Bank and others and will also be issued in exchange for the currently issued and outstanding shares of Sound Financial, Inc., a federal corporation, the current mid-tier holding company for the Bank (“SFI”) held by persons other than Sound Community MHC (“MHC”). The Registrant filed a registration statement on Form S-1 (File No. 333-180385) with the Securities and Exchange Commission (the “SEC”) on March 27, 2012, which was declared effective by the SEC on June 29, 2012. The Conversion and related offering were conditionally approved by the Federal Reserve Board on June 29, 2012. Completion of the Conversion and related offering is subject to, among other things, the receipt of final regulatory approvals and approval by SFI’s shareholders and the members of Sound Community Bank MHC. The information in this Form 10-Q is for SFI; certain information contained within may not be relevant for the Registrant. Separate financial statements for the Registrant have not been included in this report because the Registrant, which has not issued any shares and has engaged only in organizational activities to date, has no significant assets, contingent or other liabilities, equity, revenues or expenses.

The Board of Directors of Sound Community MHC (“MHC”), the Company and Sound Community Bank (the “Bank”) adopted a Plan of Conversion and Reorganization (the “Plan”) on January 27, 2012. Pursuant to the Plan, MHC will convert from the mutual holding company form of organization to a stock form of organization. MHC will be merged into the Company, and MHC will no longer exist. Pursuant to the Plan, the Company, which owns 100% of the Bank, also will be succeeded by a new Maryland corporation, named Sound Financial Bancorp, Inc. As part of the conversion, MHC’s ownership interest of the Company will be offered for sale in a public offering. The existing publicly held shares of the Company, which represents the remaining ownership interest in the Company, will be exchanged for new shares of common stock of Sound Financial Bancorp, Inc., the new Maryland corporation. The exchange ratio will ensure that immediately after the conversion and public offering, the public stockholders of the Company will own the same aggregate percentage of Sound Financial, Inc. common stock that they owned of the Company common stock immediately prior to that time. When the conversion and public offering are completed, all of the outstanding capital stock of the Bank will be owned by Sound Financial Bancorp, Inc. and all of the outstanding capital stock of Sound Financial Bancorp, Inc. will be owned by the public. The conversion and reorganization is expected to be completed by the third quarter of 2012, subject to the receipt of final regulatory approvals and approval by the Company’s shareholders and the members of MHC.

The Plan provides for the establishment, upon the completion of the reorganization, of special “liquidation accounts” at Sound Financial Bancorp, Inc. and at the Bank for the benefit of certain depositors of the Bank in an amount equal to MHC’s ownership interest in the retained earnings of the Company as of the date of the latest balance sheet contained in the prospectus for the public offering. Following the completion of the reorganization, neither Sound Financial Bancorp, Inc. nor the Bank, will be permitted to pay dividends on its capital stock to its stockholders, if stockholders’ equity would be reduced below the amount of its liquidation account.

Direct costs of the conversion and public offering will be deferred and reduce the proceeds from the shares sold in the public offering. If the conversion and public offering are not completed, all costs will be charged to expense in the period in which the public offering is terminated. As of June 30, 2012, the Bank had deferred \$581,000 in costs related to the offering.

SOUND FINANCIAL, INC.
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PART I FINANCIAL INFORMATION

Financial Statements

SOUND FINANCIAL, INC AND SUBSIDIARY
Condensed Consolidated Balance Sheets
(Unaudited)

	June 30, 2012	December 31, 2011
	(Dollars in thousands)	
ASSETS		
Cash and cash equivalents	\$19,400	\$17,031
Available-for-sale securities, at fair value	9,033	2,992
Federal Home Loan Bank stock, at cost	2,444	2,444
Loans held for sale	1,053	1,807
Loans	306,394	300,096
Less allowance for loan losses	(4,449)	(4,455)
Total loans, net	301,945	295,641
Accrued interest receivable	1,234	1,234
Bank-owned life insurance, net	7,099	6,981
Mortgage servicing rights, at fair value	2,558	2,437
Other real estate owned and repossessed assets, net	2,839	2,821
Premises and equipment, net	2,233	2,385
Other assets	5,234	3,967
Total assets	\$355,072	\$339,740
LIABILITIES		
Deposits		
Interest-bearing	277,607	269,421
Noninterest-bearing demand	36,122	30,576
Total deposits	313,729	299,997
Borrowings		
Accrued interest payable	78	84
Other liabilities	2,778	2,149
Advance payments from borrowers for taxes and insurance	260	291
Total liabilities	325,030	311,027
COMMITMENTS AND CONTINGENCIES (NOTE 6)		
STOCKHOLDERS' EQUITY		
Preferred stock, \$0.01 par value, 1,000,000 shares authorized, none outstanding	-	-
Common stock, \$0.01 par value, 24,000,000 shares authorized, 2,960,045 and 2,949,045 issued and outstanding as of June 30, 2012 and December 31, 2011, respectively	30	30
Additional paid-in capital	12,005	11,939
Unearned shares - Employee Stock Ownership Plan ("ESOP")	(693)	(693)

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Retained earnings	19,235	18,096
Accumulated other comprehensive loss, net of tax	(535)	(659)
Total stockholders' equity	30,042	28,713
Total liabilities and stockholders' equity	\$355,072	\$339,740

See notes to condensed consolidated financial statements

SOUND FINANCIAL, INC. AND SUBSIDIARY

Condensed Consolidated Statements of Income

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
	(Dollars in thousands, except per share amounts)			
INTEREST INCOME				
Loans, including fees	\$4,514	\$4,645	\$9,022	\$9,232
Interest and dividends on investments, cash and cash equivalents	84	56	139	118
Total interest income	4,598	4,701	9,161	9,350
INTEREST EXPENSE				
Deposits	531	618	1,076	1,266
Borrowings	57	65	112	169
Total interest expense	588	683	1,188	1,435
NET INTEREST INCOME	4,010	4,018	7,973	7,915
PROVISION FOR LOAN LOSSES	1,100	1,225	2,600	2,050
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	2,910	2,793	5,373	5,865
NONINTEREST INCOME				
Service charges and fee income	513	476	1,064	999
Earnings on cash surrender value of bank-owned life insurance	52	66	118	128
Mortgage servicing income	21	123	199	207
Fair value adjustment on mortgage servicing rights	(76)	) 208	308	257
Loss on sale of securities	-	-	-	(34)
Other-than-temporary impairment losses on securities	(32)	) -	(124)	) (39)
Loss on sale of assets	-	(80)	) -	(80)
Gain on sale of loans	308	102	559	137
Total noninterest income	786	895	2,124	1,575
NONINTEREST EXPENSE				
Salaries and benefits	1,423	1,287	2,705	2,753
Operations	728	598	1,310	1,266
Regulatory assessments	99	125	221	351
Occupancy	294	253	604	548
Data processing	262	228	505	467
Losses and expenses on other real estate owned and repossessed assets	22	545	492	684
Total noninterest expense	2,828	3,036	5,837	6,069
INCOME BEFORE PROVISION FOR INCOME TAXES	868	652	1,660	1,371

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PROVISION FOR INCOME TAXES	275	198	520	421
NET INCOME	\$593	\$454	\$1,139	\$950
BASIC EARNINGS PER SHARE	\$0.20	\$0.16	\$0.39	\$0.33
DILUTED EARNINGS PER SHARE	\$0.20	\$0.16	\$0.39	\$0.33

See notes to condensed consolidated financial statements

SOUND FINANCIAL, INC. AND SUBSIDIARY

Condensed Consolidated Statements of Comprehensive Income
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Net income	\$593	\$454	\$1,139	\$950
Other comprehensive income, net of tax				
Unrealized holding gain on available for sale securities, net of taxes (benefit) of \$(17), \$(63), \$22 and \$5, respectively	(33	) (121	) 42	10
Reclassification adjustments for realized losses on sales of securities, net of taxes of \$0, \$0, \$0 and \$12, respectively	-	-	-	22
Reclassification adjustments for other-than-temporary impairment on securities, net of taxes of \$11, \$0, \$42 and \$13, respectively	21	-	82	26
Other comprehensive income	\$(12	) \$(121	) \$124	\$58
Comprehensive income (loss)	\$581	\$333	\$1,263	\$1,008

See notes to condensed consolidated financial statements

SOUND FINANCIAL, INC. AND SUBSIDIARY
Condensed Consolidated Statement of Stockholders' Equity
For the Six Months Ended June 30, 2012 and 2011
(unaudited)

	Shares	Common Stock	Additional Paid-in Capital	Unearned ESOP Shares (in thousands)	Retained Earnings	Accumulated Other Comprehensive Loss, net of tax	Total Stockholders' Equity
BALANCE, December 31, 2010	2,954	\$30	\$11,808	\$(809)	\$16,545	\$ (671)	\$ 26,903
Net income					950		950
Net unrealized gain in fair value of available for sale securities, net of tax of \$30						58	58
Share-based compensation			66				66
BALANCE, June 30, 2011	2,954	\$30	\$11,874	\$(809)	\$17,495	\$ (613)	\$ 27,977
	Shares	Common Stock	Additional Paid-in Capital	Unearned ESOP Shares (in thousands)	Retained Earnings	Accumulated Other Comprehensive Loss, net of tax	Total Stockholders' Equity
BALANCE, December 31, 2011	2,949	\$30	\$11,939	\$(693)	\$18,096	\$ (659)	\$ 28,713
Net income					1,139		1,139
Net unrealized gain in fair value of available for sale securities,						124	124

net of tax of \$90

Restricted stock awards	11							-
Share-based compensation			66					66
BALANCE, June 30, 2012	2,960	\$30	\$12,005	\$(693)	)	\$19,235	\$ (535)	) \$ 30,042

See notes to condensed consolidated financial statements

SOUND FINANCIAL, INC. AND SUBSIDIARY
Condensed Consolidated Statements of Cash Flows
(unaudited)

	Six Months Ended June 30,	
	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$1,139	\$950
Adjustments to reconcile net income to net cash from operating activities		
Accretion of net premium on investments	(9) -
Loss on sale of available for sale securities	-	34
Other-than-temporary impairment losses on securities	124	39
Provision for loan losses	2,600	2,050
Depreciation and amortization	180	196
Compensation expense related to stock options and restricted stock	66	66
Fair value adjustment on mortgage servicing rights	(308	) (257
Additions to mortgage servicing rights	(328	) (216
Amortization of mortgage servicing rights	515	399
Increase in cash surrender value of bank owned life insurance	(118	) (128
Proceeds from sale of loans	33,046	22,841
Originations of loans held for sale	(31,733	) (22,194
Loss on sale of other real estate owned and repossessed assets	169	395
Loss on sale of fixed assets	-	80
Gain on sale of loans	(559	) (137
Change in operating assets and liabilities		
Accrued interest receivable	-	41
Other assets	(1,331	) 759
Accrued interest payable	(6	) (45
Other liabilities	629	(1,241
Net cash provided by operating activities	4,076	3,632
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from principal payments, maturities and sales of available for sale securities	263	1,263
Purchase of available for sale securities	(6,231) -
Net increase in loans	(10,583	) (4,246
Improvements to other real estate owned (“OREO”) and other repossessed assets	(358	) (30
Proceeds from sale of OREO and other repossessed assets	1,850	1,474
Purchases of premises and equipment	(28	) 702
Net cash used by investing activities	(15,087	) (837
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	13,732	9,142
Proceeds from borrowings	-	51,700
Repayment of borrowings	(321) (57,721
Net change in advances from borrowers for taxes and insurance	(31) (74

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Net cash provided by financing activities	13,380	3,047
INCREASE IN CASH AND CASH EQUIVALENTS	2,369	5,842
CASH AND CASH EQUIVALENTS, beginning of period	17,031	9,092
CASH AND CASH EQUIVALENTS, end of period	\$19,400	\$14,934
SUPPLEMENTAL CASH FLOW INFORMATION		
Cash paid for income taxes	\$75	\$1,125
Interest paid on deposits and borrowings	\$1,194	\$1,480
Net transfer of loans to other real estate owned	\$1,679	\$2,791

See notes to condensed consolidated financial statements

SOUND FINANCIAL, INC. AND SUBSIDIARY
Selected Notes to Condensed Consolidated Financial Statement (unaudited)

Note 1 – Basis of Presentation

The accompanying financial information is unaudited and has been prepared from the consolidated financial statements of Sound Financial, Inc. (“we,” “us,” “our,” “Sound Financial,” or the “Company”) and its wholly owned subsidiary Sound Community Bank (the “Bank”). These unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission (“SEC”). In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. Certain information and disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations of the SEC. These unaudited financial statements should be read in conjunction with the Company’s Annual Report on Form 10-K for the year ended December 31, 2011, as filed with the SEC. The results for the interim periods are not necessarily indicative of results for a full year. For further information, refer to the consolidated financial statements and footnotes for the year ended December 31, 2011, included in the Company’s Annual Report on Form 10-K.

Certain amounts in the prior quarters’ financial statements have been reclassified to conform to the current presentation. These classifications do not have an impact on previously reported net income, retained earnings or earnings per share.

Note 2 – Accounting Pronouncements Recently Issued or Adopted

In April 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011-03, Reconsideration of Effective Control for Repurchase Agreements. The ASU amends existing guidance to remove from the assessment of effective control, the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee and, as well, the collateral maintenance implementation guidance related to that criterion. ASU No. 2011-03 is effective for the Company’s reporting period beginning on or after December 15, 2011. The guidance applies prospectively to transactions or modification of existing transactions that occur on or after the effective date and early adoption is not permitted. The adoption of this ASU did not have a material impact on the Company’s consolidated financial statements.

In April 2011, the FASB issued ASU No. 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. The ASU amends existing guidance regarding the highest and best use and valuation premise by clarifying these concepts are only applicable to measuring the fair value of nonfinancial assets. The ASU also clarifies that the fair value measurement of financial assets and financial liabilities which have offsetting market risks or counterparty credit risks that are managed on a portfolio basis, when several criteria are met, can be measured at the net risk position. Additional disclosures about Level 3 fair value measurements are required including a quantitative disclosure of the unobservable inputs and assumptions used in the measurement, a description of the valuation process in place, and discussion of the sensitivity of fair value changes in unobservable inputs and interrelationships about those inputs as well disclosure of the level of the fair value of items

that are not measured at fair value in the financial statements but disclosure of fair value is required. The provisions of ASU No. 2011-04 are effective for the Company's reporting period beginning after December 15, 2011 and are applied prospectively. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

SOUND FINANCIAL, INC. AND SUBSIDIARY
Selected Notes to Condensed Consolidated Financial Statement (unaudited)

In June 2011, the FASB issued ASU No. 2011-05, Presentation of Comprehensive Income. The ASU amends current guidance to allow a company the option of presenting the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The provisions do not change the items that must be reported in other comprehensive income or when an item of other comprehensive must be reclassified to net income. The amendments do not change the option for a company to present components of other comprehensive income either net of related tax effects or before related tax effects, with one amount shown for the aggregate income tax expense (benefit) related to the total of other comprehensive income items. The amendments do not

affect how earnings per share is calculated or presented. The provisions of ASU No. 2011-05 are effective for the Company's reporting period beginning after December 15, 2011 and are applied retrospectively. Early adoption was permitted and there are no required transition disclosures. In December 2011, the FASB issued ASU No. 2011-12, Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. The ASU defers indefinitely the requirement to present reclassification adjustments and the effect of those reclassification adjustments on the face of the financial statements where net income is presented, by component of net income, and on the face of the financial statements where other comprehensive income is presented, by component of other comprehensive income. The adoption of the ASUs did not have a material impact on the Company's consolidated financial statements.

In September 2011, the FASB issued ASU No. 2011-08, Testing Goodwill for Impairment. With the ASU, a company testing goodwill for impairment now has the option of performing a qualitative assessment before calculating the fair value of the reporting unit (the first step of goodwill impairment test). If, on the basis of qualitative factors, the fair value of the reporting unit is more likely than not greater than the carrying amount, a quantitative calculation would not be needed. Additionally, new examples of events and circumstances that an entity should consider in performing its qualitative assessment about whether to proceed to the first step of the goodwill impairment have been made to the guidance and replace the previous guidance for triggering events for interim impairment assessment. The amendments are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

In December 2011, the FASB issued ASU No. 2011-11, Disclosures about Offsetting Assets and Liabilities. The ASU requires an entity to offset, and present as a single net amount, a recognized eligible asset and a recognized eligible liability when it has an unconditional and legally enforceable right of setoff and intends either to settle the asset and liability on a net basis or to realize the asset and settle the liability simultaneously. The ASU requires an entity to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. The amendments are effective for annual and interim reporting periods beginning on or after January 1, 2013. The Company is currently in the process of evaluating the ASU but does not expect it will have a material impact on the Company's consolidated financial statements.

SOUND FINANCIAL, INC. AND SUBSIDIARY

Selected Notes to Condensed Consolidated Financial Statement (unaudited)

In December 2011, the FASB issued ASU No. 2011-12, Deferral of the Effective Date for Amendments to Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update 2011-05 (“ASU 2011-12”). This ASU defers only those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments. ASU 2011-12 was issued in order to allow the FASB time to redeliberate whether to present on the face of the financial statements the effects of reclassifications out of accumulated other comprehensive income on the components of net income and other comprehensive income for all periods presented. While the FASB is considering the operational concerns about the presentation requirements for reclassification adjustments and the needs of financial statement users for additional information about reclassification adjustments, the Company will continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect before the issuance of ASU 2011-05. ASU 2011-12 was effective for the Company’s financial statements for annual and interim periods beginning after December 31, 2011, and was applied prospectively. The adoption of this standard did not have a material impact on the Company’s consolidated financial statements.

In July 2012, the FASB issued ASU No. 2011-02, Testing Indefinite-Lived Intangible Assets for Impairment. With the ASU, a company testing indefinite-lived intangibles for impairment now has the option to assess qualitative factors to determine whether the existence of events and circumstances indicates that it is more likely than not that the indefinite-lived intangible asset is impaired. If, after assessing the totality of events and circumstances, an entity concludes that it is not more likely than not that the indefinite-lived intangible asset is impaired, then the entity is not required to take further action. However, if an entity concludes otherwise, then it is required to determine the fair value of the indefinite-lived intangible asset and perform the quantitative impairment test by comparing the fair value with the carrying amount in accordance with current guidance. An entity also has the option to bypass the qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test. An entity will be able to resume performing the qualitative assessment in any subsequent period. The amendments are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after September 15, 2012. The Company is currently in the process of evaluating the ASU but does not expect it will have a material impact on the Company’s consolidated financial statements.

SOUND FINANCIAL, INC. AND SUBSIDIARY
Selected Notes to Condensed Consolidated Financial Statements (unaudited)

Note 3 – Investments

The amortized cost and fair value of our available for sale securities and the corresponding amounts of gross unrealized gains and losses were as follows:

	Amortized Cost	Gains	Gross Unrealized		Estimated Fair Value
			Losses 1 Year or Less	Losses Greater Than 1 Year	
June 30, 2012			(in thousands)		
Agency mortgage-backed securities	\$6,273	\$6	\$(47	) \$-	\$6,232
Non-agency mortgage-backed securities	3,571	-	-	(770	) 2,801
Total	\$9,844	\$6	\$(47	) \$(770	) \$9,033

	Amortized Cost	Gains	Gross Unrealized		Estimated Fair Value
			Losses 1 Year or Less	Losses Greater Than 1 Year	
December 31, 2011			(in thousands)		
Agency mortgage-backed securities	\$53	\$6	\$-	\$-	\$59
Non-agency mortgage-backed securities	3,939	-	-	(1,006	) 2,933
Total	\$3,992	\$6	\$-	\$(1,006	) \$2,992

The amortized cost and fair value of mortgage-backed securities by contractual maturity, at June 30, 2012, are shown below. Expected maturities of mortgage-backed securities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	June 30, 2012	
	Amortized Cost	Fair Value
Due after ten years	\$9,844	\$9,033

Securities with a carrying value of \$58,000 at June 30, 2012 were pledged to secure Washington State Public Funds. Additionally, the Company has letters of credit with a notional amount of \$31.5 million to secure public deposits.

SOUND FINANCIAL, INC. AND SUBSIDIARY
Selected Notes to Condensed Consolidated Financial Statements (unaudited)

Sales of available for sale securities were as follows:

	Six Months Ended June 30,	
	2012	2011
	(in thousands)	
Proceeds	\$-	\$1,118
Gross gains	-	3
Gross losses	-	(37)

The following table summarizes the aggregate fair value and gross unrealized loss by length of time those investments have been continuously in an unrealized loss position:

	June 30, 2012					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
	(in thousands)					
Agency mortgage-backed securities	\$6,174	\$(47)	\$-	\$-	\$6,174	\$(47)
Non-agency mortgage-backed securities	-	-	2,801	(770)	2,801	(770)
Total	\$6,174	\$(47)	\$2,801	\$(770)	\$8,975	\$(817)

	December 31, 2011					
	Less Than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
	(in thousands)					
Non-agency mortgage-backed securities	\$-	\$-	\$2,933	\$(1,006)	\$2,933	\$(1,006)
Total	\$-	\$-	\$2,933	\$(1,006)	\$2,933	\$(1,006)

The following table presents the cumulative roll forward of credit losses recognized in earnings relating to the Company's non-U.S. agency mortgage backed securities:

	Six Months Ended June 30,	
	2012	2011
	(in thousands)	
Estimated credit losses, beginning balance	\$347	\$160
Additions for credit losses not previously recognized	124	39
Reduction for increases in cash flows	-	-
Reduction for realized losses	-	-

Estimated losses, ending balance	\$471	\$199
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SOUND FINANCIAL, INC. AND SUBSIDIARY
Selected Notes to Condensed Consolidated Financial Statements (unaudited)

As of June 30, 2012, our securities portfolio consisted of six U.S. agency and five non-U.S. agency mortgage backed securities with a fair value of \$9.0 million, of which all five non-U.S. agency securities and four U.S. agency securities were in an unrealized loss position. The unrealized losses were primarily caused by changes in interest rates and a lack of market liquidity causing a decline in the fair value subsequent to the purchase. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than par. While management does not intend to sell the securities, and it is unlikely that the Company will be required to sell these securities before recovery of its amortized cost basis, management's impairment evaluation indicates that certain securities possess qualitative and quantitative factors that suggest an other-than-temporary impairment (OTTI). These factors include, but are not limited to: the length of time and extent of the fair value declines, ratings agency down grades, the potential for an increased level of actual defaults, and the extension in duration of the securities. In addition to the qualitative factors, management's evaluation includes an assessment of quantitative evidence that involves the use of cash flow modeling and present value calculations as determined by considering the applicable OTTI accounting guidance. The Company compares the present value of the current estimated cash flows to the present value of the previously estimated cash flows. Accordingly, if the present value of the current estimated cash flows is less than the present value of the previous period's present value, an adverse change is considered to exist and the security is considered OTTI. The associated "credit loss" is the amount by which the security's amortized cost exceeds the present value of the current estimated cash flows. Based upon the results of the cash flow modeling as of June 30, 2012, four securities reflected OTTI during the six month period ended June 30, 2012. Estimating the expected cash flows and determining the present values of the cash flows involves the use of a variety of assumptions and complex modeling. In developing its assumptions, the Company considers all available information relevant to the collectability of the applicable security, including information about past events, current conditions, and reasonable and supportable forecasts. Furthermore, the Company asserts that the cash flows used in the determination of OTTI are its "best estimate" of cash flows.

The Company engages a third party to assist management with modeling cash flows. The model includes each individual non-agency mortgage backed securities' structural features. The modeled cash flows are discounted and they incorporate additional projected defaults based upon risk analysis of the financial condition and performance. Utilizing the quantitative change in the net present value of the cash flows compared to the amortized cost of the security, the Company recognized additional credit losses of \$124,000 in non-cash pre-tax impairment charges for the six months ended June 30, 2012. Cumulative at June 30, 2012, the Company has recognized a total of \$471,000 of OTTI on four of the five non-agency mortgage backed securities.

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Note 4 – Loans

The composition of the loan portfolio, including loans held for sale, is as follows:

	June 30, 2012	December 31, 2011
	(in thousands)	
Real Estate Loans:		
One-to four- family	\$95,657	\$96,305
Home equity	38,175	39,656
Commercial and multifamily	111,804	106,016
Construction and land	20,564	17,805
Total real estate loans	266,200	259,782
Consumer loans:		
Manufactured homes	17,463	18,444
Other consumer	9,861	10,920
Total consumer loans	27,324	29,364
Commercial business loans	14,556	13,163
Total loans	308,080	302,309
Deferred fees	(633)	(406)
Loans held for sale	(1,053)	(1,807)
Total loans, gross	306,394	300,096
Allowance for loan losses	(4,449)	(4,455)
Total loans, net	\$301,945	\$295,641

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The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of June 30, 2012:

	One- to four- family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Other consumer	Commercial business	Unallocated	Total
	(In thousands)								
Allowance for loan losses: Ending balance: individually evaluated for impairment	\$ 845	\$ 212	\$ 21	\$ 75	\$ 140	\$ 60	\$ 107	\$ -	\$ 1,460
Ending balance: collectively evaluated for impairment	831	1,000	626	106	196	113	108	9	\$ 2,989
Ending balance	\$ 1,676	\$ 1,212	\$ 647	\$ 181	\$ 336	\$ 173	\$ 215	\$ 9	\$ 4,449
Loans receivable: Ending balance: individually evaluated for impairment	\$ 7,511	\$ 2,169	\$ 2,218	\$ 816	\$ 772	\$ 171	\$ 966	\$ -	\$ 14,623
Ending balance: collectively evaluated for impairment	88,146	36,006	109,586	19,748	16,691	9,690	13,590	-	293,457
Ending balance	\$ 95,657	\$ 38,175	\$ 111,804	\$ 20,564	\$ 17,463	\$ 9,861	\$ 14,556	\$ -	\$ 308,080

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The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2011:

	One- to four- family	Home equity	Commercial and multifamily	Commercial Construction and land	Manufactured homes	Other consumer	Commercial business	Unallocated	Total
	(In thousands)								
Allowance for loan losses: Ending balance: individually evaluated for impairment	\$541	\$447	\$ 38	\$ 37	\$ 11	\$48	\$ 132	\$ -	\$1,254
Ending balance: collectively evaluated for impairment	576	979	931	68	279	165	122	81	3,201
Ending balance	\$1,117	\$1,426	\$ 969	\$ 105	\$ 290	\$ 213	\$ 254	\$ 81	\$4,455
Loans receivable: Ending balance: individually evaluated for impairment	\$8,260	\$1,784	\$ 2,003	\$ 902	\$ 122	\$ 101	\$ 447	\$ -	\$13,619
Ending balance: collectively evaluated for impairment	88,045	37,872	104,013	16,903	18,322	10,819	12,716	-	288,690

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Ending balance	\$96,305	\$39,656	\$ 106,016	\$ 17,805	\$ 18,444	\$ 10,920	\$ 13,163	\$ -	\$302,309
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SOUND FINANCIAL, INC. AND SUBSIDIARY
Selected Notes to Condensed Consolidated Financial Statements (unaudited)

The following table summarizes the activity in loan losses for the three months ended June 30, 2012:

	Beginning Allowance	Charge-offs	Recoveries (in thousands)	Provision	Ending Allowance
One-to four- family	\$1,582	\$(650)	\$4	\$740	\$1,676
Home equity	1,410	(20)	130	(308)	1,212
Commercial and multifamily	508	(503)	83	559	647
Construction and land	66	(4)	-	119	181
Manufactured homes	377	(32)	-	(9)	336
Other consumer	142	(27)	9	49	173
Commercial business	234	(1)	10	(28)	215
Unallocated	31	-	-	(22)	9
	\$4,350	\$(1,237)	\$236	\$1,100	\$4,449

The following table summarizes the activity in loan losses for the six months ended June 30, 2012:

	Beginning Allowance	Charge-offs	Recoveries (in thousands)	Provision	Ending Allowance
One-to four- family	\$1,117	\$(1,399)	\$4	\$1,954	\$1,676
Home equity	1,426	(735)	132	389	1,212
Commercial and multifamily	969	(503)	83	98	647
Construction and land	105	(41)	-	117	181
Manufactured homes	290	(60)	-	106	336
Other consumer	213	(106)	16	50	173
Commercial business	254	(7)	10	(42)	215
Unallocated	81	-	-	(72)	9
	\$4,455	\$(2,851)	\$245	\$2,600	\$4,449

The following table summarizes the activity in loan losses for the three months ended June 30, 2011:

	Beginning Allowance	Charge-offs	Recoveries (in thousands)	Provision	Ending Allowance
One-to four- family	\$863	\$(290)	\$-	\$254	\$827
Home equity	1,405	(360)	-	560	1,605
Commercial and multifamily	1,300	(434)	18	329	1,213
Manufactured	287	(100)	29	86	273
Other consumer	197	(132)	-	114	208
Commercial business	209	(9)	-	(28)	172
Unallocated	155	-	-	(90)	65
	\$4,416	\$(1,325)	\$47	\$1,225	\$4,363

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Selected Notes to Condensed Consolidated Financial Statements (unaudited)

The following table summarizes the activity in loan losses for the six months ended June 30, 2011:

	Beginning Allowance	Charge-offs	Recoveries (in thousands)	Provision	Ending Allowance
One-to four- family	\$909	\$(533)	\$12	\$439	\$827
Home equity	1,480	(792)	6	911	1,605
Commercial and multifamily	664	(504)	18	1,035	1,213
Manufactured	294	(201)	-	180	273
Other consumer	309	(162)	40	21	208
Commercial business	163	(8)	1	16	172
Unallocated	617	-	-	(552)	65
	\$4,436	\$(2,200)	\$77	\$2,050	\$4,363

Credit Quality Indicators. Federal regulations provide for the classification of lower quality loans and other assets, such as debt and equity securities, as substandard, doubtful or loss. An asset is considered substandard if it is inadequately protected by the current net worth and payment capacity of the borrower or of any collateral pledged. Substandard assets include those characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all the weaknesses of currently existing facts, conditions and values. Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets without establishment of a specific loss reserve is not warranted.

When we classify problem assets as either substandard or doubtful, we may establish a specific allowance in an amount we deem prudent to address the risk specifically or we may allow the loss to be addressed in the general allowance. General allowances represent loss reserves which have been established to recognize the inherent risk associated with lending activities, but which, unlike specific allowances, have not been specifically allocated to particular problem assets. When an insured institution classifies problem assets as a loss, it is required to charge off such assets in the period in which they are deemed uncollectible. Assets that do not currently expose us to sufficient risk to warrant classification as substandard or doubtful but possess identified weaknesses are required to be classified as either watch or special mention assets. Our determination as to the classification of our assets and the amount of our valuation allowances is subject to review by the OCC, which can order the establishment of additional loss allowances.

Early indicator loan grades are used to identify and track potential problem loans which do not rise to the levels described for substandard, doubtful or loss. The grades for watch and special mention are assigned to loans which have been criticized based upon known characteristics such as periodic payment delinquency or stale financial information from the borrower and/or guarantors. Loans identified as criticized (watch and special mention) or classified (substandard, doubtful or loss) are subject to monthly problem loan reporting.

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The following table represents the internally assigned grades as of June 30, 2012 by type of loan:

Grade:	One-to four- family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Other consumer	Commercial Business	Total
				(in thousands)				
Pass	\$76,053	\$30,292	\$ 105,903	\$ 19,092	\$ 14,934	\$ 8,689	\$ 11,854	\$266,817
Watch	15,497	6,447						