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

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 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: 001-35633

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

Maryland (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 [X] 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 [X] No [ ]

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	
			(Do not check if smaller reporting company)

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 November 14, 2012, there were 2,587,544 shares of the registrant's common stock outstanding.

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PART I FINANCIAL INFORMATION

Financial Statements

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

	September 30, 2012	December 31, 2011
	(Dollars in thousands)	
ASSETS		
Cash and cash equivalents	$15,655	$17,031
Available-for-sale securities, at fair value	20,891	2,992
Federal Home Loan Bank stock, at cost	2,422	2,444
Loans held for sale	2,089	1,807
Loans	308,998	300,096
Less allowance for loan losses	(4,333)	(4,455)
Total loans, net	304,665	295,641
Accrued interest receivable	1,249	1,234
Bank-owned life insurance, net	7,160	6,981
Other real estate owned and repossessed assets, net	2,548	2,821
Mortgage servicing rights, at fair value	2,314	2,437
Premises and equipment, net	2,237	2,385
Other assets	5,268	3,967
Total assets	$366,498	$339,740
LIABILITIES		
Deposits		
Interest-bearing	279,737	269,421
Noninterest-bearing demand	33,307	30,576
Total deposits	313,044	299,997
Borrowings	8,024	8,506
Accrued interest payable	78	84
Other liabilities	2,514	2,149
Advance payments from borrowers for taxes and insurance	542	291
Total liabilities	324,202	311,027
COMMITMENTS AND CONTINGENCIES (NOTE 7)		
STOCKHOLDERS' EQUITY		
Preferred stock, $0.01 par value, 1,000,000 shares authorized, none outstanding	-	-
Common stock, $0.01 par value, 40,000,000 shares authorized, 2,587,544 and 2,578,144 issued and outstanding as of September 30, 2012 and December 31, 2011,	26	30

respectively		
Additional paid-in capital	24,722	11,939
Unearned shares - Employee Stock Ownership Plan (“ESOP”)	(1,827)	(693)
Retained earnings	19,848	18,096
Accumulated other comprehensive loss, net of tax	(473)	(659)
Total stockholders’ equity	42,296	28,713
Total liabilities and stockholders’ equity	$366,498	$339,740

See notes to condensed consolidated financial statements

SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Condensed Consolidated Statements of Income (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
	(Dollars in thousands, except per share amounts)			
INTEREST INCOME				
Loans, including fees	$4,437	$4,556	$13,459	$13,787
Interest and dividends on investments, cash and cash equivalents	105	57	244	176
Total interest income	4,542	4,613	13,703	13,963
INTEREST EXPENSE				
Deposits	540	626	1,617	1,893
Borrowings	56	55	167	223
Total interest expense	596	681	1,784	2,116
NET INTEREST INCOME	3,946	3,932	11,919	11,847
PROVISION FOR LOAN LOSSES	1,075	1,300	3,675	3,350
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	2,871	2,632	8,244	8,497
NONINTEREST INCOME				
Service charges and fee income	574	516	1,638	1,514
Earnings on cash surrender value of bank-owned life insurance	60	61	179	189
Mortgage servicing income	148	110	346	318
Fair value adjustment on mortgage servicing rights	(211)	(491)	97	(235)
Loss on sale of securities	-	-	-	(33)
Other-than-temporary impairment losses on securities	(32)	(56)	(156)	(96)
Loss on sale of assets	-	-	-	(80)
Gain on sale of loans	668	126	1,226	263
Total noninterest income	1,207	266	3,330	1,840
NONINTEREST EXPENSE				
Salaries and benefits	1,537	1,189	4,242	3,942
Operations	697	602	2,007	1,869
Regulatory assessments	108	103	329	454
Occupancy	314	288	918	835
Data processing	264	218	769	685
Losses and expenses on other real estate owned and repossessed assets	265	274	757	958
Total noninterest expense	3,185	2,674	9,022	8,743
INCOME BEFORE PROVISION FOR INCOME TAXES	893	224	2,552	1,594
PROVISION FOR INCOME TAXES	281	43	800	463
NET INCOME	$612	$181	$1,752	$1,131
Net income per share (see Note 9):				
Basic	$0.24	$0.07	$0.68	$0.44
Diluted	$0.23	$0.07	$0.67	$0.43

Weighted average shares outstanding:				
Basic	2,587,669	2,582,733	2,585,694	2,582,733
Diluted	2,627,820	2,609,137	2,616,070	2,609,852

See notes to condensed consolidated financial statements

SOUND FINANCIAL BANCORP, INC. AND SUBSIDIARY
Condensed Consolidated Statements of Comprehensive Income (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	$612	$181	$1,752	$1,131
Other comprehensive income, net of tax				
Unrealized holding gain (loss) on available for sale securities, net of taxes (benefit) of $22, $(7), $43 and $37 respectively	42	(14)	83	71
Reclassification adjustments for realized losses on sales of securities, net of taxes of $0, $0, $0 and $11, respectively	-	-	-	22
Reclassification adjustments for other-than-temporary impairment on securities, net of taxes of $11, $19, $53 and $32, respectively	21	37	103	63
Other comprehensive income	$63	$23	$186	$156
Comprehensive income	$675	$204	$1,938	$1,287

See notes to condensed consolidated financial statements

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

	Shares	Common Stock	Additional Paid-in Capital	Unearned ESOP Shares	Retained Earnings	Accumulated Other Comprehensive Loss, net of tax	Total Stockholders' Equity
			(in thousands, except number of shares)				
BALANCE, December 31, 2011	2,949,045	$30	$11,939	$(693)	$18,096	$ (659)	$ 28,713
Net income					1,752		1,752
Other comprehensive income, net of tax						186	186
Restricted stock awards	11,000	-					
Cancel Sound Community Bank MHC shares	(1,621,435)	(16)					(16)
Exchange of common stock at 0.87423 shares per common share	(168,357)	(2)					(2)
Fractional share distribution	(209)	-					
Proceeds from stock offering, net of offering costs	1,417,500	14	12,658				12,672
Purchase of common stock by ESOP				(1,134)			(1,134)
Share-based compensation			125				125
	2,587,544	$26	$24,722	$(1,827)	$19,848	$ (473)	$ 42,296

BALANCE, September 30, 2012	

See notes to condensed consolidated financial statements

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

	Nine Months Ended September 30, 2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$1,752	$1,131
Adjustments to reconcile net income to net cash from operating activities		
Accretion of net premium on investments	69	-
Loss on sale of available for sale securities	-	33
Other-than-temporary impairment losses on securities	156	96
Provision for loan losses	3,675	3,350
Depreciation and amortization	284	286
Compensation expense related to stock options and restricted stock	125	99
Fair value adjustment on mortgage servicing rights	(97)	235
Additions to mortgage servicing rights	(554)	(329)
Amortization of mortgage servicing rights	774	611
Increase in cash surrender value of bank owned life insurance	(179)	(189)
Proceeds from sale of loans	63,865	32,912
Originations of loans held for sale	(65,373)	(32,876)
Loss on sale of other real estate owned and repossessed assets	314	722
Loss on sale of fixed assets	-	80
Gain on sale of loans	(1,226)	(263)
Change in operating assets and liabilities		
Accrued interest receivable	(15)	84
Other assets	(1,398)	1,022
Accrued interest payable	(6)	(45)
Other liabilities	366	(1,683)
Net cash provided by operating activities	4,984	5,276
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from principal payments, maturities and sales of available for sale securities	1,219	1,382
Purchase of available for sale securities	(19,056)	-
Net increase in loans	(15,074)	(11,209)
Improvements to other real estate owned (“OREO”) and other repossessed assets	(392)	(30)
Proceeds from sale of OREO and other repossessed assets	2,726	2,392
Purchases of premises and equipment	(136)	698
Net cash used by investing activities	(30,713)	(6,767)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	13,046	21,352
Proceeds from borrowings	-	61,700
Repayment of borrowings	(482)	(77,882)
Net change in advances from borrowers for taxes and insurance	251	268
Common stock purchase by ESOP	(1,134)	-
Proceeds from stock offering, net of offering costs	12,672	-
Net cash provided by financing activities	24,353	5,438

INCREASE IN CASH AND CASH EQUIVALENTS	(1,376)	3,947
CASH AND CASH EQUIVALENTS, beginning of period	17,031	9,092
CASH AND CASH EQUIVALENTS, end of period	$15,655	$13,039
SUPPLEMENTAL CASH FLOW INFORMATION		
Cash paid for income taxes	$750	$1,185
Interest paid on deposits and borrowings	$1,790	$2,161
Net noncash transfer of loans to other real estate owned	$2,375	$3,730

See notes to condensed consolidated financial statements

SOUND FINANCIAL BANCORP, 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 Bancorp, Inc. ("we," "us," "our," "Sound Financial Bancorp," 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.

On August 22, 2012, the Company completed its conversion from the mutual holding company structure and related public stock offering, so that it is now a stock holding company that is wholly owned by public shareholders. Please see Note 2 – Conversion and Stock Issuance for more information.

Note 2 – Conversion and Stock Issuance

The Company, a Maryland corporation, was organized by Sound Community MHC ("the MHC"), Sound Financial, Inc. and Sound Community Bank to facilitate the "second-step" conversion of Sound Community Bank from the mutual holding company structure to the stock holding company structure (the "Conversion"). Upon consummation of the Conversion, which occurred on August 22, 2012, the Company became the holding company for Sound Community Bank and now owns all of the issued and outstanding shares of Sound Community Bank's common stock.

In connection with the Conversion, the Company sold a total of 1,417,500 shares of common stock in offering to certain depositors of Sound Community Bank and others, including 113,400 shares to the Sound Community Bank employee stock ownership plan ("ESOP"). All shares were sold at a purchase price of $10.00 per share. Proceeds from the offering, net of $1.5 million in expenses, totaled $12.7 million. The Company used $1.1 million of the proceeds to fund the ESOP and made a $7.5 million dividend to the Bank. In addition, concurrent with the offering, shares of Sound Financial, Inc. common stock owned by public stockholders were exchanged for 0.87423 shares of the Company's common stock, with cash being paid in lieu of issuing any fractional shares. As a result of the offering, exchange and cash in lieu of fractional shares, the Company now has 2,587,544 shares outstanding.

All share and per share information in this report for periods prior to the Conversion has been revised to reflect the 0.87423 Conversion exchange ratio.

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

Note 3 – Accounting Pronouncements Recently Issued or Adopted

In September 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("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.

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.

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

In July 2012, the FASB issued ASU No. 2012-02, 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.

In October 2012, the FASB issued ASU. 2012-06, Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution. The Update clarifies that when an entity recognizes an indemnification asset as a result of a government-assisted acquisition of a financial institution and subsequently, a change in the cash flows expected to be collected on the indemnification asset occurs, as a result of a change in cash flows expected to be collected on the assets subject to indemnification, the reporting entity should subsequently account for the change in the measurement of the indemnification asset on the same basis as the change in the assets subject to indemnification. Any amortization of changes in value should be limited to the contractual term of the indemnification agreement. The amendments are effective for annual and interim reporting periods beginning on or after December 15, 2012. The adoption of this ASU will not have a material impact on the Company’s consolidated financial statements.

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

Note 4 – Investments

The amortized cost and fair value of our available for sale securities and the corresponding amounts of gross unrealized gains and losses at September 30, 2012 and December 31, 2011 were as follows:

September 30, 2012	Amortized Cost	Gains	Gross Unrealized Losses 1 Year or Less (in thousands)	Losses Greater Than 1 Year	Estimated Fair Value
Agency mortgage-backed securities	$18,208	$33	$(178)	$-	$18,063
Non-agency mortgage-backed securities	3,400	-	-	(572)	2,828
Total	$21,608	$33	$(178)	$(572)	$20,891

December 31, 2011	Amortized Cost	Gains	Gross Unrealized Losses 1 Year or Less (in thousands)	Losses Greater Than 1 Year	Estimated Fair Value
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 September 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.

	September 30, 2012	
	Amortized Cost	Fair Value
	(in thousands)	
Due after ten years	$21,608	$20,891

Securities with a carrying value of $57,000 at September 30, 2012 were pledged to secure Washington State Public Funds. Additionally, at September 30, 2012, the Company had letters of credit with a notional amount of $30.0 million to secure public deposits.

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

Sales of available for sale securities for the nine months ended September 30, 2012 and 2011 were as follows:

	Nine Months Ended September 30,	
	2012	2011
	(in thousands)	
Proceeds	$-	$1,118
Gross gains	-	3
Gross losses	-	(36)

The following table summarizes at September 30, 2012 and December 31, 2011 the aggregate fair value and gross unrealized loss by length of time those investments have been continuously in an unrealized loss position:

	September 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	$13,645	$(178)	$-	$-	$13,645	$(178)
Non-agency mortgage-backed securities	-	-	2,828	(572)	2,828	(572)
Total	$13,645	$(178)	$2,828	$2,828	$16,473	$(750)

	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 during the nine months ended September 30, 2012 and 2011 relating to the Company's non-U.S. agency mortgage backed securities:

	Nine Months Ended September 30,	
	2012	2011
	(in thousands)	
Estimated credit losses, beginning balance	$256	$160
Additions for credit losses not previously recognized	156	96
Reduction for increases in cash flows	-	-
Reduction for realized losses	-	-
Estimated losses, ending balance	$412	$256

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

As of September 30, 2012, our securities portfolio consisted of fourteen U.S. agency and five non-U.S. agency mortgage backed securities with a fair value of $20.9 million, of which all five non-U.S. agency securities and nine 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 September 30, 2012, four securities reflected OTTI during the nine month period ended September 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 $156,000 in non-cash pre-tax impairment charges for the nine months ended September 30, 2012. Cumulative at September 30, 2012, the Company has recognized a total of $412,000 of OTTI on four of the five non-agency mortgage backed securities.

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

Note 5 – Loans

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

	September 30, 2012	December 31, 2011
	(in thousands)	
Real Estate Loans:		
One-to four- family	$94,341	$96,305
Home equity	35,883	39,656
Commercial and multifamily	119,938	106,016
Construction and land	20,694	17,805
Total real estate loans	270,856	259,782
Consumer loans:		
Manufactured homes	17,010	18,444
Other consumer	9,085	10,920
Total consumer loans	26,095	29,364
Commercial business loans	14,761	13,163
Total loans	311,712	302,309
Deferred fees	(625)	(406)
Loans held for sale	(2,089)	(1,807)
Total loans, gross	308,998	300,096
Allowance for loan losses	(4,333)	(4,455)
Total loans, net	$304,665	$295,641

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

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 September 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	$837	$280	$ 74	$ 25	$ 120	$41	$ 153	$ -	$1,530
Ending balance: collectively evaluated for impairment	938	786	566	135	152	133	82	11	2,803
Ending balance	$1,775	$1,066	$ 640	$ 160	$ 272	$174	$ 235	$ 11	$4,333
Loans receivable:									
Ending balance: individually evaluated for impairment	$6,766	$1,794	$ 2,148	$ 653	$ 663	$97	$ 1,236	$ -	$13,357
Ending balance: collectively evaluated for impairment	87,575	34,089	117,790	20,041	16,347	8,988	13,525	-	298,355
Ending balance	$94,341	$35,883	$ 119,938	$ 20,694	$ 17,010	$9,085	$ 14,761	$ -	$311,712

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

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	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

Ending balance	$96,305	$39,656	$ 106,016	$ 17,805	$ 18,444	$10,920	$ 13,163	$ -	$302,309

SOUND FINANCIAL BANCORP, 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 September 30, 2012:

	Beginning Allowance	Charge-offs	Recoveries (in thousands)	Provision	Ending Allowance
One-to four- family	$1,676	$(609)	$-	$708	$1,775
Home equity	1,212	(216)	-	70	1,066
Commercial and multifamily	647	-	-	(7)	640
Construction and land	181	(162)	-	141	160
Manufactured homes	336	(46)	-	(18)	272
Other consumer	173	(126)	6	121	174
Commercial business	215	(38)	-	58	235
Unallocated	9	-	-	2	11
	$4,449	$(1,197)	$6	$1,075	$4,333

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

	Beginning Allowance	Charge-offs	Recoveries (in thousands)	Provision	Ending Allowance
One-to four- family	$1,117	$(2,008)	$4	$2,662	$1,775
Home equity	1,426	(951)	132	459	1,066
Commercial and multifamily	969	(503)	83	91	640
Construction and land	105	(203)	-	258	160
Manufactured homes	290	(106)	-	88	272
Other consumer	213	(232)	22	171	174
Commercial business	254	(45)	10	16	235
Unallocated	81	-	-	(70)	11
	$4,455	$(4,048)	$251	$3,675	$4,333

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

	Beginning Allowance	Charge-offs	Recoveries (in thousands)	Provision	Ending Allowance
One-to four- family	$827	$(261)	$-	$407	$973
Home equity	1,605	(352)	1	(211)	1,043
Commercial and multifamily	1,213	(807)	16	667	1,089
Manufactured	273	(82)	-	148	339
Other consumer	208	(37)	8	25	204
Commercial business	172	(180)	38	191	221
Unallocated	65	-	-	73	138
	$4,363	$(1,719)	$63	$1,300	$4,007

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

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

	Beginning Allowance	Charge-offs	Recoveries (in thousands)	Provision	Ending Allowance
One-to four- family	$909	$(794)	$12	$846	$973
Home equity	1,480	(1,144)	7	700	1,043
Commercial and multifamily	664	(1,311)	34	1,702	1,089
Manufactured	294	(283)	-	328	339
Other consumer	309	(199)	48	46	204
Commercial business	163	(188)	39	207	221
Unallocated	617	-	-	(479)	138
	$4,436	$(3,919)	$140	$3,350	$4,007

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 and related provision for loan losses 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.

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

The following table represents the internally assigned grades as of September 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	$76,595	$28,687	$ 113,700	$ 19,366	$ 14,656	$ 8,186	$ 11,342	$272,532
Watch	14,536	5,791	4,271	778	2,331	849	2,819	31,375
Special Mention	493	502	598	-	-	-	-	1,593
Substandard	2,717	903	1,369	550	23	50	600	6,212
Doubtful	-	-	-	-	-	-	-	-
Loss	-	-	-	-	-	-	-	-
Total	$94,341	$35,883	$ 119,938	$ 20,694	$ 17,010	$ 9,085	$ 14,761	$311,712

The following table represents the internally assigned grades as of December 31, 2011 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	$70,392	$31,943	$ 100,002	$ 16,087	$ 16,062	$ 9,507	$ 10,331	$254,324
Watch	18,088	6,138	4,048	778	2,260	1,312	2,385	35,009
Special Mention	1,505	183	-	-	-	4	11	1,703
Substandard	6,320	1,392	1,966	940	122	97	436	11,273
Doubtful	-	-	-	-	-	-	-	-
Loss	-	-	-	-	-	-	-	-
Total	$96,305	$39,656	$ 106,016	$ 17,805	$ 18,444	$ 10,920	$ 13,163	$302,309

Nonaccrual and Past Due Loans. Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are automatically placed on nonaccrual once the loan is 90 days past due or if, in management's opinion, the borrower may be unable to meet payment of obligations as they become due, as well as when required by regulatory provisions.

The following table presents the recorded investment in nonaccrual loans as of September 30, 2012 and December 31, 2011 by type of loan:

	September 30, 2012	December 31, 2011
	(in thousands)	
One- to four- family	$1,358	$3,124

Home equity	404	731
Commercial and multifamily	1,124	1,299
Construction and land	550	-
Other consumer	3	64
Commercial business	91	-
Total	$3,530	$5,218

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

The following table represents the aging of the recorded investment in past due loans as of September 30, 2012 by type of loan:

	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Recorded Investment 90 Days or Greater and Accruing (in thousands)	Total Past Due	Current	Total Loans
One- to four-family	$-	$411	$1,592	$-	$2,003	$92,338	$94,341
Home equity	324	108	358	-	790	35,093	35,883
Commercial and multifamily	-	-	-	-	-	119,938	119,938
Construction and land	-	-	551	-	551	20,143	20,694
Manufactured homes	76	-	-	-	76	16,934	17,010
Other consumer	113	2	3	-	118	8,967	9,085
Commercial business	30	-	90	-	120	14,641	14,761
Total	$543	$521	$2,594	$-	$3,658	$308,054	$311,712

The following table represents the aging of the recorded investment in past due loans as of December 31, 2011 by type of loan:

	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Recorded Investment 90 Days or Greater and Accruing (in thousands)	Total Past Due	Current	Total Loans
One- to four-family	$4,321	$935	$2,683	$-	$7,939	$88,366	$96,305
Home equity	583	176	683	-	1,442	38,214	39,656
Commercial and multifamily	-	-	-	-	-	106,016	106,016
	-	123	80	-	203	17,602	17,805

Construction and land							
Manufactured homes	327	7	-	-	334	18,110	18,444
Other consumer	172	3	-	-	175	10,745	10,920
Commercial business	669	-	-	-	669	12,494	13,163
Total	$6,072	$1,244	$3,446	$-	$10,762	$291,547	$302,309

Nonperforming Loans. Loans are considered nonperforming when they are 90 days past due, placed on nonaccrual, or when they are past due troubled debt restructurings ("TDRs"). The following table represents the credit risk profile based on payment activity as of September 30, 2012 by type of loan:

	One- to four-family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Other consumer	Commercial business	Total
			(in thousands)					
Performing	$92,934	$35,093	$ 118,572	$ 20,144	$ 16,991	$ 9,082	$ 14,552	$307,368
Nonperforming	1,407	790	1,366	550	19	3	209	4,344
Total	$94,341	$35,883	$ 119,938	$ 20,694	$ 17,010	$ 9,085	$ 14,761	$311,712

The following table represents the credit risk profile based on payment activity as of December 31, 2011 by type of loan:

	One-to four-family	Home equity	Commercial and multifamily	Construction and land	Manufactured homes	Other consumer	Commercial business	Total
			(in thousands)					
Performing	$91,904	$38,783	$ 104,797	$ 17,725	$ 18,444	$ 10,856	$ 13,163	$295,672
Nonperforming	4,401	873	1,219	80	-	64	-	6,637
Total	$96,305	$39,656	$ 106,016	$ 17,805	$ 18,444	$ 10,920	$ 13,163	$302,309

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

Impaired Loans. A loan is considered impaired when we have determined that we may be unable to collect payments of principal or interest when due under the terms of the loan. In the process of identifying loans as impaired, we take into consideration factors which include payment history and status, collateral value, financial condition of the borrower, and the probability of collecting scheduled payments in the future. Minor payment delays and insignificant payment shortfalls typically do not result in a loan being classified as impaired. The significance of payment delays and shortfalls is considered on a case by case basis, after taking into consideration the totality of circumstances surrounding the loans and the borrowers, including payment history and amounts of any payment shortfall, length and reason for delay, and likelihood of return to stable performance. Impairment is measured on a loan by loan basis for all loans in the portfolio.

The following table presents loans individually evaluated for impairment as of September 30, 2012 by type of loan:

	Recorded Investment	Unpaid Principal Balance (in thousands)	Related Allowance
With no related allowance recorded:			
One-to four-family	$2,172	$2,329	$-
Home equity	935	1,252	-
Commercial and multifamily	1,904	1,904	-
Construction and land	552	730	-
Manufactured homes	68	68	-
Other consumer	13	54	-
Commercial business	846	846	-
Total	$6,490	$7,183	$-
With an allowance recorded:			
One-to four-family	$4,594	$4,611	$837
Home equity	859	859	280
Commercial and multifamily	244	244	74
Construction and land	101	102	25
Manufactured homes	595	595	120
Other consumer	84	84	41
Commercial business	390	430	153
Total	$6,867	$6,925	$1,530
Totals:			
One-to four- family	$6,766	$6,940	$837
Home equity	1,794	2,111	280
Commercial and multifamily	2,148	2,148	74
Construction and land	653	832	25
Manufactured homes	663	663	120
Other consumer	97	138	41
Commercial business	1,236	1,276	153

Total	$13,357	$14,108	$1,530

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

The following table presents loans individually evaluated for impairment as of December 31, 2011 by type of loan:

	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded:		(in thousands)	
One-to four-family	$3,104	$3,104	$-
Home equity	773	773	-
Commercial and multifamily	1,784	1,784	-
Construction and land	779	785	-
Manufactured homes	-	-	-
Other consumer	14	55	-
Commercial business	233	233	-
Total	$6,687	$6,734	$-
With an allowance recorded:			
One-to four-family	$5,156	$5,280	$541
Home equity	1,011	1,038	447
Commercial and multifamily	219	219	38
Construction and land	123	178	37
Manufactured homes	122	122	11
Other consumer	87	87	48
Commercial business	214	214	132
Total	$6,932	$7,138	$1,254
Totals:			
One-to four-family	$8,260	$8,384	$541
Home equity	1,784	1,811	447
Commercial and multifamily	2,003	2,003	38
Construction and land	902	963	37
Manufactured homes	122	122	11
Other consumer	101	142	48
Commercial Business	447	447	132
Total	$13,619	$13,872	$1,254

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

The following table presents loans individually evaluated for impairment as of September 30, 2012 and 2011 by type of loan:

	Three Months Ended			
	September 30, 2012		September 30, 2011	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:				
One-to four-family	$ 1,908	$ 28	$ 2,437	$ 44
Home equity	783	9	623	5
Commercial and multifamily	1,938	26	1,915	20
Construction and land	574	-	-	-
Manufactured homes	70	1	13	1
Other consumer	8	1	39	1
Commercial business	847	3	82	-
Total	$ 6,126	$ 68	$ 5,109	$ 71
With an allowance recorded:				
One-to four-family	$ 5,132	$ 37	$ 3,658	$ 5
Home equity	1,141	9	865	3
Commercial and multifamily	245	4	1,227	2
Construction and land	161	1	-	-
Manufactured homes	648	10	145	2
Other consumer	127	2	46	2
Commercial business	255	4	163	1
Total	$ 7,708	$ 67	$ 6,104	$ 15
Totals:				
One-to four-family	$ 7,040	$ 65	$ 6,095	$ 49
Home equity	1,923	18	1,488	8
Commercial and multifamily	2,183	30	3,142	22
Construction and land	735	1	-	-
Manufactured homes	718	11	158	3
Other consumer	134	3	85	3
Commercial Business	1,101	7	245	1
Total	$ 13,833	$ 135	$ 11,212	