McGladrey & Pullen
Certified Public Accountants

# Puget Sound Financial Services, Inc. and Subsidiary

## Consolidated Financial Report
## December 31, 2007

Puget

Sound

Financial

Services

Inc.

and

Subsidiary

# Consolidated

# Financial

# Report

December 31

2007

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## Independent Auditor's Report

To the Board of Directors
Puget Sound Financial Services, Inc.
Fife, Washington

We have audited the accompanying consolidated balance sheets of Puget Sound Financial Services, Inc. and Subsidiary as of December 31, 2007 and 2006, and the related consolidated statements of income, shareholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Puget Sound Financial Services, Inc. and Subsidiary as of December 31, 2007 and 2006, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

McGladrey & Pullen, LLP

Seattle, Washington
March 21, 2008

# Consolidated
# Financial
# Statements

## Consolidated Balance Sheets

(Dollars in Thousands, Except Share Amounts)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2007 and 2006

| | 2007 | 2006 |
|---|---|---|
| **Assets** | | |
| Cash and cash equivalents: | | |
| Cash and due from banks | $ 2,251 | $ 1,989 |
| Interest-bearing deposits in other financial institutions | 4,531 | 2,099 |
| Federal funds sold | - - | 4,730 |
| Total cash and cash equivalents | 6,782 | 8,818 |
| Securities available for sale | 3,068 | 2,386 |
| Federal Home Loan Bank stock, at cost | 412 | 412 |
| Loans | 73,171 | 74,114 |
| Less allowance for credit losses | 925 | 914 |
| Net loans | 72,246 | 73,200 |
| Premises and equipment, net | 885 | 886 |
| Accrued interest receivable | 429 | 364 |
| Bank owned life insurance | 1,227 | 1,181 |
| Other assets | 226 | 146 |
| Total assets | $85,275 | $87,393 |
| **Liabilities and Shareholders' Equity** | | |
| **Liabilities** | | |
| Deposits: | | |
| Demand, non-interest-bearing | $10,683 | $11,519 |
| Savings and interest-bearing demand | 16,485 | 13,112 |
| Time | 44,494 | 47,966 |
| Total deposits | 71,662 | 72,597 |
| Accrued interest payable | 10 | 22 |
| Deferred compensation payable | 1,025 | 806 |
| Federal funds purchased | 100 | - - |
| Long-term borrowings | 4,750 | 6,450 |
| Other liabilities | 161 | 204 |
| Total liabilities | 77,708 | 80,079 |
| **Commitments and Contingencies** | - - | - - |
| **Shareholders' Equity** | | |
| Common stock (par value $1); authorized 2,000,000 shares; issued and outstanding: 2007 - 159,181 shares; 2006 - 160,431 shares | 159 | 160 |
| Additional paid-in capital | 2,186 | 2,272 |
| Retained earnings | 5,218 | 4,965 |
| Unearned KSOP shares | (29) | (87) |
| Accumulated other comprehensive income | 33 | 4 |
| Total shareholders' equity | 7,567 | 7,314 |
| Total liabilities and shareholders' equity | $85,275 | $87,393 |

*See notes to consolidated financial statements.*

## Consolidated Statements of Income

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
Years Ended December 31, 2007 and 2006

| | 2007 | 2006 |
|---|---|---|
| **Interest and Dividend Income** | | |
| Loans | $6,933 | $6,572 |
| Federal funds sold and interest-bearing deposits in other financial institutions | 454 | 356 |
| Securities available for sale | 135 | 147 |
| Dividends on Federal Home Loan Bank stock | 2 | - - |
| Total interest and dividend income | 7,524 | 7,075 |
| **Interest Expense** | | |
| Deposits | 2,894 | 2,176 |
| Long-term borrowings | 224 | 283 |
| Total interest expense | 3,118 | 2,459 |
| Net interest income | 4,406 | 4,616 |
| **Provision for Credit Losses** | 11 | 80 |
| Net interest income after provision for credit losses | 4,395 | 4,536 |
| **Non-Interest Income** | | |
| Service charges on deposit accounts | 177 | 153 |
| Mortgage loan brokerage fees | 65 | 212 |
| Earnings on bank owned life insurance | 47 | 43 |
| Gains on securities available for sale | - - | 12 |
| Other operating income | 25 | 32 |
| Total non-interest income | 314 | 452 |
| **Non-Interest Expense** | | |
| Salaries and employee benefits | 1,478 | 1,748 |
| Occupancy | 68 | 47 |
| Furniture and equipment | 80 | 29 |
| Data processing | 169 | 173 |
| Other | 761 | 812 |
| Total non-interest expense | 2,556 | 2,809 |
| Net income | $2,153 | $2,179 |

*See notes to consolidated financial statements.*

## Consolidated Statements of Shareholders' Equity

(Dollars in Thousands, Except Share Information)

Puget Sound Financial Services, Inc. and Subsidiary
Years Ended December 31, 2007 and 2006

| | Common Stock | | Additional Paid-in | Retained | Unearned KSOP | Accumulated Other Compre-hensive Income | |
|---|---|---|---|---|---|---|---|
| | Shares | Amount | Capital | Earnings | Shares | (Loss) | Total |
| Balance at December 31, 2005 | 151,981 | $152 | $2,011 | $4,571 | ($261) | ($ 9) | $6,464 |
| Comprehensive income: | | | | | | | |
| Net income | - - | - - | - - | 2,179 | - - | - - | 2,179 |
| Other comprehensive income: | | | | | | | |
| Change in fair value of securities available for sale | - - | - - | - - | - - | - - | 13 | 13 |
| Comprehensive income | | | | | | | 2,192 |
| Earned KSOP shares | - - | - - | 92 | - - | 174 | - - | 266 |
| Cash dividends ($11 per share) | - - | - - | - - | (1,785) | - - | - - | (1,785) |
| Stock options exercised | 8,450 | 8 | 169 | - - | - - | - - | 177 |
| Balance at December 31, 2006 | 160,431 | 160 | 2,272 | 4,965 | (87) | 4 | 7,314 |
| Comprehensive income: | | | | | | | |
| Net income | - - | - - | - - | 2,153 | - - | - - | 2,153 |
| Other comprehensive income: | | | | | | | |
| Change in fair value of securities available for sale | - - | - - | - - | - - | - - | 29 | 29 |
| Comprehensive income | | | | | | | 2,182 |
| Earned KSOP shares | - - | - - | 30 | - - | 58 | - - | 88 |
| Cash dividends ($12 per share) | - - | - - | - - | (1,900) | - - | - - | (1,900) |
| Repurchase of common stock | (1,250) | (1) | (116) | - - | - - | - - | (117) |
| Balance at December 31, 2007 | 159,181 | $159 | $2,186 | $5,218 | ($ 29) | $33 | $7,567 |

*See notes to consolidated financial statements.*

## Consolidated Statements of Cash Flows

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
Years Ended December 31, 2007 and 2006

| | 2007 | 2006 |
|---|---|---|
| **Cash Flows from Operating Activities** | | |
| Net income | $2,153 | $2,179 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for credit losses | 11 | 80 |
| Depreciation and amortization | 75 | 97 |
| Change in fair value of unearned KSOP shares and KSOP compensation expense | 88 | 266 |
| Increase in accrued interest receivable | (65) | (70) |
| Increase (decrease) in accrued interest payable | (12) | 15 |
| Increase in deferred compensation payable | 219 | 227 |
| Securities available for sale amortization (accretion), net | 4 | (19) |
| Gains on sale of securities available for sale | - - | (12) |
| Earnings on bank owned life insurance | (46) | (43) |
| Other, net | (123) | (86) |
| Net cash provided by operating activities | 2,304 | 2,634 |
| **Cash Flows from Investing Activities** | | |
| Activity in securities available for sale: | | |
| Maturities, prepayments and calls | 2,836 | 2,120 |
| Purchases | (3,493) | (2,224) |
| Net (increase) decrease in loans made to customers | 943 | (7,506) |
| Purchases of premises and equipment | (75) | (85) |
| Proceeds from sales of premises and equipment | 1 | - - |
| Net cash provided by (used in) investing activities | 212 | (7,695) |
| **Cash Flows from Financing Activities** | | |
| Net increase (decrease) in deposits | (935) | 7,232 |
| Proceeds from issuance of federal funds purchased | 100 | - - |
| Repayment of long-term borrowings | (1,700) | (1,311) |
| Stock options exercised | - - | 177 |
| Payment of cash dividends | (1,900) | (1,785) |
| Repurchase of common stock | (117) | - - |
| Net cash provided by (used in) financing activities | (4,552) | 4,313 |
| Net decrease in cash and cash equivalents | (2,036) | (748) |
| **Cash and Cash Equivalents** | | |
| Beginning of year | 8,818 | 9,566 |
| End of year | $6,782 | $8,818 |

*(continued)*

*See notes to consolidated financial statements.*

## Consolidated Statements of Cash Flows

*(concluded)* (Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
Years Ended December 31, 2007 and 2006

| | 2007 | 2006 |
|---|---|---|
| **Supplemental Disclosure of Cash Flow Information** | | |
| Interest paid | $3,130 | $2,444 |
| **Supplemental Disclosure of Non-Cash Investing Activities** | | |
| Change in fair value of securities available for sale | $29 | $13 |

*See notes to consolidated financial statements.*

## Note 1 - Summary of Significant Accounting Policies

### Principles of Consolidation

The consolidated financial statements include the accounts of Puget Sound Financial Services, Inc. (the Company) and its wholly owned subsidiary, Fife Commercial Bank (the Bank). All significant intercompany transactions and balances have been eliminated.

### Nature of Operations

The Company is a holding company that operates primarily through its subsidiary, the Bank. The Bank operates one branch in Fife, Washington, and provides loan and deposit services to customers, who are predominately small- and middle-market businesses and middle-income individuals in western Washington.

### Consolidated Financial Statement Presentation

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and practices within the banking industry. Preparation of consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities, as of the date of the consolidated balance sheets, as well as the reported amounts of revenue and expenses during the reporting period. Actual results could differ significantly from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for credit losses.

Certain prior year amounts have been reclassified, with no change to shareholders' equity or net income previously reported, to conform to the 2007 presentation. All dollar amounts, except share information, are stated in thousands.

### Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents are defined to include the Company's cash on hand, due from banks, short-term interest-bearing deposits in other financial institutions and federal funds sold. The Company reports net cash flows from customer loan and deposit transactions and time deposits in other financial institutions.

### Interest-Bearing Deposits in Other Financial Institutions

Interest-bearing deposits in other financial institutions are carried at cost and are either invested on a daily basis and have next day availability or mature within a year.

### Securities Available for Sale

Securities available for sale consist of debt securities that the Bank intends to hold for an indefinite period but not necessarily to maturity. Such securities may be sold to implement the Bank's asset/liability management strategies and in response to changes in interest rates and similar factors. Securities available for sale are reported at fair value. Unrealized gains and losses are reported as a net amount in a separate component of shareholders' equity entitled "accumulated other comprehensive income (loss)." Realized gains and losses on securities available for sale, determined using the specific-identification method, are included in earnings. Amortization of premiums and accretion of discounts are recognized in interest income over the period to maturity.

*(continued)*

## Note 1 - Summary of Significant Accounting Policies *(continued)*

### Securities Available for Sale *(concluded)*

Declines in the fair value of individual securities available for sale below their cost that are other than temporary result in write-downs of the individual securities to their fair value. Such write-downs are included in earnings as realized losses.

### Federal Home Loan Bank Stock

The Bank, as a member of the Federal Home Loan Bank (FHLB) system, is required to maintain an investment in FHLB capital stock in an amount equal to the greater of 1 percent of its outstanding home loans or 5 percent of advances from FHLB. The recorded amount of FHLB stock equals its fair value because the shares can only be redeemed by FHLB at the $100 per share par value.

### Loans Receivable

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding principal balances, adjusted for any charge-offs, the allowance for credit losses, any deferred fees or costs on originated loans, and unamortized premiums or discounts on purchased loans. Loan fees and certain direct loan origination costs are deferred, and the net fee or cost is recognized as an adjustment to interest income using the interest method.

Because some loans may not be repaid in full, an allowance for credit losses is recorded. An allowance for credit losses is a valuation allowance for probable incurred credit losses. The allowance for credit losses is increased by a provision for credit losses charged to expense and decreased by charge-offs (net of recoveries). The allowance is based on ongoing, quarterly assessments of the probable and estimable losses inherent in the loan portfolio. The Company's methodology for assessing the appropriateness of the allowance consists of several key elements, which include the formula allowance and specific allowances.

The formula portion of the general credit loss allowance is established by applying a loss percentage factor to the different loan types. The allowances are provided based on management's continuing evaluation of the pertinent factors underlying the quality of the loan portfolio, including changes in the size and composition of the loan portfolio, actual loan loss experience, current economic conditions, geographic concentrations, seasoning of the loan portfolio, specific industry conditions, and the duration of the current business cycle. The recovery of the carrying value of loans is susceptible to future market conditions beyond the Company's control, which may result in losses or recoveries differing from those provided.

Specific allowances are established for loans evaluated for impairment in accordance with the provisions of SFAS 114, *Accounting by Creditors for Impairment of a Loan*, which require an allowance to be established as a component of the allowance for loan losses when it is probable all amounts due will not be collected pursuant to the contractual terms of the loan and the recorded investment in the loan exceeds its fair value. Fair value is measured using either the present value of expected future cash flows, discounted at the loan's effective interest rate, the observable market price of the loan, or the fair value of the collateral, if the loan is collateral dependent. All loans subject to evaluation and considered impaired are included in nonperforming assets. Smaller balance loans are excluded from this analysis.

*(continued)*

## Note 1 - Summary of Significant Accounting Policies *(continued)*

### Loans Receivable *(concluded)*

The ultimate recovery of all loans is susceptible to conditions beyond the Company's control. These factors may result in losses or recoveries differing significantly from those provided in the consolidated financial statements. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for credit losses, and may require the Company to make additions to the allowance based on their judgment about information available to them at the time of their examinations.

Interest income on loans is accrued over the term of the loans based on the principal outstanding. The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. Past due status is based on contractual terms of the loan. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent that cash payments are received until, in management's judgment, the borrower has the ability to make contractual interest and principal payments, in which case, the loan is returned to accrual status.

### Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation, which is computed on the straight-line method over the estimated useful lives of the assets, which range from three to seven years for furniture and equipment and a useful life of 39 years for the building. Gains or losses on dispositions are reflected in earnings.

The assets are reviewed for impairment when events indicate their carrying value may not be recoverable. If management determines impairment exists, the asset is reduced with an offsetting charge to expense.

### Federal Funds Purchased

Federal funds purchased are short-term borrowings that typically mature within one to 90 days.

### Transfers of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (1) the assets have been isolated from the Bank; (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets; and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

### Advertising Costs

Advertising costs are expensed as incurred.

*(continued)*

## Note 1 - Summary of Significant Accounting Policies *(continued)*

### Income Taxes

Effective January 1, 2004, the Company elected to report its earnings under Subchapter S of the Internal Revenue Code, whereby such earnings are reported by the individual shareholders. The Company may be required to pay taxes on certain built-in gains realized in future years relating to assets acquired prior to election of Subchapter S status. Taxes on these gains would be realized only if the Company were to dispose of the assets within the 10 years immediately following the Subchapter S conversion, and then only to the extent of the lesser of the built-in gains tax associated with the disposal or the Company's current year corporate tax liability.

Management intends to pay dividends to shareholders equal to approximately 40 percent of net income annually, to service the related tax liability.

### 401(k) Employee Stock Ownership Plan (KSOP)

The Company sponsors a combined 401(k) profit sharing plan and internally leveraged employee stock ownership plan (KSOP). The KSOP is accounted for in accordance with the AICPA Statement of Position (SOP) 93-6, *Employer's Accounting for Employee Stock Ownership Plans.* The cost of shares issued to the ESOP but not yet allocated to participants is shown as a reduction of shareholders' equity. Stock and cash dividends on allocated shares are recorded as a reduction of retained earnings and paid directly to plan participants or distributed directly to participant accounts. As shares are released, compensation expense is recorded equal to the then current market price of the shares.

The Company records cash dividends on unallocated shares as a reduction of debt and accrued interest.

### Stock-Based Compensation

The Company has a stock-based compensation option plan, which is described more fully in Note 13. The Company accounts for the stock option plan under the recognition and measurement principles of SFAS No. 123R*, Share-Based Payment,* SFAS No. 123(R). SFAS No. 123(R*)* requires measurement of the compensation cost for all stock-based awards based on the grant-date fair value and recognition of compensation cost over the service period of stock-based awards. The fair value of stock options is determined using the Black-Scholes valuation model. There was no compensation expense recognized during the years ended December 31, 2007 and 2006, as there were no unvested options as of January 1, 2006, and there have been no options granted since that date.

### Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, which provides enhanced guidance for using fair value to measure assets and liabilities. The standard applies whenever other standards require or permit assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances. SFAS No. 157 is effective for the Company's consolidated financial statements for fiscal years beginning January 1, 2008, and interim periods within those fiscal years. However, in February 2008, the FASB decided that an entity need not apply this standard to nonfinancial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis until the subsequent year. The Company does not expect the adoption of SFAS No. 157 will have a material impact on the Company's consolidated financial statements or results of operations.

*(continued)*

## Note 1 - Summary of Significant Accounting Policies *(concluded)*

### Recent Accounting Pronouncements *(concluded)*

In February 2007, the FASB issued SFAS No. 159, *Fair Value Option for Financial Assets and Financial Liabilities – Including an amendment of FASB Statement No. 115* (SFAS No. 159). SFAS No. 159 provides all entities with an option to report selected financial assets and liabilities at fair value. A business entity shall report unrealized gains and losses on items for which the fair value option has been elected in earnings. The option to report items at fair value generally may be applied on an instrument-by-instrument basis and is irrevocable. The options may not be applied to portions of instruments. SFAS No. 159 is effective for the Company's fiscal year beginning January 1, 2008. The statement also requires additional disclosures. Management is currently evaluating the impact of the adoption of SFAS No. 159; however, it is not expected to have a material impact on the Company's financial position or results of operations, as election of this option for the Company's financial instruments is expected to be limited.

In September 2006, the FASB ratified the consensuses reached by the Emerging Issues Task Force (the Task Force) on Issue No. 06-5 (EITF 06-5) *Accounting for the Purchases of Life Insurance - Determining the Amount that Could be Realized in Accordance with FASB Technical Bulletin No. 85-4* (FTB 85-4). FTB 85-4 indicates that the amount of the asset included on the balance sheet for life insurance contracts within its scope should be "the amount that could be realized under the insurance contract as of the date of the statement of financial position." Questions arose in applying the guidance in FTB 85-4 related to whether "the amount that could be realized" should consider: 1) any additional amounts included in the contractual terms of the insurance policy other than the cash surrender value, and 2) the contractual ability to surrender all of the individual life policies (or certificates in a group policy) at the same time. EITF 06-5 determined that "the amount that could be realized" should: 1) consider any additional amounts included in the contractual terms of the policy, and 2) assume the surrender of an individual life by individual life policy (or certificate by certificate in a group policy). Any amount that is ultimately realized by the policy holder upon the assumed surrender of the final policy (or final certificate in a group policy) shall be included in the "amount that could be realized." An entity should apply the provisions of EITF 06-5 through either a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption or a change in accounting principle through retrospective application to all prior periods. The provisions of EITF 06-5 are effective for fiscal years beginning January 1, 2008. The Company does not expect the adoption of SFAS No. 157 will have a material impact on the Company's consolidated financial statements or results of operations.

In September 2006, the Emerging Issues Task Force (EITF) reached a final consensus on the subject titled Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Arrangements*. EITF 06-4 requires the recognition of a liability and related compensation expense for the endorsement split-dollar life insurance policies that provide a benefit to an employee that extends to post retirement periods. Pursuant to the final consensus, if an employer has promised to pay a death benefit directly from the company to a participant (or designated beneficiary), then a liability for the present value of the death benefit must be accrued over the participant's required service period. However, if the employer has agreed to maintain a split-dollar arrangement and share some portion of the death benefits of the underlying insurance policy, then the postretirement cost of insurance, rather than the death benefit, should be accrued. Since most of the Company's agreements involving postretirement death benefits are split-dollar arrangements associated with an underlying insurance policy, management anticipates that the Company's accrual requirement will, for the most part, be limited to the postretirement cost of insurance. The new guidance will be effective for fiscal years beginning January 1, 2008. Transition to the new guidance requires a cumulative-effect adjustment to retained earnings at the beginning of the year of implementation, to reflect the change in accounting principle. Upon implementation on January 1, 2008, this EITF guidance has an approximate one-time charge to retained earnings of $43 and a quarterly charge to expense of about $4 thereafter.

(Dollars in Thousands)

## Note 2 - Restricted Assets

Federal Reserve Board regulations require that the Bank maintain certain minimum reserve balances in either cash on hand or on deposit with the Federal Reserve Bank, based on a percentage of deposits. Such balances were insignificant for the years ended December 31, 2007 and 2006.

## Note 3 - Securities Available for Sale

Debt securities have been classified as available for sale according to management's intent. The amortized cost of securities and their approximate fair value were as follows:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| December 31, 2007 | | | | |
| U.S. agency securities | $2,454 | $ 9 | $- - | $2,463 |
| Mortgage-backed securities | 64 | 1 | - - | 65 |
| Collateralized mortgage obligations | - - | - - | - - | - - |
| Obligations of states and political subdivisions | 516 | 24 | - - | 540 |
| Total | $3,034 | $34 | $- - | $3,068 |
| December 31, 2006 | | | | |
| U.S. agency securities | $1,198 | $- - | ($10) | $1,188 |
| Mortgage-backed securities | 91 | - - | (1) | 90 |
| Collateralized mortgage obligations | 574 | - - | (7) | 567 |
| Obligations of states and political subdivisions | 519 | 22 | - - | 541 |
| Total | $2,382 | $22 | ($18) | $2,386 |

Contractual maturities of securities available for sale at December 31, 2007, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations, with or without call or prepayment penalties; therefore, mortgage-backed securities and collateralized mortgage obligations have been classified separately in the maturity table.

| | Amortized Cost | Fair Value |
|---|---|---|
| Due in one year or less | $ - - | $ - - |
| Due from one year to five years | 565 | 571 |
| Due from five to 10 years | 2,199 | 2,217 |
| Due after 10 years | 206 | 215 |
| Mortgage-backed securities and collateralized mortgage obligations | 64 | 65 |
| Total | $3,034 | $3,068 |

*(continued)*

(Dollars in Thousands)

## Note 3 - Securities Available for Sale *(concluded)*

There were no realized gains or losses on securities in 2007. Gross gains realized on securities were $12 in 2006. Securities, carried at approximately $537 and $742 at December 31, 2007 and 2006, were pledged to secure public deposits and for other purposes required or permitted by law.

For the year ended December 31, 2007, there were no individual securities held in an unrealized loss position. Information pertaining to securities with gross unrealized losses at December 31, 2006, aggregated by investment category and length of time that the individual securities have been in a continuous loss position follows:

| | Less Than 12 Months | | More Than 12 Months | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| December 31, 2006 | | | | | | |
| U.S. agency securities | $- - | $- - | $ 690 | $10 | $ 690 | $10 |
| Mortgage-backed securities | - - | - - | 90 | 1 | 90 | 1 |
| Collateralized mortgage obligations | - - | - - | 567 | 7 | 567 | 7 |
| Total | $- - | $- - | $1,347 | $18 | $1,347 | $18 |

## Note 4 - Loans

Loans at December 31 consist of the following:

| | 2007 | 2006 |
|---|---|---|
| Commercial | $11,083 | $10,739 |
| Real estate: | | |
| Residential 1-4 family | 9,793 | 9,347 |
| Multifamily | 8,027 | 7,694 |
| Commercial | 25,927 | 25,296 |
| Construction | 17,338 | 19,414 |
| Consumer | 1,003 | 1,624 |
| Total loans | $73,171 | $74,114 |

Changes in the allowance for credit losses for the years ended December 31 are as follows:

| | 2007 | 2006 |
|---|---|---|
| Balance at beginning of year | $914 | $834 |
| Provision for credit losses | 11 | 80 |
| Charge-offs | - - | - - |
| Balance at end of year | $925 | $914 |

*(continued)*

(Dollars in Thousands)

## Note 4 - Loans *(concluded)*

Following is a summary of information pertaining to impaired loans at December 31:

| | 2007 | 2006 |
|---|---|---|
| December 31 | | |
| Loan impaired with an associated allowance | $560 | $- - |
| Loans impaired without an associated allowance | 264 | 1 |
| Total recorded investment in impaired loans | $824 | $ 1 |
| Amount of allowance for credit losses allocated to impaired loans | $ 27 | $- - |
| Average recorded investment in impaired loans | 753 | 3 |
| Interest income recognized for cash payments received on impaired loans | 70 | - - |

The Bank had no loans that were 90 days past due and still accruing interest at December 31, 2007, and one loan totaling $103 that was 90 days past due and still accruing interest at December 31, 2006.

Certain related parties of the Bank, principally Bank directors and their associates, were loan customers of the Bank in the ordinary course of business during 2007 and 2006. Loans outstanding at December 31, 2007 and 2006, to key officers and directors totaled $2,098 and $2,471. During 2007 and 2006, advances totaled $2,597 and $4,561, and repayments totaled $2,970 and $6,529 on these loans.

## Note 5 - Premises and Equipment

Components of premises and equipment at December 31 are as follows:

| | 2007 | 2006 |
|---|---|---|
| Land | $ 168 | $ 168 |
| Building | 795 | 764 |
| Furniture | 138 | 133 |
| Equipment | 340 | 312 |
| | 1,441 | 1,377 |
| Less accumulated depreciation | 556 | 491 |
| Total premises and equipment, net | $885 | $ 886 |

(Dollars in Thousands)

## Note 6 - Deposits

The composition of deposits at December 31 is as follows:

| | 2007 | 2006 |
|---|---|---|
| Demand deposits, non-interest-bearing | $10,683 | $11,519 |
| NOW and money market accounts | 14,673 | 11,147 |
| Savings deposits | 1,812 | 1,965 |
| Time certificates, $100 or more | 22,136 | 25,491 |
| Other time certificates | 22,358 | 22,475 |
| Total deposits | $71,662 | $72,597 |

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

| | |
|---|---|
| 2008 | $42,750 |
| 2009 | 1,506 |
| 2010 | 37 |
| 2011 | 201 |
| Total | $44,494 |

## Note 7 - Long-Term Borrowings

Long-term borrowings at December 31 consist of the following:

| | 2007 | 2006 |
|---|---|---|
| Advances from the Federal Home Loan Bank of Seattle, bearing interest at 3.2 percent to 4.4 percent; maturing through 2010. If management chooses to prepay these advances, a prepayment penalty will be incurred. Loans totaling $15,165 are pledged as collateral for these advances at December 31, 2007. | $4,750 | $6,450 |

Principal reductions due for future years ending December 31 are as follows:

| | |
|---|---|
| 2008 | $1,500 |
| 2009 | 2,250 |
| 2010 | 1,000 |
| Total | $4,750 |

(Dollars in Thousands)

## Note 8 - Benefit Plans

### 401(k) Employee Stock Ownership Plan (KSOP)

Eligible employees may defer a portion of their annual compensation on a pretax basis, subject to certain IRS limits. The Company makes an annual safe harbor contribution equal to 3 percent of eligible compensation. Additional contributions to the plan may also be made, at the discretion of the board of directors, up to 2 percent of eligible compensation. The Company also makes contributions equal to the amount required to service the plan's debt under the terms of the KSOP note.

Upon termination from the plan, a participant may choose to have his or her account distributed in the Company's stock, to the extent of the participant's investment, in stock or in cash. Certain participants may also be eligible to diversify a certain percentage of their accounts. Distribution of stock in the event of termination or diversification requires the Company to issue put options to the participant. This permits the participant to sell the stock to the Company, at fair value, at any time during the option periods, which can be as long as 18 months. At December 31, 2007, there were no put options outstanding.

During 2006 the Company retired the KSOP debt and provided a loan directly to the KSOP. KSOP compensation expense, included in salaries and benefits, was $111 and $234 for the years ended December 31, 2007 and 2006.

KSOP share activity is summarized in the following table:

| | Fair Value of Unearned Shares | Unreleased ESOP Shares | Allocated and Released Shares | Total |
|---|---|---|---|---|
| Balance, January 1, 2006 | $343 | 3,987 | 1,013 | 5,000 |
| Allocation in 2006 | - - | (2,554) | 2,554 | - - |
| Balance, December 31, 2006 | 132 | 1,433 | 3,567 | 5,000 |
| Allocation in 2007 | - - | (963) | 963 | - - |
| Balance, December 31, 2007 | $ 43 | 470 | 4,530 | 5,000 |

## Note 9 - Deferred Compensation Agreements

In December 2002, the Bank established a nonqualified deferred compensation agreement with the board of directors, under which, as determined at the beginning of each plan year, the directors may defer a portion or all of their director fees. Amounts deferred will earn interest at a rate to be determined annually. Amounts deferred will be paid to the directors after their retirement from the board.

*(continued)*

## Note 9 - Deferred Compensation Agreements *(concluded)*

In December 2002, the board of directors approved a nonqualified deferred compensation agreement with certain key employees. These employees may elect, at the beginning of each plan year, to defer a percentage of their compensation. Amounts deferred will earn interest at a rate to be determined annually and will be paid to the employees at retirement.

Interest credited to these plans totaled $57 and $41 in 2007 and 2006. Amounts deferred under both plans totaled $1,025 and $806 at December 31, 2007 and 2006.

Benefits to directors and employees may be funded by life insurance policies purchased by the Company, which had a total cash surrender value of $1,227 and $1,181 at December 31, 2007 and 2006. In conjunction with the purchase of life insurance policies, the Company executed “Endorsement Split-Dollar Life Insurance Agreements” with two executive officers. Pursuant to the agreements, the Company paid the premium on the policy of each officer’s life. The Company is the sole owner of the policies and their net surrender value. In the event of an officer’s death, the Company will be entitled to receive, at a minimum, that amount of the death proceeds equal to the cash surrender value. A portion of the death proceeds will be paid to the officer’s designated beneficiary.

## Note 10 - Income Taxes

Effective January 1, 2004, the Company is subject to a corporate-level tax on the net unrealized built-in gain at the date of conversion that will be realized during the 10-year period after conversion. The net unrealized built-in gain is the excess of the fair value of the S corporation’s assets at the effective date of the S corporation election over the aggregate adjusted tax bases of those assets at that date. The taxable built-in gain is that portion of a gain on the disposition of an asset during the 10-year period subsequent to the conversion that is attributable to a difference between the fair value and the tax basis of the asset at the date of conversion. During the 10-year period after conversion, tax is computed by applying the applicable corporate income tax rate for the year. The Company performs an ongoing analysis of its potential built-in gain tax liability, considering its current tax planning strategies to reduce those gains, and has estimated its liability to be $87 at December 31, 2007.

## Note 11 - Commitments and Contingencies

The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized on the consolidated balance sheets.

*(continued)*

(Dollars in Thousands)

## Note 11 - Commitments and Contingencies *(concluded)*

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. A summary of the Bank's commitments at December 31 is as follows:

| | 2007 | 2006 |
|---|---|---|
| Commitments to extend credit: | | |
| Real estate secured | $ 3,807 | $ 7,395 |
| Other | 7,083 | 4,674 |
| Total commitments to extend credit | $10,890 | $12,069 |
| Standby letters of credit | $148 | $110 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank estimates that approximately 75 percent of its loan commitments are drawn upon by customers. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are issued primarily to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral held varies, as specified above, and is required in instances where the Bank deems necessary.

The Bank has agreements with correspondent banks for lines of credit totaling $6,500, all of which was available at December 31, 2007, and a credit line with the Federal Home Loan Bank of Seattle totaling 15 percent of assets, $4,750 of which was used at December 31, 2007.

Because of the nature of its activities, the Company is subject to various pending and threatened legal actions which may arise in the ordinary course of business. In the opinion of management, liabilities arising from these claims, if any, will not have a material effect on the financial position of the Company.

## Note 12 - Significant Concentrations of Credit Risk

Most of the Bank's business activity is with customers in the state of Washington. Investments in state and municipal securities involve governmental entities primarily within the state. Loans are generally limited, by state banking regulations, to 20 percent of the Bank's shareholders' equity, excluding accumulated other comprehensive income (loss). Standby letters of credit were granted primarily to commercial borrowers.

## Note 13 - Stock Options

Under the Company's employee stock option plan, the Company may grant options for up to 22,500 shares (6,075 shares remain available for grant at December 31, 2007) of its common stock to certain key employees. The exercise price of each option equals the fair market value of the Company's stock on the date of grant, and an option's maximum term is 10 years. Under its director plan, the Company may grant options for up to 9,000 shares (1,000 shares remain available for grant at December 31, 2007) of its common stock to its directors. The exercise price equals the fair market value of the Company's stock on the date of grant, and an option's maximum term is 10 years. Under both plans, options vest 20 percent on the date of grant and 20 percent on the anniversary of the date of grant in the succeeding four years.

The Company uses the Black-Scholes option-pricing model to value stock options. The Black-Scholes model requires the use of employee exercise behavior data and a number of assumptions, including volatility of the Company's stock price, dividend yield, weighted-average risk-free interest rate, and weighted-average expected life of the options. There were no options granted during the years ended December 31, 2007 and 2006.

No options were outstanding or exercisable as of December 31, 2007 and 2006. The intrinsic value of shares exercised in 2006 was $736.

## Note 14 - Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory -- and possibly additional discretionary -- actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines on the regulatory framework for prompt corrective action, the Bank must meet specific capital adequacy guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance-sheet items, as calculated under regulatory accounting practices. The Bank's capital classification is also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of Tier 1 capital (as defined in the regulations) to total average assets (as defined), and minimum ratios of Tier 1 and total capital (as defined) to risk-weighted assets (as defined).

As of December 31, 2007, the most recent notification from the Bank's regulator categorized the Bank as well-capitalized under the regulatory framework for prompt corrective action. To be categorized as well-capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios, as set forth in the table on page 20. There are no conditions or events since that notification that management believes have changed the Bank's category.

*(continued)*

(Dollars in Thousands)

Note 14 - Regulatory Matters *(concluded)*

The Bank's actual capital amounts and ratios are also presented in the table. Management believes, as of December 31, 2007, that the Bank meets all capital requirements to which it is subject.

| | Actual Amount | Ratio | Capital Adequacy Purposes Amount | Ratio | To be Well-Capitalized Under Prompt Corrective Action Provisions Amount | Ratio |
|---|---|---|---|---|---|---|
| December 31, 2007 | | | | | | |
| *Tier 1 capital (to average assets):* | | | | | | |
| Bank | $7,437 | 8.28% | $3,594 | 4.00% | $4,491 | 5.00% |
| *Tier 1 capital (to risk-weighted assets):* | | | | | | |
| Bank | 7,437 | 9.81 | 3,034 | 4.00 | 4,551 | 6.00 |
| *Total capital (to risk-weighted assets):* | | | | | | |
| Bank | 8,362 | 11.03 | 6,068 | 8.00 | 7,584 | 10.00 |
| December 31, 2006 | | | | | | |
| *Tier 1 capital (to average assets):* | | | | | | |
| Bank | $7,145 | 8.09% | $3,532 | 4.00% | $4,415 | 5.00% |
| *Tier 1 capital (to risk-weighted assets):* | | | | | | |
| Bank | 7,145 | 9.80 | 2,916 | 4.00 | 4,374 | 6.00 |
| *Total capital (to risk-weighted assets):* | | | | | | |
| Bank | 8,056 | 11.05 | 5,832 | 8.00 | 7,290 | 10.00 |

The Bank is subject to certain restrictions on the amount of dividends that it may declare without prior regulatory approval. At December 31, 2007, the Bank may pay dividends up to the point that it would not be well-capitalized without regulatory approval.

(Dollars in Thousands)

## Note 15 - Condensed Financial Information - Parent Company Only

### Condensed Balance Sheets - December 31

| | 2007 | 2006 |
|---|---|---|
| **Assets** | | |
| Cash | $ 60 | $ 96 |
| Investment in the Bank | 7,471 | 7,234 |
| Other assets | 67 | 77 |
| Total assets | $7,598 | $7,407 |
| **Liabilities and Shareholders' Equity** | | |
| Long-term borrowings | $ 31 | $ 93 |
| Equity | 7,567 | 7,314 |
| Total liabilities and shareholders' equity | $7,598 | $7,407 |

### Condensed Statements of Income - Years Ended December 31

| | 2007 | 2006 |
|---|---|---|
| Dividend Income of the Bank | $2,035 | $1,907 |
| Expenses | (37) | (14) |
| Income before undistributed income of the Bank | 1,998 | 1,893 |
| Equity in Undistributed Income of the Bank | 155 | 286 |
| Net income | $2,153 | $2,179 |

*(continued)*

(Dollars in Thousands)

## Note 15 - Condensed Financial Information - Parent Company Only *(concluded)*

### Condensed Statements of Cash Flows - Years Ended December 31

| | 2007 | 2006 |
|---|---|---|
| **Cash Flows from Operating Activities** | | |
| Net income | $2,153 | $2,179 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Dividends in excess of income (equity in undistributed income) of the Bank | (155) | (286) |
| Contribution to Bank | (53) | (75) |
| Other - net | (19) | (57) |
| **Net cash provided by operating activities** | 1,926 | 1,761 |
| **Cash Flows from Financing Activities** | | |
| Payment of debt | (62) | (261) |
| Stock options exercised | - - | 177 |
| Dividends paid | (1,900) | (1,785) |
| **Net cash used in financing activities** | (1,962) | (1,869) |
| **Cash Flows from Investing Activities** | | |
| Contribution from Bank | - - | 61 |
| **Decrease in cash** | (36) | (47) |
| **Cash** | | |
| Beginning of year | 96 | 143 |
| **End of year** | $ 60 | $ 96 |

## Note 16 - Comprehensive Income

Net unrealized gains (losses) at December 31 are as follows:

| | 2007 | 2006 |
|---|---|---|
| Unrealized holding gains arising during the year | $29 | $25 |
| Less reclassification adjustment for gains realized in net income | - - | 12 |
| **Net unrealized gains** | $29 | $13 |