

Puget Sound Financial Services, Inc. and Subsidiary

Consolidated Financial Report
December 31, 2011

Puget
Sound
Financial
Services
Inc.
and
Subsidiary

**Consolidated
Financial
Report**

December 31
2011

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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, 2011 and 2010, 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 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, 2011 and 2010, 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 22, 2012

**Consolidated
Financial
Statements**

Consolidated Balance Sheets

(Dollars in Thousands, Except Share Amounts)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

	2011	2010
Assets		
Cash and cash equivalents:		
Cash and due from banks	\$ 1,450	\$ 1,029
Interest-bearing deposits in other financial institutions	11,846	6,260
Total cash and cash equivalents	13,296	7,289
Certificates of deposit in other financial institutions	7,787	4,770
Securities available for sale	1,557	1,637
Federal Home Loan Bank stock, at cost	412	412
Loans	60,462	66,616
Less allowance for credit losses	1,214	1,013
Net loans	59,248	65,603
Premises and equipment, net	841	755
Accrued interest receivable	241	241
Bank-owned life insurance	1,414	1,370
Foreclosed real estate	402	100
Other assets	453	541
Total assets	\$85,651	\$82,718
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Demand, non-interest-bearing	\$12,459	\$10,297
Savings and interest-bearing demand	22,490	17,657
Time	32,466	37,934
Total deposits	67,415	65,888
Accrued interest payable	3	4
Deferred compensation payable	1,589	1,493
FHLB advances	6,000	6,000
Other liabilities	361	319
Dividends payable	233	--
Total liabilities	75,601	73,704
Commitments and Contingencies	--	--
Shareholders' Equity		
Common stock (par value \$1); authorized 2,000,000 shares; 155,618 shares issued and outstanding in 2011 and 2010	156	156
Additional paid-in capital	1,874	1,874
Retained earnings	7,906	6,981
Accumulated other comprehensive income	114	3
Total shareholders' equity	10,050	9,014
Total liabilities and shareholders' equity	\$85,651	\$82,718

See notes to consolidated financial statements.

Consolidated Statements of Income

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
Years Ended December 31, 2011 and 2010

	2011	2010
Interest and Dividend Income		
Loans	\$4,470	\$4,851
Interest-bearing deposits in other financial institutions	116	146
Securities available for sale	50	74
Total interest and dividend income	4,636	5,071
Interest Expense		
Deposits	576	889
Long-term borrowings	156	179
Total interest expense	732	1,068
Net interest income	3,904	4,003
Provision for Credit Losses	631	648
Net interest income after provision for credit losses	3,273	3,355
Non-Interest Income		
Service charges on deposit accounts	155	162
Loan sale brokerage fees	--	43
Earnings on bank-owned life insurance	43	47
Other operating income	29	35
Gain on sale of securities	--	24
Total non-interest income	227	311
Non-Interest Expense		
Salaries and employee benefits	1,108	1,107
Occupancy	68	68
Furniture and equipment	67	49
Data processing	169	169
Other	776	982
Total non-interest expense	2,188	2,375
Net income	\$1,312	\$1,291

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, 2011 and 2010

	<u>Common Stock</u>		Additional Paid-in Capital	Retained Earnings	Accumulated Other Compre- hensive Income	Total
	Shares	Amount				
Balance at December 31, 2009	155,618	\$156	\$1,874	\$6,002	\$ 16	\$ 8,048
Comprehensive income:						
Net income	--	--	--	1,291	--	1,291
Other comprehensive income:						
Change in net unrealized loss on securities available for sale	--	--	--	--	(13)	(13)
Total comprehensive income						1,278
Cash dividends (\$2 per share)	--	--	--	(312)	--	(312)
Balance at December 31, 2010	155,618	156	1,874	6,981	3	9,014
Comprehensive income:						
Net income	--	--	--	1,312	--	1,312
Other comprehensive income:						
Change in net unrealized gain on securities available for sale	--	--	--	--	111	111
Total comprehensive income						1,423
Cash dividends (\$2.50 per share)	--	--	--	(387)	--	(387)
Balance at December 31, 2011	155,618	\$156	\$1,874	\$7,906	\$114	\$10,050

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, 2011 and 2010

	2011	2010
Cash Flows from Operating Activities		
Net income	\$ 1,312	\$1,291
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for credit losses	631	648
Gain (loss) on sale of foreclosed real estate	(21)	93
Valuation allowance for foreclosed real estate losses	14	31
Depreciation and amortization	67	40
Decrease in accrued interest receivable	--	48
Decrease in accrued interest payable	(1)	(4)
Gain on sale of securities	--	(24)
Increase in deferred compensation payable	96	61
Securities available for sale amortization (accretion), net	--	36
Earnings on bank-owned life insurance	(44)	(46)
Other, net	111	166
Net cash provided by operating activities	2,165	2,340
Cash Flows from Investing Activities		
Activity in securities available for sale:		
Maturities, prepayments and calls	642	1,202
Purchases	(451)	(1,566)
Proceeds from sale of securities	--	1,586
Net change in certificates of deposit in other financial institutions	(3,017)	1,277
Net decrease in loans made to customers	4,719	2,616
Proceeds from sale of foreclosed real estate	710	557
Purchases of premises and equipment	(134)	(2)
Net cash provided by investing activities	2,469	5,670
Cash Flows from Financing Activities		
Net increase (decrease) in deposits	1,527	(8,844)
Advances on long-term borrowings	1,000	2,500
Repayment of long-term borrowings	(1,000)	(2,000)
Payment of cash dividends	(154)	(312)
Net cash provided by (used in) financing activities	1,373	(8,656)
Net increase (decrease) in cash and cash equivalents	6,007	(646)
Cash and Cash Equivalents		
Beginning of year	7,289	7,935
End of year	\$13,296	\$7,289
Supplemental Disclosure of Cash Flow Information		
Interest paid	\$733	\$1,072
Supplemental Disclosures of Non-Cash Investing Activities		
Change in fair value of securities available for sale	\$ 111	\$ 13
Loans transferred to foreclosed real estate	1,005	669
Accrued but unpaid cash dividends	233	--

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

Note 1 - Summary of Significant Accounting Policies

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.

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.

Subsequent Events

Management has evaluated subsequent events through March 22, 2012, which is the date the consolidated financial statements were available to be issued. All material subsequent events that required recognition or disclosure are reflected in the consolidated financial statements for the year ended December 31, 2011.

Use of Estimates

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.

Reclassifications

Certain prior year amounts have been reclassified, with no change to shareholders' equity or net income previously reported, to conform to the 2011 presentation. All dollar amounts, except share information, are stated in thousands.

(continued)

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

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

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, and short-term interest-bearing deposits in other financial institutions with maturities under 90 days. The Company reports net cash flows from customer loan and deposit transactions and certificates of deposit in other financial institutions.

Federal Reserve Board regulations require that the Bank maintains 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, 2011 and 2010.

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 excluded from earnings and reported as a net amount in a separate component of shareholders' equity entitled "accumulated other comprehensive income." 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.

Management evaluates securities for other-than temporary impairment (OTTI) at least on a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. Consideration is given to: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, including an evaluation of credit ratings, (3) the impact of changes in market interest rates, (4) the intent of the Company to sell a security, and (5) whether it is more-likely-than-not the Company will have to sell the security before recovery of its cost basis.

If the Company intends to sell an impaired security, the Company records an other-than-temporary loss in an amount equal to the entire difference between the fair value and amortized cost. If a security is determined to be other-than-temporarily impaired, but the Company does not intend to sell the security, only the credit portion of the estimated loss is recognized in earnings, with the other portion of the loss recognized in other comprehensive income.

Federal Home Loan Bank Stock

The Bank, as a member of the Federal Home Loan Bank (FHLB) of Seattle, 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.

(continued)

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

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

Federal Home Loan Bank Stock *(concluded)*

The Company views its investment in the FHLB stock as a long-term investment. Accordingly, when evaluating for impairment, the value is determined based on the ultimate recovery of the par value rather than recognizing temporary declines in value. The determination of whether a decline affects the ultimate recovery is influenced by criteria such as: 1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount and length of time a decline has persisted; 2) impact of legislative and regulatory changes on the FHLB; and 3) the liquidity position of the FHLB. FHLB stock was not considered impaired at December 31, 2011 and 2010.

Loans Receivable and Interest on Loans

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.

Interest income is recognized over the term of the loan based on the contractual interest rate and the principal balance outstanding using the interest method. 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 as well as required by regulatory provisions. Past due status is based on contractual terms of the loan. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest payments received after a loan is placed on nonaccrual status are applied as principal reductions until such time the loan is returned to accrual status. Generally, a loan returns to accrual status when the loan is brought current and the collectibility of principal and interest is no longer in doubt, typically, after the loan has been performing for a period of six months.

Allowance for Credit Losses

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 of nonimpaired loans. 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 over the prior three years, 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.

(continued)

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

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

Allowance for Credit Losses *(concluded)*

Specific allowances are established for loans evaluated for impairment in accordance with the Receivables Topic of the Financial Accounting Standards Board (FASB) Accounting Standards Codification, 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.

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.

Troubled Debt Restructuring

A troubled debt restructuring (TDR) is a concession provided by the Bank to a borrower with the expectation of receiving a greater benefit, such as more cash or other value, or of increasing the probability of receipt, by granting the concession than by not granting it. The concession is provided due to the borrower's financial difficulties provoked by economic or legal reasons. Modifications in loan terms under TDR include, but are not limited to, a reduction in interest rate, an extension of the maturity at an interest rate below market, a reduction in the face amount of debt, a reduction in accrued interest, or an extension, deferral, renewal or rewrite. The selection of the type and extent of concession granted to the borrower is based on expectations to obtain more cash or other value from the borrower, or to increase the probability of receipt by granting the concession than by not granting it.

The restructured loans may be classified as "special mention" or "substandard" depending on the severity of the modification and are considered impaired. Loans that were paid current at the time of modification may be upgraded in their classification after a sustained period of repayment performance, usually six months or longer. Past due loans at the time of modification are classified as substandard and are considered impaired and placed on nonaccrual status. Those loans may be upgraded in their classification and placed on accrual status upon a sustained period of repayment performance during six months or longer and the achievement of reasonable assurance that repayment will continue.

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.

(continued)

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

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

Foreclosed Real Estate

Premises and equipment acquired through, or in lieu of, foreclosure are to be sold and are initially recorded at the fair value of the properties, less estimated costs of disposal, establishing a new cost basis. Any write-down to fair value at the time of transfer to foreclosed real estate is charged to the allowance for credit losses. Properties are evaluated regularly to ensure that the recorded amounts are supported by their current fair values. Any subsequent reductions in carrying values, and revenue and expenses from operations of the properties, are charged to operations.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales only 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 Company, (2) the transferee obtains the right to pledge or exchange the assets it received, and no condition both constrains the transferee from taking advantage of its right to pledge or exchange the assets it received, and no condition both constrains the transferee from taking advantage of its right to pledge or exchange and provides more than a modest benefit to the transferor, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets. In addition, for transfers of a portion of financial assets (for example, participations of loan receivables), the transfer must meet the definition of a 'participating interest' in order to account for the transfer as a sale. Following are the characteristics of a 'participating interest':

- Pro-rata ownership in an entire financial asset.
- From the date of the transfer, all cash flows received from entire financial assets are divided proportionately among the participating interest holders in an amount equal to their share of ownership.
- The rights of each participating interest holder have the same priority, and no participating interest holder's interest is subordinated to the interest of another participating interest holder. That is, no participating interest holder is entitled to receive cash before any other participating interest holder under its contractual rights as a participating interest holder.
- No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.

Advertising Costs

Advertising costs are expensed as incurred.

(continued)

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

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.

The Company has reviewed its tax positions for the open tax years (current and prior three tax years) and has concluded that no provision for income tax is required in the Company's consolidated financial statements for uncertain tax positions.

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 employee stock ownership plan (KSOP). The KSOP is accounted for in accordance with the Compensation Topic of the FASB Accounting Standards Codification. 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. During 2008 the KSOP debt was paid in full. There were no unallocated shares as of December 31, 2011 or 2010.

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 the Compensation Topic of the FASB Accounting Standards Codification and 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, 2011 and 2010, as there were no unvested options as of January 1, 2007, and there have been no options granted since that date.

(continued)

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

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

Postretirement Benefit Aspects of Endorsement Split-Dollar Arrangements

The Company has entered into agreements with officers of the Company to pay life insurance premiums over the life of the officer as more fully discussed in Note 9. The Company accounts for postretirement benefit aspects of endorsed split-dollar arrangements in accordance with Compensation Topic of the FASB Accounting Standards Codification (ASC), which 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 postretirement periods. As the Company 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, is accrued.

Fair Value Measurements

ASC 820, *Fair Value Measurements and Disclosures* establishes a framework for measuring fair value. The framework comprises a hierarchy that prioritizes inputs to valuation techniques used to measure fair value into three levels:

Level 1: Unadjusted quoted prices for identical assets or liabilities in active markets.

Level 2: Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; data other than observable quoted prices or derived principally from or corroborated by observable market data by correlation or other means.

Level 3: Data unobservable and significant to the fair value measurement, including financial instruments whose value is determined using discounted cash flows, as well as instruments for which the determination of fair value requires significant judgment or estimation.

Provided fair value disclosures and balances, which pertain to the Company's consolidated financial statements, do not represent the aggregate net fair value of the Company. Further, fair value estimates are based on various assumptions, methodologies and subjective considerations which vary widely among different financial institutions and which are subject to change. See Note 15 for further discussion on fair value measurements.

(continued)

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

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

Recent Accounting Pronouncements

In January 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-01, *Receivables (Topic 310), Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update 2010-20*, through which the amendments previously introduced under ASU 2010-20 *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses* were deferred. In April 2011, the FASB issued ASU 2011-02, *Receivables (Topic 310), A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, which provides further guidance on the evaluation of whether a concession was granted and whether a debtor is experiencing financial difficulties. In addition, the update precludes using the effective interest rate test in the debtor's guidance on restructuring of payables when evaluating whether a restructuring constitutes a TDR. The Company is required to adopt this amendment from the annual period commencing on January 1, 2012. Although the Company is currently evaluating the implementation of this accounting standard, adoption is not expected to have a material effect on the Company's consolidated financial statements.

In May 2011, the FASB issued ASU No. 2011-04, *Fair Value Measurement (Topic 820), Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. This update explains how to measure fair value, while it does not require additional fair value measurements and it is not intended to establish valuation standards or affect valuation practices outside of financial reporting. This update clarifies the application of existing fair value measurement standards and changes a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements. The Company is required to adopt this amendment from the annual period commencing on January 1, 2012. Although the Company is currently evaluating the implementation of this accounting standard, adoption is not expected to have a material effect on the Company's consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income (Topic 220), Presentation of Comprehensive Income*, which provides the Company the option to present the total of comprehensive income, the components of net income and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. In December 2011, the FASB issued ASU No. 2011-12, *Comprehensive Income (Topic 220), Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*, through which the FASB superseded certain previously issued paragraphs under ASU No. 2011-05. The Company is currently assessing the impact from the adoption of these updates, which will be required to the Company from the annual period commencing on January 1, 2012, and will only impact the presentation of other comprehensive income in the consolidated financial statements.

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

Note 2 - Certificates of Deposit in Other Financial Institutions

Scheduled maturities of certificates of deposit in other financial institutions for future years ending December 31 are as follows:

2012	\$3,719
2013	2,181
2014	1,391
2015	--
2016	496
Total	\$7,787

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, 2011				
U.S. agency securities	\$ 625	\$ 22	\$ -	\$ 647
Residential mortgage-backed securities	14	--	--	14
Obligations of states and political subdivisions	804	92	--	896
Total	\$1,443	\$114	\$ -	\$1,557
December 31, 2010				
U.S. agency securities	\$1,061	\$ 3	(\$ 9)	\$1,055
Residential mortgage-backed securities	16	--	--	16
Obligations of states and political subdivisions	557	9	--	566
Total	\$1,634	\$12	(\$ 9)	\$1,637

As of December 31, 2011, the Company had no securities available for sale in an unrealized loss position. As of December 31, 2010, the Company had one security available for sale, with a total fair value of \$616 that had been in an unrealized loss position for less than 12 months.

(continued)

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

Note 3 - Securities Available for Sale (concluded)

Contractual maturities of securities available for sale at December 31, 2011, 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	\$ 105	\$ 107
Due from one year to five years	625	647
Due from five to 10 years	--	--
Due after 10 years	699	789
Mortgage-backed securities	14	14
Total	\$1,443	\$1,557

There was a net increase of \$111 recorded in accumulated other comprehensive income during 2011, of which \$0 was a reclassification of gross gains realized in 2011. There was a net decrease of \$13 recorded in accumulated other comprehensive income during 2010, of which \$24 was a reclassification of gross gains realized in 2010. Securities, carried at approximately \$377 and \$318 at December 31, 2011 and 2010, respectively, were pledged to secure public deposits and for other purposes required or permitted by law.

Note 4 - Loans

Loans at December 31 consist of the following:

	2011	2010
Construction and land development	\$ 5,493	\$ 6,940
Commercial real estate	25,709	26,770
Residential real estate	22,111	24,328
Commercial	6,614	7,893
Consumer and other	535	685
Total loans	\$60,462	\$66,616

(continued)

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

Note 4 - Loans (continued)

The following table details activity in the allowance for credit losses by portfolio segment at December 31, 2011. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

	Construction and Land Development	Commercial Real Estate	Residential Real Estate	Commercial	Consumer and Other	Total
Allowance for Credit Losses						
Beginning balance	\$ 88	\$527	\$271	\$120	\$ 7	\$1,013
Charge-offs	(100)	--	(120)	(253)	--	(473)
Recoveries	1	--	2	40	--	43
Provisions	196	(60)	272	225	(2)	631
Ending balance	\$185	\$467	\$425	\$132	\$ 5	\$1,214
Ending balance:						
Individually evaluated for impairment	\$ --	\$ --	\$ --	\$ --	\$--	\$ --
Collectively evaluated for impairment	185	467	425	132	5	1,214
Total	\$185	\$467	\$425	\$132	\$ 5	\$1,214

The following table details activity in the allowance for credit losses in aggregate at December 31, 2010

Balance at beginning of year	\$1,279
Provision for credit losses	648
Charge-offs	(925)
Recoveries	11
Net charge-offs	(914)
Balance at end of year	\$1,013

(continued)

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

Note 4 - Loans (continued)

Risk Management

The Company has lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management and the board of directors review and approve these policies and procedures on a regular basis. A reporting system supplements the internal review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies, and nonperforming and potential problem loans. The Company also engages a third party to perform a credit review of the loan portfolio regularly.

The following loan portfolio segments have been identified with a discussion of the risk characteristics of these portfolio segments.

Construction and land development loans include loans made for both residential and commercial construction and land development. Residential real estate construction loans are loans secured by real estate to build 1-4 family dwellings. These are loans made to borrowers obtaining loans in their personal name for the personal construction of their own dwellings, or loans to builders for the purpose of constructing homes for resale. These loans to builders can be for speculative homes for which there is no specific home owner for which the home is being built, as well as loans to builders that have a pre-sale contract to another individual. Commercial construction loans extended to borrowers secured by and to build commercial structures such as retail strip centers, industrial warehouses or office buildings. Land development loans are granted to commercial borrowers to finance the improvement of real estate by adding infrastructure so that ensuing construction can take place. Construction and land development loans are generally short term in maturity to match the expected completion of a particular project. These loan types are generally more vulnerable to changes in economic conditions in that they project there will be a demand for the product. The repayment of these loans tends to depend on the ability of the borrowers to complete and sell projects within the given time frame. They require monitoring to insure the project is progressing in a timely manner within the expected budgeted amount. This monitoring is accomplished via periodic physical inspections by an outside third party.

Commercial real estate loans are secured by improved commercial property. Improved commercial property can be owner occupied or non-owner occupied secured by retail strip centers, industrial warehouses or office buildings. The repayment of these loans tends to depend upon the operation and management of a business or lease income from a business, and therefore adverse economic conditions can affect the ability to repay. Owner occupied properties are thought to bear less risk than non-owner occupied, as the Company can readily analyze the financial condition of the owner, whose financial strength and ability to pay directly relate to the loan.

Residential real estate loans are secured by 1-4 family dwellings or multifamily complexes. 1-4 family residential loans are both open-end and closed-end loans secured by first or junior liens on 1-4 family improved residential dwellings. Open-end loans are home equity lines of credit that allow the borrower to use equity in the real estate to borrow and repay as the need arises. First and junior lien residential real estate loans are closed-end loans with a specific maturity that generally does not exceed 5 years. Economic conditions can affect the borrower's ability to repay the loans and value of the real estate securing the loans can change over the life of the loan. Multi-family real estate secured loans include those loans secured by 5 or more multi-family dwelling units. These loans are typically exemplified by apartment buildings or complexes. The ability to manage and rent units affects the income that usually provides repayment for this type of loan.

Commercial loans are generally extended for the operation of a business. They are not secured by real estate. Commercial loans are used to provide working capital, acquire inventory, finance the carrying of receivables, purchase equipment or vehicles, or purchase other capital assets. The repayment of these loans comes from the cash flow of a business and is generated by sales of inventory or providing of services. The collateral tends to depreciate over time and is difficult to monitor. Frequent statements are required from the borrower pertaining to inventory levels or receivables aging.

(continued)

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

Note 4 - Loans *(continued)*

Risk Management *(concluded)*

Consumer loans are loans extended to individuals for purposes such as to purchase a vehicle or other consumer goods. These loans are not secured by real estate but are frequently collateralized by the consumer items being acquired with the loan proceeds. This type of collateral tends to depreciate and therefore the term of the loan is tailored to fit the expected value of the collateral as it depreciates, along with specific underwriting policies and procedures.

Credit Quality Indicators

Management tracks certain credit quality indicators including trends related to: (i) risk grade by loan type, (ii) delinquency status, (iii) net charge-offs, (iv) nonperforming status, and (v) general economic conditions. The Company also uses an internal credit risk rating system that categorizes loans into pass, special mention or substandard categories.

The following are the definitions of the Company's credit quality indicators:

- **Pass:** Loans that are not adversely rated, are contractually current as to principal and interest, and are otherwise in compliance with the contractual terms of the loan agreement. Management believes there is a low likelihood of loss related to those loans that are considered pass.
- **Special Mention:** Loans that have potential weaknesses that deserve management's close attention. If not addressed, these potential weaknesses may result in deterioration of the repayment prospects for the loan. Management believes there is a moderate likelihood of some loss related to those loans that are considered special mention.
- **Substandard:** Loans within the portfolio that are inadequately protected by the sound worth and paying capacity of the borrower or of the collateral pledged, if any. Under this risk grade, a loan has defined weaknesses that make payment default or principal exposure likely, but not yet certain.
- **Doubtful:** Loans with a high probability of loss, but because of certain important and reasonably specific pending factors, its classification as an estimated loss is deferred until a more exact status may be determined. Pending factors include proposed merger, acquisition or liquidation procedures, capital injection, perfecting liens on additional collateral, and refinancing plans.
- **Loss:** Loans which are considered uncollectible and of low value, for which the continuation as a bankable asset is not warranted. While this classification results in the prompt charge-off of the loan, it is not intended to imply that the loan or some portion of it will never be collected, nor does it in any way imply that there has been a forgiveness of debt.

(continued)

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

Note 4 - Loans (continued)

Credit Quality Indicators (concluded)

The following is a summary of the credit risk profile by internally assigned grades as of December 31, 2011:

	Construction and Land Development	Commercial Real Estate	Residential Real Estate	Commercial	Consumer and Other	Total
Pass	\$1,817	\$25,269	\$17,286	\$5,838	\$535	\$50,745
Special Mention	1,054	440	4,676	600	--	6,770
Substandard	2,622	--	149	176	--	2,947
Total	\$5,493	\$25,709	\$22,111	\$6,614	\$535	\$60,462

Past Due Loans

The following table is a summary of current and past due loans by loan type at December 31, 2011:

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Nonaccrual	Loans Past Due 90 Days and Accruing Interest
Construction and land development	\$--	\$1,595	\$267	\$1,862	\$ 3,631	\$ 5,493	\$267	\$--
Commercial real estate	--	--	--	--	25,709	25,709	--	--
Residential real estate	--	--	149	149	21,962	22,111	149	--
Commercial	--	--	175	175	6,439	6,614	175	--
Consumer	--	--	--	--	535	535	--	--
Total	\$--	\$1,595	\$591	\$2,186	\$58,276	\$60,462	\$591	\$--

Impaired Loans

The following table is a summary of impaired loans at December 31, 2011:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Construction and land development	\$ 814	\$ 845	\$--	\$1,200	\$140
Residential real estate	253	315	--	302	42
Commercial	175	400	--	395	--
Total	\$1,242	\$1,560	\$--	\$1,897	\$182

There were no impaired loans with a specific reserve at December 31, 2011.

(continued)

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

Note 4 - Loans (concluded)

Impaired Loans (concluded)

The following is a summary of impaired loans at December 31, 2010:

Impaired loans with a valuation allowance	\$ 156
Impaired loans without a valuation allowance	3,917
Total recorded investment in impaired loans	\$4,073
Amount of allowance for credit losses allocated to impaired loans	\$ 1
Average recorded investment in impaired loans	4,395
Interest income recognized for cash payments received on impaired loans	206

Modifications

A modification of a loan constitutes a TDR when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Company offers and participates in various types of concessions when modifying a loan, although forgiveness of principal is rarely granted. Modifications summarized below include extensions on maturity dates at interest rates that are below the market rate for the financial condition of the borrower.

The table below summarizes troubled debt restructurings at December 31, 2011:

	Number of Contracts	Pre- Modification Outstanding Recorded Investments	Post- Modification Outstanding Recorded Investments
Troubled debt restructuring			
Construction and land development	1	\$928	\$547
Commercial	1	39	19
Total	2	\$967	\$566

The pre-modification investment balance represents the amount of the recorded investment in modified loans prior to the modification being made. The post-modification recorded investment balance represents the amount outstanding at December 31, 2011. There are no commitments to extend additional funds to these borrowers.

Related Parties

Certain related parties of the Company, principally Company directors, executive officers and their associates, were loan customers of the Bank in the ordinary course of business during 2011 and 2010. Loans outstanding at December 31, 2011 and 2010, to executive officers and directors totaled \$3,566 and \$2,618, respectively. During 2011 and 2010, advances totaled \$2,057 and \$499, and repayments totaled \$1,109 and \$673, respectively, on these loans.

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

Note 5 - Premises and Equipment

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

	2011	2010
Land	\$ 168	\$ 168
Building	802	801
Furniture	139	139
Equipment	492	355
	1,601	1,463
Less accumulated depreciation	760	708
Premises and equipment, net	\$ 841	\$ 755

Note 6 - Deposits

The composition of deposits at December 31 is as follows:

	2011	2010
Demand deposits, non-interest-bearing	\$12,459	\$10,297
NOW and money market accounts	19,205	14,201
Savings deposits	3,285	3,456
Time certificates, \$100 or more	18,693	20,973
Other time certificates	13,773	16,961
Total deposits	\$67,415	\$65,888

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

2012	\$27,871
2013	1,193
2014	1,432
2015	1,359
2016	611
Total	\$32,466

As of December 31, 2011, the deposit balance included \$751 of certificates of deposit obtained through a brokerage representing less than 2 percent of total deposits.

The Bank is a State of Washington Public Depository. As part of this program, the Bank may be required to fund the losses of any uninsured deposits due to a failure of other banks participating in the program based on the Company's pro rata share of total public deposits outstanding at the State of Washington Public Depository. As of December 31, 2011, the Bank held \$153 of public deposits.

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

Note 7 - FHLB Advances

FHLB advances at December 31 consist of the following:

	2011	2010
Federal Home Loan Bank of Seattle (FHLB), bearing interest at 1.67 percent to 3.35 percent; maturing through 2016. If management chooses to prepay these advances, a prepayment penalty will be incurred. Loans totaling \$24,046 are pledged as collateral for these advances at December 31, 2011.	\$6,000	\$6,000

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

2012	\$ 900
2013	1,100
2014	1,500
2015	1,500
2016	1,000
Total	\$6,000

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, 2011, there were no put options outstanding.

KSOP compensation expense, included in salaries and benefits, was \$39 and \$45 for the years ended December 31, 2011 and 2010, respectively.

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

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.

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 \$84 in 2011 and 2010, respectively. Amounts deferred under both plans totaled \$1,589 and \$1,493 at December 31, 2011 and 2010.

Benefits to directors and employees may be funded by life insurance policies purchased by the Company, which had a total cash surrender value of \$1,414 and \$1,370 at December 31, 2011 and 2010. 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 is to pay the premiums on the policies over the life of each officer. 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. The liability accrued to account for the postretirement benefits associated with these agreements is \$91 and \$82 as of December 31, 2011 and 2010, respectively.

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. The recorded, accrued, estimated liability related to built-in gains was \$87 as of December 31, 2011 and 2010.

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

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.

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:

	2011	2010
Commitments to extend credit:		
Real estate secured	\$1,961	\$ 524
Other	3,184	4,672
Total commitments to extend credit	\$5,145	\$5,196
Standby letters of credit	\$149	\$149

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 \$5,500, all of which was available at December 31, 2011, and a credit line with the Federal Home Loan Bank of Seattle totaling 25 percent of assets, \$6,000 of which was used at December 31, 2011.

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.

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

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. Standby letters of credit were granted primarily to commercial borrowers. At December 31, 2011, the Bank had loan industry concentrations in rental real estate and construction which represents 46 percent and 17 percent, respectively, of the loan portfolio.

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, 2011) 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, 2011) 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, 2011 and 2010. No options were outstanding or exercisable as of December 31, 2011 and 2010.

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.

(continued)

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

Note 14 - Regulatory Matters (concluded)

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) 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, 2011, 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 following table. There are no conditions or events since that notification that management believes have changed the Bank's category.

The Bank's actual capital amounts and ratios are also presented in the following table. Management believes, as of December 31, 2011, 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, 2011						
<i>Tier 1 capital (to average assets):</i>						
Bank	\$ 9,845	11.42%	\$3,488	4.00%	\$6,397	5.00%
<i>Tier 1 capital (to risk-weighted assets):</i>						
Bank	9,845	18.24	2,159	4.00	7,686	6.00
<i>Total capital (to risk-weighted assets):</i>						
Bank	10,554	19.50	4,318	8.00	6,209	10.00
December 31, 2010						
<i>Tier 1 capital (to average assets):</i>						
Bank	\$8,923	10.24%	\$3,486	4.00%	\$4,357	5.00%
<i>Tier 1 capital (to risk-weighted assets):</i>						
Bank	8,923	13.78	2,591	4.00	3,886	6.00
<i>Total capital (to risk-weighted assets):</i>						
Bank	9,735	15.03	5,181	8.00	6,477	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, 2011, the Bank may pay dividends subject to regulatory approval up to the point that it would not be well-capitalized.

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

Note 15 - Fair Value Measurements

The Fair Value Measurements Topic of the FASB ASC establishes a three-level valuation hierarchy for disclosure of fair value measurements and enhances disclosure requirements for fair value measurements. The three levels are defined as follows:

- Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
- Level 2: Significant other observable inputs other than quoted prices included within Level 1, such as quoted prices in markets that are not active, and inputs other than quoted prices that are observable or can be corroborated by observable market data.
- Level 3: Significant unobservable inputs that reflect a company's own assumptions about the assumptions market participants would use in pricing an asset or liability based on the best information available in the circumstances.

The Company has identified securities available for sale as items requiring disclosure under the Fair Value Measurements Topic of the FASB ASC.

Following is a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such investments pursuant to the valuation hierarchy.

Financial and Non-Financial Instruments Recorded at Fair Value

At December 31, 2011, the Company has no financial or nonfinancial liabilities subject to fair value measurements. Assets measured at fair value on a recurring basis include securities available for sale and are as follows:

	Fair Value Measurements Using			Total
	Quoted Prices in Active Markets For Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
December 31, 2011				
Available for sale securities:				
U.S. agency securities	\$ -	\$647	\$ -	\$647
Mortgage-backed securities	--	14	--	14
Obligations of states and political subdivision	--	896	--	896
December 31, 2010				
Available for sale securities:				
U.S. agency securities	\$ -	\$1,055	\$ -	\$1,055
Mortgage-backed securities	--	16	--	16
Obligations of states and political subdivision	--	566	--	566

(continued)

Notes to Consolidated Financial Statements

(Dollars in Thousands)

Puget Sound Financial Services, Inc. and Subsidiary
December 31, 2011 and 2010

Note 15 - Fair Value Measurements *(concluded)*

Financial and Non-Financial Instruments Recorded at Fair Value *(concluded)*

The Company discloses securities available for sale at fair value on a recurring basis. The fair value of the Company's securities available for sale is determined using Level 2 inputs, which are derived from quoted prices for identical or similar assets in markets that are active or not active, that is, markets in which there are few transactions for the asset, the prices are not current, or price quotations vary substantially over time or among market makers, or in which little information is released publicly.

Certain assets are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The following presents such assets carried on the consolidated balance sheets:

	Fair Value Measurements Using			Total
	Quoted Prices In Active Markets For Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
December 31, 2011				
Foreclosed real estate	\$ -	\$ -	\$442	\$442
December 31, 2010				
Foreclosed real estate	\$ -	\$ -	\$109	\$109

Foreclosed real estate is reported at the fair value of foreclosed collateral. Collateral values are estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria. At the time of foreclosure, other real estate owned is recorded at fair value less costs to sell, which becomes the property's new basis.

The fair value measurement of foreclosed real estate above is not reduced by the estimated costs to sell.