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TIMBERLAND BANCORP INC  
Form 10-Q  
August 10, 2009

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended June 30, 2009

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
For the Transition Period From \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-23333

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

Washington91-1863696  
(State of Incorporation) (IRS Employer Identification No.)

624 Simpson Avenue, Hoquiam, Washington 98550  
(Address of principal executive office) (Zip Code)

(360) 533-4747  
(Registrant's telephone number, including area code)

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

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

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

|                          |                                     |                          |                           |
|--------------------------|-------------------------------------|--------------------------|---------------------------|
| Large accelerated filer  | Accelerated Filer                   | Non-accelerated filer    | Smaller reporting company |
| <input type="checkbox"/> | <input checked="" type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/>  |

Indicate by check mark whether the registrant is a shell company (in Rule 12b-2 of the Exchange Act). Yes  No

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

| CLASS                         | SHARES OUTSTANDING AT JULY 31, 2009 |
|-------------------------------|-------------------------------------|
| Common stock, \$.01 par value | 7,045,036                           |

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

TIMBERLAND BANCORP, INC. AND SUBSIDIARY  
 CONDENSED CONSOLIDATED BALANCE SHEETS  
 June 30, 2009 and September 30, 2008  
 (Dollars in thousands, except share amounts)

|   | June 30,<br>2009 | September 30,<br>2008 |
|---|------------------|-----------------------|
| -----   |                  |                       |
| Assets  | (Unaudited)      |                       |
| Cash equivalents:   |                  |                       |
| Non-interest bearing  | \$ 12,118        | \$ 14,013             |
| Interest bearing deposits in banks                              | 31,853           | 3,431                 |
| Federal funds sold  | -                | 25,430                |
|   | -----            | -----                 |
|   | 43,971           | 42,874                |
|   | -----            | -----                 |
| Investments and mortgage-backed securities: held to maturity    | 10,196           | 14,233                |
| Investments and mortgage-backed securities: available for sale  | 13,898           | 17,098                |
| Federal Home Loan Bank ("FHLB") stock                           | 5,705            | 5,705                 |
| Loans receivable  | 555,961          | 563,964               |
| Loans held for sale   | 2,245            | 1,773                 |
| Less: Allowance for loan losses                                 | (12,440)         | (8,050)               |
|   | -----            | -----                 |
| Net loans receivable  | 545,766          | 557,687               |
| Accrued interest receivable                                     | 2,918            | 2,870                 |
| Premises and equipment  | 18,174           | 16,884                |
| Other real estate owned ("OREO") and other repossessed items    | 7,698            | 511                   |
| Bank owned life insurance ("BOLI")                              | 13,403           | 12,902                |
| Goodwill  | 5,650            | 5,650                 |
| Core deposit intangible ("CDI")                                 | 809              | 972                   |
| Mortgage servicing rights ("MSRs")                              | 2,366            | 1,306                 |
| Other assets  | 4,938            | 3,191                 |
|   | -----            | -----                 |
| Total assets  | \$ 675,492       | \$ 681,883            |
|   | =====            | =====                 |
| Liabilities and shareholders' equity                            |                  |                       |
| Deposits  | \$ 487,419       | \$ 498,572            |
| FHLB advances   | 95,000           | 104,628               |
| Other borrowings: repurchase agreements                         | 666              | 758                   |
| Other liabilities and accrued expenses                          | 3,652            | 3,084                 |
|   | -----            | -----                 |
| Total liabilities   | 586,737          | 607,042               |
|   | -----            | -----                 |
| Commitments and contingencies                                   | -                | -                     |
| Shareholders' equity  |                  |                       |
| Preferred stock, \$.01 par value; 1,000,000 shares authorized;  |                  |                       |
| June 30, 2009 - 16,641 shares, Series A, issued and outstanding | 15,487           | -                     |
| Common stock, \$.01 par value; 50,000,000                       |                  |                       |

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|   |            |            |
|---|------------|------------|
| shares authorized;  | 10,328     | 8,672      |
| June 30, 2009 - 7,045,036 shares issued<br>and outstanding      |            |            |
| September 30, 2008 - 6,967,579 shares<br>issued and outstanding |            |            |
| Unearned shares - Employee Stock Ownership<br>Plan ("ESOP")     | (2,578)    | (2,776)    |
| Retained earnings   | 66,802     | 69,406     |
| Accumulated other comprehensive loss                            | (1,284)    | (461)      |
|   | -----      | -----      |
| Total shareholders' equity                                      | 88,755     | 74,841     |
|   | -----      | -----      |
| Total liabilities and shareholders' equity                      | \$ 675,492 | \$ 681,883 |
|   | =====      | =====      |

See notes to unaudited condensed consolidated financial statements

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TIMBERLAND BANCORP, INC. AND SUBSIDIARY  
CONDENSED CONSOLIDATED STATEMENTS OF INCOME  
For the three and nine months ended June 30, 2009 and 2008  
(Dollars in thousands, except per share amounts)  
(unaudited)

|  | Three Months<br>Ended June 30, |          | Nine Months<br>Ended June 30, |          |
|--|--------------------------------|----------|-------------------------------|----------|
|  | 2009                           | 2008     | 2009                          | 2008     |
|  | -----                          | -----    | -----                         | -----    |
| Interest and dividend income                           |                                |          |                               |          |
| Loans receivable                                       | \$ 9,240                       | \$ 9,825 | \$28,229                      | \$30,947 |
| Investments and mortgage-backed<br>securities          | 322                            | 235      | 1,081                         | 625      |
| Dividends from mutual funds and FHLB stock             | 9                              | 272      | 29                            | 1,090    |
| Federal funds sold                                     | 8                              | 28       | 36                            | 87       |
| Interest bearing deposits in banks                     | 32                             | 8        | 62                            | 22       |
|  | -----                          | -----    | -----                         | -----    |
| Total interest and dividend income                     | 9,611                          | 10,368   | 29,437                        | 32,771   |
|  | -----                          | -----    | -----                         | -----    |
| Interest expense                                       |                                |          |                               |          |
| Deposits   | 2,440                          | 2,703    | 7,321                         | 9,153    |
| FHLB advances - short term                             | - -                            | 57       | - -                           | 591      |
| FHLB advances - long term                              | 979                            | 1,104    | 3,042                         | 2,919    |
| Other borrowings                                       | - -                            | 4        | 1                             | 18       |
|  | -----                          | -----    | -----                         | -----    |
| Total interest expense                                 | 3,419                          | 3,868    | 10,364                        | 12,681   |
|  | -----                          | -----    | -----                         | -----    |
| Net interest income                                    | 6,192                          | 6,500    | 19,073                        | 20,090   |
| Provision for loan losses                              | 1,000                          | 500      | 7,491                         | 2,400    |
|  | -----                          | -----    | -----                         | -----    |
| Net interest income after provision<br>for loan losses | 5,192                          | 6,000    | 11,582                        | 17,690   |
|  | -----                          | -----    | -----                         | -----    |
| Non-interest income                                    |                                |          |                               |          |
| Total other-than-temporary impairment                  |                                |          |                               |          |

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|   |       |         |         |         |
|---|-------|---------|---------|---------|
| ("OTTI") on securities  | (881) | - -     | (3,044) | - -     |
| Less: portion recorded as other<br>comprehensive loss (before income) | 756   | - -     | 756     | - -     |
| Net OTTI loss recognized  | (125) | - -     | (2,288) | - -     |
| Service charges on deposits   | 1,066 | 948     | 3,224   | 2,292   |
| Gain on sale of loans, net  | 1,170 | 343     | 2,471   | 827     |
| Loss on redemption of mutual funds                                    | - -   | (2,822) | - -     | (2,822) |
| BOLI net earnings   | 123   | 121     | 501     | 360     |
| Servicing income on loans sold  | 20    | 18      | 76      | 68      |
| Valuation allowance on MSRs   | (169) | - -     | (169)   | - -     |
| ATM transaction fees  | 326   | 329     | 920     | 930     |
| Fee income from non-deposit investment sales                          | 24    | 31      | 68      | 87      |
| Other   | 239   | 139     | 688     | 417     |
| Total non-interest income   | 2,674 | (893)   | 5,491   | 2,159   |

See notes to unaudited condensed consolidated financial statements (continued)

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TIMBERLAND BANCORP, INC. AND SUBSIDIARY  
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (concluded)  
For the three and nine months ended June 30, 2009 and 2008  
(Dollars in thousands, except per share amounts)  
(unaudited)

|  | Three Months<br>Ended June 30,<br>2009 |       | Nine Months<br>Ended June 30,<br>2009 |        |
|--|--|-------|---------------------------------------|--------|
|  | 2009                                   | 2008  | 2009                                  | 2008   |
| Non-interest expense                                   |  |       |                                       |        |
| Salaries and employee benefits                         | 2,919                                  | 2,812 | 8,818                                 | 8,718  |
| Premises and equipment                                 | 719                                    | 519   | 2,079                                 | 1,634  |
| Advertising  | 252                                    | 228   | 672                                   | 678    |
| OREO and other repossessed items<br>expense            | 391                                    | - -   | 552                                   | - -    |
| ATM expenses   | 162                                    | 136   | 448                                   | 426    |
| FDIC insurance expense                                 | 400                                    | 25    | 586                                   | 51     |
| Postage and courier                                    | 203                                    | 129   | 448                                   | 376    |
| Amortization of CDI                                    | 54                                     | 62    | 163                                   | 186    |
| State and local taxes                                  | 152                                    | 149   | 449                                   | 447    |
| Professional fees                                      | 199                                    | 175   | 547                                   | 467    |
| Other  | 922                                    | 684   | 2,589                                 | 1,993  |
| Total non-interest expense                             | 6,373                                  | 4,919 | 17,351                                | 14,976 |
| Income (loss) before federal and state<br>income taxes | 1,493                                  | 188   | (278)                                 | 4,873  |
| Provision (benefit) for federal<br>income taxes        | 434                                    | 734   | (309)                                 | 2,218  |
| State income taxes                                     | 1                                      | - -   | 4                                     | - -    |

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|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Net income (loss)                                   | \$1,058   | \$ (546)  | \$ 27     | \$2,655   |
|   | =====     |           | =====     |           |
| Preferred stock dividends                           | \$ 210    | \$ - -    | \$ 437    | \$ - -    |
| Preferred stock discount accretion                  | 79        | - -       | 79        | - -       |
|   | -----     |           | -----     |           |
| Net income (loss) available to common shareholders: | \$ 769    | \$ (546)  | \$ (489)  | \$2,655   |
|   | =====     |           | =====     |           |
| Earnings (loss) per common share:                   |           |           |           |           |
| Basic   | \$ 0.12   | \$ (0.08) | \$ (0.07) | \$ 0.41   |
| Diluted   | \$ 0.12   | \$ (0.08) | \$ (0.07) | \$ 0.40   |
| Weighted average common shares outstanding:         |           |           |           |           |
| Basic   | 6,645,229 | 6,446,303 | 6,609,915 | 6,467,874 |
| Diluted   | 6,645,229 | 6,524,818 | 6,609,915 | 6,587,120 |
| Dividends paid per common share:                    | \$ 0.11   | \$ 0.11   | \$ 0.33   | \$ 0.32   |

See notes to unaudited condensed consolidated financial statements

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TIMBERLAND BANCORP, INC. AND SUBSIDIARY  
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
For the year ended September 30, 2008 and the nine months ended June 30, 2009  
(Dollars in thousands, except per share amounts, common shares and preferred shares)

|  | Preferred Shares | Common Shares | Preferred Stock Amount | Common Stock Amount | Unearned Shares Issued to ESOP | Retained Earnings | Accumulated Other Comprehensive Loss |
|--|------------------|---------------|------------------------|---------------------|--------------------------------|-------------------|--------------------------------------|
|  | -----            | -----         | -----                  | -----               | -----                          | -----             | -----                                |
| Balance, Sept. 30, 2007  | - -              | 6,953,360     | \$ - -                 | \$ 9,993            | \$ (3,040)                     | \$68,378          | \$ (784)                             |
| Net income   | - -              | - -           | - -                    | - -                 | - -                            | 4,005             | - -                                  |
| Stock split  | - -              | - -           | - -                    | - -                 | - -                            | - -               | - -                                  |
| Issuance of MRDP(1) shares   | - -              | 20,315        | - -                    | - -                 | - -                            | - -               | - -                                  |
| Repurchase of common stock   | - -              | (144,950)     | - -                    | (1,921)             | - -                            | - -               | - -                                  |
| Exercise of stock options  | - -              | 138,854       | - -                    | 857                 | - -                            | - -               | - -                                  |
| Cash dividends (\$.43 per common share)                              | - -              | - -           | - -                    | - -                 | - -                            | (2,977)           | - -                                  |
| Earned ESOP shares   | - -              | - -           | - -                    | (409)               | 264                            | - -               | - -                                  |
| MRDP compensation expense  | - -              | - -           | - -                    | 147                 | - -                            | - -               | - -                                  |
| Stock option compensation expense                                    | - -              | - -           | - -                    | 5                   | - -                            | - -               | - -                                  |
| Unrealized holding gain on securities available for sale, net of tax | - -              | - -           | - -                    | - -                 | - -                            | - -               | 323                                  |
| Balance, Sept. 30, 2008  | - -              | 6,967,579     | \$ - -                 | \$8,672             | \$ (2,776)                     | \$69,406          | \$ (461)                             |

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|  |        |           |          |          |            |          |            |
|--|--------|-----------|----------|----------|------------|----------|------------|
| (Unaudited)  |        |           |          |          |            |          |            |
| Net income   | -      | -         | -        | -        | -          | -        | 27         |
| Issuance of preferred stock with attached common stock warrants                      | 16,641 | -         | 15,408   | 1,158    | -          | -        | -          |
| Accretion of preferred stock discount  | -      | -         | 79       | -        | -          | -        | (79)       |
| Issuance of MRDP (1) shares  | -      | 19,758    | -        | -        | -          | -        | -          |
| Exercise of stock options  | -      | 57,699    | -        | 392      | -          | -        | -          |
| Cash dividends (\$0.33 per common share)   | -      | -         | -        | -        | -          | -        | (2,315)    |
| (5% preferred stock)   | -      | -         | -        | -        | -          | -        | (328)      |
| Earned ESOP shares   | -      | -         | -        | (55)     | 198        | -        | -          |
| MRDP compensation expense  | -      | -         | -        | 159      | -          | -        | -          |
| Stock option compensation expense  | -      | -         | -        | 2        | -          | -        | -          |
| Cumulative effect of adoption of FAS 115-2 relating to impairment of debt securities | -      | -         | -        | -        | -          | -        | 91         |
| Unrealized holding loss on securities available for sale, net of tax                 | -      | -         | -        | -        | -          | -        | (241)      |
| OTTI on securities held-to-maturity, net of tax                                      | -      | -         | -        | -        | -          | -        | (491)      |
| Balance, June 30, 2009   | 16,641 | 7,045,036 | \$15,487 | \$10,328 | \$ (2,578) | \$66,802 | \$ (1,284) |

(1) 1998 Management Recognition and Development Plan ("MRDP").

See notes to unaudited condensed consolidated financial statements

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TIMBERLAND BANCORP, INC. AND SUBSIDIARY  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 For the nine months ended June 30, 2009 and 2008  
 (In thousands)  
 (unaudited)

| Cash flow from operating activities                               | Nine Months<br>Ended June 30, |         |
|---|-------------------------------|---------|
|   | 2009                          | 2008    |
| Net income  | \$ 27                         | \$2,655 |
| Non-cash revenues, expenses, gains and losses included in income: |                               |         |
| Provision for loan losses   | 7,491                         | 2,400   |
| Depreciation  | 843                           | 830     |
| Deferred federal income taxes                                     | (1,263)                       | (1,076) |
| Amortization of CDI   | 163                           | 186     |
| Earned ESOP shares  | 198                           | 198     |
| MRDP compensation expense   | 141                           | 97      |

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|   |           |          |
|---|-----------|----------|
| Stock option compensation expense                         | 2         | 3        |
| Stock option tax effect less excess tax benefit           | 46        | 4        |
| Gain on sale of OREO, net                                 | (3)       | -        |
| Gain on the disposition of premises and equipment         | -         | (294)    |
| BOLI cash surrender value increase                        | (501)     | (360)    |
| Gain on sale of loans                                     | (2,471)   | (827)    |
| Decrease in deferred loan origination fees                | (421)     | (103)    |
| OTTI losses on securities                                 | 2,288     | 2,822    |
| Loans originated for sale                                 | (139,176) | (34,790) |
| Proceeds from sale of loans                               | 141,175   | 35,309   |
| Increase (decrease) in other assets, net                  | (1,245)   | 226      |
| Increase in other liabilities and accrued expenses, net   | 442       | 119      |
|   | -----     | -----    |
| Net cash provided by operating activities                 | 7,736     | 7,399    |
| <br>Cash flow from investing activities                   |           |          |
| Proceeds from maturities of securities available for sale | 2,719     | 21,867   |
| Proceeds from maturities of securities held to maturity   | 1,367     | 73       |
| Proceeds from sale of securities available for sale       | -         | 6,929    |
| Increase in loans receivable, net                         | (2,055)   | (44,180) |
| Additions to premises and equipment                       | (2,133)   | (621)    |
| Proceeds from the disposition of premises and equipment   | -         | 374      |
| Proceeds from sale of OREO                                | 104       | -        |
|   | -----     | -----    |
| Net cash provided by (used in) investing activities       | 2         | (15,558) |
| <br>Cash flow from financing activities                   |           |          |
| Increase (decrease) in deposits, net                      | (11,153)  | 13,199   |
| Proceeds from FHLB advances long term                     | -         | 50,000   |
| Repayment of FHLB advances long term                      | (9,628)   | (15,052) |
| Repayment of FHLB advances short term                     | -         | (30,000) |
| Increase (decrease) in repurchase agreements              | (92)      | 412      |
| Proceeds from exercise of stock options                   | 345       | 444      |
| ESOP tax effect   | (55)      | 132      |
| MRDP compensation tax effect                              | 18        | 12       |
| Stock option excess tax benefit                           | -         | 12       |
| Issuance of common stock                                  | 1         | -        |
| Repurchase of common stock                                | -         | (1,922)  |
| Issuance of stock warrants                                | 1,158     | -        |
| Issuance of preferred stock                               | 15,408    | -        |
| Payment of dividends                                      | (2,643)   | (2,211)  |
|   | -----     | -----    |
| Net cash provided by (used in) financing activities       | (6,641)   | 15,026   |

See notes to unaudited condensed consolidated financial statements  
(continued)

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TIMBERLAND BANCORP, INC. AND SUBSIDIARY  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (concluded)  
For the nine months ended June 30, 2009 and 2008  
(In thousands)  
(unaudited)

|                                  | Nine Months<br>Ended June 30, |       |
|----------------------------------|-------------------------------|-------|
|                                  | 2009                          | 2008  |
|                                  | -----                         | ----- |
| Net increase in cash equivalents | 1,097                         | 6,867 |



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|   |           |           |
|---|-----------|-----------|
| Cash equivalents  |           |           |
| Beginning of period   | 42,874    | 16,670    |
|   | -----     | -----     |
| End of period   | \$ 43,971 | \$ 23,537 |
|   | -----     | -----     |
| Supplemental disclosure of cash flow information                          |           |           |
| Income taxes paid   | \$ 1,002  | \$ 3,288  |
| Interest paid   | 10,407    | 12,834    |
| Supplemental disclosure of non-cash investing activities                  |           |           |
| Change in unrealized holding loss on securities held for sale, net of tax | \$ (241)  | \$ 804    |
| Change in OTTI on securities, held-to-maturity, net of tax                | (491)     | - -       |
| Mutual funds redeemed for mortgage-backed securities                      | - -       | 22,188    |
| Loans transferred to OREO and other repossessed assets                    | 7,504     | 879       |
| Supplemental disclosure of non-cash financing activities                  |           |           |
| Shares issued to MRDP   | \$ 138    | \$ 259    |

See notes to unaudited condensed consolidated financial statements

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TIMBERLAND BANCORP, INC. AND SUBSIDIARY  
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
For the nine months ended June 30, 2009 and 2008  
In thousands  
(unaudited)

|  | Three Months<br>Ended June 30, |         | Nine Months<br>Ended June 30, |         |
|--|--------------------------------|---------|-------------------------------|---------|
|  | 2009                           | 2008    | 2009                          | 2008    |
|  | -----                          | -----   | -----                         | -----   |
| Comprehensive income:  |                                |         |                               |         |
| Net income (loss)  | \$ 1,058                       | (\$546) | \$ 27                         | \$2,655 |
| Cumulative effect of adoption of FAS 115-2 relating to impairment of debt securities | (91)                           | - -     | (91)                          | - -     |
| Unrealized holding gain (loss) on securities available for sale, net of tax          | 246                            | 991     | (241)                         | 804     |
| OTTI on securities held-to-maturity, net of tax                                      | (4)                            | - -     | (491)                         | - -     |
|  | -----                          | -----   | -----                         | -----   |
| Total comprehensive income (loss)  | \$ 1,209                       | \$ 445  | \$ (796)                      | \$3,459 |
|  | =====                          | =====   | =====                         | =====   |

See notes to unaudited condensed consolidated financial statements

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Timberland Bancorp, Inc. and Subsidiary  
Notes to Condensed Consolidated Financial Statements (unaudited)

### (1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) **Basis of Presentation:** The accompanying unaudited condensed consolidated financial statements for Timberland Bancorp, Inc. ("Company") were prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with instructions for Form 10-Q and therefore, do not include all disclosures necessary for a complete presentation of financial condition, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America. However, all adjustments, which are in the opinion of management, necessary for a fair presentation of the interim condensed consolidated financial statements have been included. All such adjustments are of a normal recurring nature. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended September 30, 2008 ("2008 Form 10-K"). The results of operations for the nine months ended June 30, 2009 are not necessarily indicative of the results that may be expected for the entire fiscal year.

(b) **Principles of Consolidation:** The interim condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Timberland Bank ("Bank"), and the Bank's wholly-owned subsidiary, Timberland Service Corp. All significant inter-company balances have been eliminated in consolidation.

(c) **Operating Segment:** The Company has one reportable operating segment which is defined as community banking in western Washington under the operating name Timberland Bank.

(d) The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

(e) Certain prior period amounts have been reclassified to conform to the June 30, 2009 presentation with no change to net income or total shareholders' equity previously reported. Additional paid-in capital and stock warrants, which were previously reported as separate components in the shareholders' equity section are now reported as part of common stock and preferred stock.

### (2) U.S. TREASURY DEPARTMENT'S CAPITAL PURCHASE PROGRAM

On December 23, 2008, the Company received \$16.64 million from the U.S. Treasury Department ("Treasury") as a part of the Treasury's Capital Purchase Program. The Company sold \$16.64 million in senior preferred stock, with a related warrant to purchase up to \$2.50 million in common stock to the U.S. Treasury. The transaction is part of the Treasury's program to encourage qualified financial institutions to build capital to increase the flow of financing to businesses and consumers and to support the U.S. economy. The preferred stock pays a 5.0% dividend for the first five years, after which the rate increases to 9.0% if the preferred shares are not redeemed by the Company. In addition to the preferred shares, the Treasury received a warrant to purchase 370,899 shares of the Company's common stock at a price of \$6.73 per share at any time during the next ten years.

Preferred stock callable at the option of the Company is initially recorded at

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the amount of proceeds received. Any discount from the liquidation value is accreted to the expected call date and charged to retained earnings. This accretion is recorded using the level-yield method. Preferred dividends paid (declared and accrued) and

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any accretion is deducted from net income for computing income available to common shareholders and earnings per share computations.

(3) INVESTMENTS AND MORTGAGE-BACKED SECURITIES

Investments and mortgage-backed securities have been classified according to management's intent (in thousands):

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
|  | -----             | -----                        | -----                         | -----         |
| June 30, 2009                          |                   |                              |                               |               |
| Held to Maturity ("HTM")               |                   |                              |                               |               |
| Residential mortgage-backed securities | \$10,169          | \$ 20                        | (\$3,721)                     | \$ 6,468      |
| U.S. agency securities                 | 27                | 1                            | - -                           | 28            |
| Total                                  | \$10,196          | \$ 21                        | (\$3,721)                     | \$ 6,496      |
| Available for Sale                     |                   |                              |                               |               |
| Residential mortgage-backed securities | \$13,978          | \$189                        | (\$1,223)                     | 12,944        |
| Mutual funds                           | 1,000             | - -                          | (46)                          | 954           |
| Total                                  | \$14,978          | \$189                        | (\$1,269)                     | \$13,898      |
| September 30, 2008                     |                   |                              |                               |               |
| Held to Maturity                       |                   |                              |                               |               |
| Residential mortgage-backed securities | \$14,205          | \$ 8                         | (\$2,267)                     | \$11,946      |
| U.S. agency securities                 | 28                | - -                          | - -                           | 28            |
| Total                                  | \$14,233          | \$ 8                         | (\$2,267)                     | \$11,974      |
| Available for Sale                     |                   |                              |                               |               |
| Residential mortgage-backed securities | \$16,806          | \$ 52                        | (\$696)                       | \$16,162      |
| Mutual funds                           | 1,000             | - -                          | (64)                          | 936           |
| Total                                  | \$17,806          | \$ 52                        | (\$760)                       | \$17,098      |

The fair value of temporarily impaired securities, the amount of unrealized losses and the length of time these unrealized losses existed as of June 30, 2009 are as follows (in thousands):

| Description of Securities | Less Than 12 Months |                   | 12 Months or Longer |                   | Total      |                   |
|---------------------------|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
|                           | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value | Unrealized Losses |
|                           | -----               | -----             | -----               | -----             | -----      | -----             |
| Held to Maturity          |                     |                   |                     |                   |            |                   |

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|  |        |          |         |            |         |            |
|--|--------|----------|---------|------------|---------|------------|
| U.S. agency securities                 | \$ - - | \$ - -   | \$ - -  | \$ - -     | \$ - -  | \$ - -     |
| Residential mortgage-backed securities | 698    | (173)    | 4,768   | (3,548)    | 5,466   | (3,721)    |
|  | -----  | -----    | -----   | -----      | -----   | -----      |
| Total                                  | \$ 698 | \$ (173) | \$4,768 | \$ (3,548) | \$5,466 | \$ (3,721) |

Available for Sale

|  |         |        |         |           |         |           |
|--|---------|--------|---------|-----------|---------|-----------|
| Residential mortgage-backed securities | 1,398   | (10)   | 2,656   | (1,213)   | 4,054   | (1,223)   |
| Mutual funds                           | - -     | - -    | 954     | (46)      | 954     | (46)      |
|  | -----   | -----  | -----   | -----     | -----   | -----     |
| Total                                  | \$1,398 | (\$10) | \$3,610 | (\$1,259) | \$5,008 | (\$1,269) |

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During the three and nine months ended June 30, 2009 the Company recorded OTTI charges through earnings on residential mortgage-backed securities of \$125,000 and \$2.29 million, respectively. As discussed later in Note 13, effective January 1, 2009, the Company adopted Financial Accounting Standards Board ("FASB") Staff Position FAS 115-2, Recognition and Presentation of Other-Than-Temporary Impairments, which provides for the bifurcation of OTTI into (i) amounts related to credit losses which are recognized through earnings, and (ii) amounts related to all other factors which are recognized as a component of other comprehensive income.

To determine the component of the gross OTTI related to credit losses, the Company compared the amortized cost basis of each OTTI security to the present value of its revised expected cash flows, discounted using its pre-impairment yield. The revised expected cash flow estimates for individual securities are based primarily on an analysis of default rates, prepayment speeds and third-party analytic reports. Significant judgment of management is required in this analysis that includes, but is not limited to, assumptions regarding the collectability of principal and interest, net of related expenses, on the underlying loans. The following table presents a summary of the significant inputs utilized to measure management's estimate of the credit loss component on OTTI securities as of June 30, 2009.

|                          | Range   |         | Weighted Average |
|--------------------------|---------|---------|------------------|
|                          | Minimum | Maximum |                  |
| Constant prepayment rate | 0.0%    | 15.0%   | 12.5%            |
| Collateral default rate  | 13.2%   | 63.0%   | 23.2%            |
| Loss severity rate       | 23.4%   | 40.5%   | 26.6%            |

The following table presents the OTTI losses for the three and nine months ended June 30, 2009. There were no similar OTTI losses recorded during the three or nine months ended June 30, 2008 (in thousands).

|  | Three months ended<br>June 30, 2009 |                       | Nine months ended<br>June 30, 2009 |                       |
|--|-------------------------------------|-----------------------|------------------------------------|-----------------------|
|  | Held To<br>Maturity                 | Available<br>For Sale | Held To<br>Maturity                | Available<br>For Sale |
|  | -----                               | -----                 | -----                              | -----                 |

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|  |                          |                          |                           |                          |
|--|--------------------------|--------------------------|---------------------------|--------------------------|
| Total OTTI losses  | \$ 881                   | \$ - -                   | \$2,920                   | \$ 124                   |
| Portion of OTTI losses<br>recognized in other comprehensive<br>loss (before taxes) (1) | 756                      | - -                      | 756                       | - -                      |
| Net impairment losses recognized<br>in earnings (2)                                    | -----<br>\$ 125<br>===== | -----<br>\$ - -<br>===== | -----<br>\$2,164<br>===== | -----<br>\$ 124<br>===== |

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(1) Represents OTTI losses related to all other factors.

(2) Represent OTTI losses related to credit losses.

The following table presents a roll forward of the credit loss component of held to maturity debt securities that have been written down for OTTI with the credit loss component recognized in earnings and the remaining impairment loss related to all other factors recognized in other comprehensive loss (in thousands).

|                               |                  |
|-------------------------------|------------------|
| Balance, March 31, 2009       | \$2,163          |
| Additions:                    |                  |
| Initial OTTI credit losses    | 29               |
| Subsequent OTTI credit losses | 96               |
|                               | -----            |
| Balance, June 30, 2009        | \$2,288<br>===== |

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During the three and nine months ended June 30, 2009 the Company recorded a \$17,000 and \$24,000 realized loss on one held to maturity residential mortgage-backed security.

Residential mortgage-backed and agency securities pledged as collateral for public fund deposits, federal treasury tax and loan deposits, FHLB collateral, retail repurchase agreements and other non-profit organization deposits totaled \$16.68 million and \$23.00 million at June 30, 2009 and September 30, 2008, respectively.

The contractual maturities of debt securities at June 30, 2009 are as follows (in thousands). Expected maturities may differ from scheduled maturities as a result of the prepayment of principal or call provisions.

|                                  | Held to Maturity  |               | Available for Sale |               |
|----------------------------------|-------------------|---------------|--------------------|---------------|
|                                  | Amortized<br>Cost | Fair<br>Value | Amortized<br>Cost  | Fair<br>Value |
| Due within one year              | \$ - -            | \$ - -        | \$ - -             | \$ - -        |
| Due after one year to five years | 14                | 14            | 495                | 402           |
| Due after five to ten years      | 61                | 62            | 252                | 264           |
| Due after ten years              | 10,094            | 6,420         | 13,231             | 12,278        |
| Mutual funds                     | - -               | - -           | 1,000              | 954           |
|                                  | -----             | -----         | -----              | -----         |
| Total                            | \$10,169          | \$6,496       | \$14,978           | \$13,898      |

(4) FHLB STOCK

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

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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) the impact of legislative and regulatory changes on the FHLB and 3) the liquidity position of the FHLB. The FHLB of Seattle reported a risk-based capital deficiency as of March 31, 2009, and therefore did not pay a dividend for the first quarter of 2009 and will not repurchase capital stock in the near term. The FHLB noted its primary concern with meeting the risk-based capital requirements relates to the potential impact of OTTI charges that they may be required to record on their private label mortgage-backed securities. While the FHLB of Seattle was less than adequately capitalized as of March 31, 2009, the Company does not believe that its investment in the FHLB is impaired. However, this estimate could change in the near term if: 1) significant other-than-temporary losses are incurred on the FHLB's mortgage-backed securities causing a significant decline in its regulatory capital status; 2) the economic losses resulting from credit deterioration on the FHLB's mortgage-backed securities increases significantly or 3) capital preservation strategies being utilized by the FHLB become ineffective. As of the date of this Quarterly Report on Form 10-Q, the FHLB of Seattle has not reported its results for the quarter ended June 30, 2009.

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### (5) LOANS

Loans receivable and loans held for sale consisted of the following (dollars in thousands):

|                                   | At June 30,<br>2009 |         | At September 30,<br>2008 |         |
|-----------------------------------|---------------------|---------|--------------------------|---------|
|                                   | Amount              | Percent | Amount                   | Percent |
|                                   | -----               | -----   | -----                    | -----   |
| Mortgage loans:                   |                     |         |                          |         |
| One- to four-family (1)           | \$110,338           | 18.7%   | \$112,299                | 18.4%   |
| Multi-family                      | 25,702              | 4.4     | 25,927                   | 4.2     |
| Commercial                        | 178,941             | 30.3    | 146,223                  | 23.9    |
| Construction and land development | 142,006             | 24.1    | 186,344                  | 30.5    |
| Land                              | 65,736              | 11.1    | 60,701                   | 9.9     |
|                                   | -----               | -----   | -----                    | -----   |
| Total mortgage loans              | 522,723             | 88.6    | 531,494                  | 86.9    |
| Consumer loans:                   |                     |         |                          |         |
| Home equity and second mortgage   | 41,950              | 7.1     | 48,690                   | 8.0     |
| Other                             | 10,107              | 1.7     | 10,635                   | 1.7     |
|                                   | -----               | -----   | -----                    | -----   |
| Total consumer loans              | 52,057              | 8.8     | 59,325                   | 9.7     |
| Commercial business loans         | 15,199              | 2.6     | 21,018                   | 3.4     |
|                                   | -----               | -----   | -----                    | -----   |
| Total loans receivable            | 589,979             | 100.0%  | 611,837                  | 100.0%  |
|                                   | =====               | =====   | =====                    | =====   |
| Less:                             |                     |         |                          |         |
| Undisbursed portion of            |                     |         |                          |         |
| construction loans in process     | 29,447              |         | 43,353                   |         |
| Deferred loan origination fees    | 2,326               |         | 2,747                    |         |

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|                             |           |           |
|-----------------------------|-----------|-----------|
| Allowance for loan losses   | 12,440    | 8,050     |
|                             | -----     | -----     |
|                             | 44,213    | 54,150    |
| Total Loans receivable, net | \$545,766 | \$557,687 |
|                             | =====     | =====     |

(1) Includes loans held-for-sale.

Construction and Land Development Loan Portfolio Composition

The following table sets forth the composition of the Company's construction and land development loan portfolio.

|                                   | At June 30,<br>2009    |         | At September 30,<br>2008 |         |
|-----------------------------------|------------------------|---------|--------------------------|---------|
|                                   | Amount                 | Percent | Amount                   | Percent |
|                                   | -----                  |         |                          |         |
|                                   | (Dollars in thousands) |         |                          |         |
| Custom and owner / builder const. | \$ 34,373              | 24.2%   | \$ 47,168                | 25.3%   |
| Speculative construction          | 19,332                 | 13.6    | 30,895                   | 16.6    |
| Commercial real estate            | 42,056                 | 29.6    | 39,620                   | 21.3    |
| Multi-family                      |                        |         |                          |         |
| (including condominium)           | 25,631                 | 18.1    | 40,509                   | 21.7    |
| Land development                  | 20,614                 | 14.5    | 28,152                   | 15.1    |
|                                   | -----                  | -----   | -----                    | -----   |
| Total construction loans          | \$142,006              | 100.0%  | \$186,344                | 100.0%  |
|                                   | =====                  | =====   | =====                    | =====   |

Allowance for Loan Losses

The following table sets forth information regarding activity in the allowance for loan losses.

|  | Three Months Ended<br>June 30, |         |
|--|--------------------------------|---------|
|  | 2009                           | 2008    |
|  | -----                          |         |
|  | (In thousands)                 |         |
| Balance at beginning of period             | \$12,049                       | \$6,697 |
| Provision for loan losses                  | 1,000                          | 500     |
| Allocated to commitments                   | -                              | -       |
| Loans charged off                          | (646)                          | (121)   |
| Recoveries on loans previously charged off | 37                             | -       |
|  | -----                          | -----   |
| Net charge-offs                            | (609)                          | (121)   |
|  | -----                          | -----   |
| Balance at end of period                   | \$12,440                       | \$7,076 |
|  | =====                          | =====   |

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|                                | Nine Months Ended<br>June 30, |         |
|--------------------------------|-------------------------------|---------|
|                                | 2009                          | 2008    |
|                                | -----                         |         |
|                                | (In thousands)                |         |
| Balance at beginning of period | \$ 8,050                      | \$4,797 |

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|  |          |         |
|--|----------|---------|
| Provision for loan losses                  | 7,491    | 2,400   |
| Allocated to commitments                   | (126)    | - -     |
| Loans charged off                          | (3,051)  | (121)   |
| Recoveries on loans previously charged off | 76       | - -     |
|  | -----    | -----   |
| Net charge-offs                            | (2,975)  | (121)   |
|  | -----    | -----   |
| Balance at end of period                   | \$12,440 | \$7,076 |
|  | =====    | =====   |

### Impaired Loans

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A loan is considered impaired when it is probable that the Bank will be unable to collect all contractual principal and interest payments due in accordance with the terms of the loan agreement. Impaired loans are measured based on the market value of the collateral if the loan is considered collateral dependent. Impaired loans not considered to be collateral dependent are measured based on the present value of expected future cash flows.

The categories of non-accrual loans and impaired loans overlap, although they are not coextensive. The Bank considers all circumstances regarding the loan and borrower on an individual basis when determining whether an impaired loan should be placed on non-accrual status, such as the financial strength of the borrower, the collateral value, reasons for the delay, payment record, the amount past due and the number of days past due.

At June 30, 2009 and 2008, the Bank had impaired loans totaling approximately \$45.01 million and \$9.39 million respectively. At June 30, 2009 the Bank had three loans totaling \$830,000 that were 90 days or more past due and still accruing interest. At June 30, 2008 no loans were 90 days or more past due and still accruing interest. Interest income recognized on impaired loans for the three months ended June 30, 2009 and 2008 was \$581,000 and \$8,000, respectively, and for the nine months ended June 30, 2009 and 2008 was \$713,000 and \$20,000, respectively. Interest income recognized on a cash basis on impaired loans for the three months ended June 30, 2009 and 2008, was \$317,000 and \$8,000, respectively, and for the nine months ended June 30, 2009 and 2008 was \$449,000 and \$20,000, respectively. The average investment in impaired loans for the nine months ended June 30, 2009 and 2008 was \$28.84 million and \$5.29 million respectively. The Bank had no restructured loans at June 30, 2008 and June 30, 2009 that were included in impaired loans.

Following is a summary of information related to impaired loans (in thousands):

|   | At June 30, |         |
|---|-------------|---------|
|   | 2009        | 2008    |
|   | -----       |         |
| Impaired loans without a valuation allowance  | \$32,147    | \$4,904 |
| Impaired loans with a valuation allowance     | 12,863      | 4,487   |
|   | -----       | -----   |
| Total impaired loans                          | \$45,010    | \$9,391 |
| Valuation allowance related to impaired loans | \$ 2,392    | \$ 540  |



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### Non-performing Assets

The following table sets forth information with respect to the Company's non-performing assets and restructured loans within the meaning of Statement of Financial Accounting Standards ("SFAS" or "Statement") No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings."

|  | At<br>June 30,<br>2009 | At<br>September 30,<br>2008 |
|--|------------------------|-----------------------------|
| -----  |                        |                             |
| (In thousands)   |                        |                             |
| Loans accounted for on a non-accrual basis:  |                        |                             |
| Mortgage loans:  |                        |                             |
| One- to four-family  | \$ 911                 | \$ 300                      |
| Commercial real estate   | 5,501                  | 714                         |
| Construction and land development  | 15,419                 | 9,840                       |
| Land   | 3,097                  | 726                         |
| Consumer loans   | 92                     | 160                         |
| Commercial business loans  | 93                     | 250                         |
|  | -----                  | -----                       |
| Total non-accrual loans  | 25,113                 | 11,990                      |
|  |                        |                             |
| Accruing loans which are contractually<br>past due 90 days or more:                      | 830                    | - -                         |
|  | -----                  | -----                       |
| Total  | 830                    | - -                         |
|  |                        |                             |
| Total of non-accrual and<br>90 days past due loans                                       | 25,943                 | 11,990                      |
|  |                        |                             |
| Non-accrual investment securities  | 175                    | - -                         |
|  |                        |                             |
| OREO and other repossessed items   | 7,698                  | 511                         |
|  | -----                  | -----                       |
| Total non-performing assets (1)  | \$ 32,986              | \$ 12,501                   |
|  | =====                  | =====                       |
|  |                        |                             |
| Restructured loans   | \$ --                  | \$ 272                      |
|  |                        |                             |
| Non-accrual and 90 days or more past<br>due loans as a percentage of loans<br>receivable | 4.65%                  | 2.12%                       |
|  |                        |                             |
| Non-accrual and 90 days or more past<br>due loans as a percentage of total assets        | 3.84%                  | 1.76%                       |
|  |                        |                             |
| Non-performing assets as a percentage<br>of total assets                                 | 4.88%                  | 1.83%                       |
|  |                        |                             |
| Loans receivable (2)   | \$558,206              | \$565,737                   |
|  | =====                  | =====                       |
|  |                        |                             |
| Total assets   | \$675,492              | \$681,883                   |
|  | =====                  | =====                       |

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- (1) Includes non-accrual loans, non-accrual investment securities, and other real estate owned and other repossessed assets. Loans considered impaired are not included if they are still on accrual status. Loans classified as troubled debt restructurings are not included if they are still on accrual status.
- (2) Includes loans held-for-sale and is before the allowance for loan losses.

### (6) GOODWILL

Goodwill is initially recorded when the purchase price paid for an acquisition exceeds the estimated fair value of the net identified tangible and intangible assets acquired and liabilities assumed. Goodwill is presumed to have an indefinite useful life and is analyzed annually for impairment. An annual test is performed during the third quarter of each fiscal year, or more frequently if indicators of potential impairment exist, to determine if the recorded goodwill is impaired. If the fair value of the Company's sole reporting unit exceeds the recorded value, goodwill is not considered impaired and no additional analysis is necessary.

One of the circumstances evaluated when determining if an impairment test of goodwill is needed more frequently than annually is the extent and duration that the Company's market capitalization (total common shares outstanding multiplied by current stock price) is less than the total equity applicable to common shareholders. During the quarter ended March 31, 2009, the Company's market capitalization decreased to a level that required a goodwill impairment test prior to the annual test. Therefore, the Company engaged a third party firm to perform an interim test for goodwill impairment during the quarter ended March 31, 2009. The test concluded that recorded goodwill was not impaired. The Company updated the interim test for goodwill impairment internally during the quarter ended June 30, 2009 and concluded that recorded goodwill was not impaired. No assurance can be given that the Company will not record an impairment loss on goodwill in the near term.

### (7) EARNINGS PER COMMON SHARE

Basic earnings per common share ("EPS") is computed by dividing net income available for common stock by the weighted average number of common shares outstanding during the period, without considering any dilutive items. Diluted EPS is computed by dividing net income available for common stock by the weighted average number of common shares and common stock equivalents for items that are dilutive, net of shares assumed to be repurchased using the treasury stock method at the average share price for the Company's common stock during the period. Common stock equivalents arise from assumed conversion of outstanding stock options, outstanding warrants to purchase common stock and restricted stock awards not yet vested. In accordance with Statement of Position ("SOP") 93-6, Employers' Accounting for Employee Stock Ownership Plans, issued by the American Institute of Certified Public Accountants, shares owned by the Bank's ESOP that have not been allocated are not considered to be outstanding for the purpose of computing earnings per share. At June 30, 2009 and 2008, there were 339,117 and 405,562 ESOP shares, respectively, that had not been allocated.

The following table is in thousands, except for share and per share data:

|                        | Three Months Ended |          | Nine Months Ended |          |
|------------------------|--------------------|----------|-------------------|----------|
|                        | June 30,           |          | June 30,          |          |
|                        | 2009               | 2008     | 2009              | 2008     |
|                        | -----              |          | -----             |          |
| Basic EPS computation  |                    |          |                   |          |
| Numerator - net income |                    |          |                   |          |
| (loss)                 | \$ 1,058           | \$ (546) | \$ 27             | \$ 2,655 |
| Less: Preferred stock  |                    |          |                   |          |

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|  |        |          |          |          |
|--|--------|----------|----------|----------|
| dividend                                     | 210    | - -      | 437      | - -      |
| Less: Preferred stock discount               | 79     | - -      | 79       | - -      |
|  | -----  | -----    | -----    | -----    |
| Net income (loss) available for common stock | \$ 769 | \$ (546) | \$ (489) | \$ 2,655 |
|  | =====  | =====    | =====    | =====    |

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|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Denominator - weighted average common shares outstanding    | 6,645,229 | 6,446,303 | 6,609,915 | 6,467,874 |
|   | -----     | -----     | -----     | -----     |
| Basic EPS   | \$ 0.12   | \$ (0.08) | \$ (0.07) | \$ 0.41   |
| Diluted EPS computation                                     |           |           |           |           |
| Numerator - net income (loss)                               | \$ 1,058  | \$ (546)  | \$ 27     | \$ 2,655  |
| Less: Preferred stock dividend                              | 210       | - -       | 437       | - -       |
| Less: Preferred stock discount                              | 79        | - -       | 79        | - -       |
|   | -----     | -----     | -----     | -----     |
| Net income (loss) available for common stock                | \$ 769    | \$ (546)  | \$ (489)  | \$ 2,655  |
|   | =====     | =====     | =====     | =====     |
| Denominator - weighted average common shares outstanding    | 6,645,229 | 6,446,303 | 6,609,915 | 6,467,874 |
| Effect of dilutive stock options (1) (2)                    | - -       | 78,515    | - -       | 119,246   |
| Effect of dilutive stock warrants (3) (4)                   | - -       | - -       | - -       | - -       |
| Effect of dilutive restricted shares                        | - -       | - -       | - -       | - -       |
|   | -----     | -----     | -----     | -----     |
| Weighted average common shares and common stock equivalents | 6,645,229 | 6,524,818 | 6,609,915 | 6,587,120 |
|   | -----     | -----     | -----     | -----     |
| Diluted EPS   | \$ 0.12   | \$ (0.08) | \$ (0.07) | \$ 0.40   |

-----

(1) For the three and nine months ended June 30, 2009, options to purchase 168,864 and 179,577 shares of common stock, respectively, were outstanding but not included in the computation of diluted earnings per common share because the options' exercise prices were greater than the average market price of the common stock and, therefore, their effect would have been anti-dilutive. For the three and nine months ended June 30, 2008, options to purchase 49,546 and 16,515 shares of common stock, respectively, were outstanding but not included in the computation of diluted earnings per common share because the options' exercise prices were greater than the average market price of the common stock and, therefore, their effect would have been anti-dilutive.

(2) For the nine months ended June 30, 2009, the effect of dilutive stock

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options was computed to be 1,738 shares. However, the dilutive effect of these stock options has been excluded from the diluted EPS computation for the nine months ended June 30, 2009 because the Company reported a net loss available for common shareholders for the period and, therefore, their effect would have been anti-dilutive.

(3) For the three and nine months ended June 30, 2009, warrants to purchase 370,899 and 247,266 shares of common stock, respectively, were outstanding but not included in the computation of diluted earnings per common share because the warrant's exercise prices were greater than the average market price of the common stock and, therefore, their effect would have been anti-dilutive. There were no warrants to purchase shares of common stock excluded from the computation of dilutive earnings per share for the three and nine months ended June 30, 2008.

(4) For the nine months ended June 30, 2009, the effect of dilutive stock warrants was computed to be 724 shares. However, the dilutive effect of these stock warrants has been excluded from the diluted EPS computation for the nine months ended June 30, 2009 because the Company reported a net loss available for common shareholders for the period and, therefore, their effect would have been anti-dilutive.

### (8) STOCK BASED COMPENSATION

The Company accounts for stock-based compensation in accordance with SFAS No. 123(R), Share Based Payment, which 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, which is consistent with the

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Company's valuation methodology previously utilized for options in footnote disclosures required under SFAS No. 123. The Company has adopted SFAS No. 123(R) using the modified prospective method, which provides for no restatement of prior periods and no cumulative adjustment to equity accounts. It also provides for expense recognition, for both new and existing stock-based awards.

### (9) STOCK COMPENSATION PLANS

#### Stock Option Plans

-----

Under the Company's stock option plans (i.e., the 1999 Stock Option Plan and the 2003 Stock Option Plan), the Company may grant options for up to a combined total of 1,622,500 shares of common stock to employees, officers and directors. Shares issued may be purchased in the open market or may be issued from authorized and unissued shares. The exercise price of each option equals the fair market value of the Company's common stock on the date of grant. Generally, options vest in 10% annual installments on each of the ten anniversaries from the date of the grant. However, if the Company meets three of four established performance criteria the vesting is accelerated to 20% for that year. These four performance criteria are: (i) generating a return on assets which exceeds that of the median of all thrifts in the 12th FHLB District having assets within \$250 million of the Company; (ii) generating an efficiency ratio which is less than that of the median of all thrifts in the 12th FHLB District having assets within \$250 million of the Company; (iii) generating a net interest margin which exceeds the median of all thrifts in the 12th FHLB District having assets within \$250 million of the Company; and

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(iv) increasing the Company's earnings per share over the prior fiscal year. At June 30, 2009, options for 275,738 shares are available for future grant under the 2003 Stock Option Plan.

Following is activity under the plans:

|  | Nine Months Ended<br>June 30, 2009<br>Total Options Outstanding |  |  |
|--|---|--|--|
|  | Shares  | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Grant Date<br>Fair<br>Value |
|  | -----   | -----                                    | -----  |
| Options outstanding, beginning of period | 273,820   | \$ 8.07                                  | \$1.99   |
| Exercised                                | 57,699  | 6.00                                     | 1.63   |
| Forfeited                                | 47,257  | 6.00                                     | 1.63   |
| Granted                                  | --  | --                                       | --   |
|  | -----   |  |  |
| Options outstanding, end of period       | 168,864   | \$ 9.35                                  | \$2.21   |
| Options exercisable, end of period       | 168,864   | \$ 9.35                                  | \$2.21   |

There was no aggregate intrinsic value of all options outstanding at June 30, 2009, as the exercise price of all options outstanding was greater than the stock's current market value. The aggregate intrinsic value of all options outstanding at June 30, 2008 was \$395,000. The aggregate intrinsic value of all options that were exercisable at June 30, 2008 was \$395,000.

At June 30, 2009, there were no unvested options.

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There were 5,668 options that vested during the nine months ended June 30, 2009 with an aggregate grant date fair value of \$13,000. There were 12,336 options that vested during the nine months ended June 30, 2008 with an aggregate grant date fair value of \$28,000.

Proceeds, related tax benefits realized from options exercised and intrinsic value of options exercised were as follows:

|                                      | Nine Months Ended<br>June 30, |       |
|--------------------------------------|-------------------------------|-------|
|                                      | -----                         |       |
|                                      | (In thousands)                |       |
|                                      | 2009                          | 2008  |
|                                      | ----                          | ----  |
| Proceeds from options exercised      | \$346                         | \$445 |
| Related tax benefit recognized       | 46                            | 15    |
| Intrinsic value of options exercised | 56                            | 451   |

Options outstanding at June 30, 2009 were as follows:

| Outstanding                  | Exercisable                  |
|------------------------------|------------------------------|
| -----                        | -----                        |
| Weighted<br>Weighted Average | Weighted<br>Weighted Average |
|                              |                              |

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| Range<br>Exercise<br>Prices | Shares  | Average<br>Exercise<br>Price | Remaining<br>Contractual<br>Life (Years) | Shares  | Average<br>Exercise<br>Price | Remaining<br>Contractual<br>Life (Years) |
|-----------------------------|---------|------------------------------|--|---------|------------------------------|--|
| \$ 6.80-7.45                | 56,638  | \$ 7.45                      | 1.9                                      | 56,638  | \$ 7.45                      | 1.9                                      |
| 7.85-7.98                   | 6,000   | 7.91                         | 2.9                                      | 6,000   | 7.91                         | 2.9                                      |
| 9.52                        | 56,680  | 9.52                         | 3.7                                      | 56,680  | 9.52                         | 3.7                                      |
| 11.46-11.63                 | 49,546  | 11.51                        | 4.5                                      | 49,546  | 11.51                        | 4.5                                      |
|                             | -----   |                              |  | -----   |                              |  |
|                             | 168,864 | \$ 9.35                      | 3.3                                      | 168,864 | \$ 9.35                      | 3.3                                      |

There were no options granted during the nine months ended June 30, 2009 and June 30, 2008.

Stock Grant Plans

The Company adopted the Management Recognition and Development Plan ("MRDP") in 1998, which was subsequently approved by shareholders in 1999 for the benefit of employees, officers and directors of the Company. The objective of the MRDP is to retain and attract personnel of experience and ability in key positions by providing them with a proprietary interest in the Company.

The MRDP allows for the issuance to participants of up to 529,000 shares of the Company's common stock. Shares may be purchased in the open market or may be issued from authorized and unissued shares. Awards under the MRDP are made in the form of restricted shares of common stock that are subject to restrictions on the transfer of ownership. Compensation expense in the amount of the fair value of the common stock at the date of the grant to the plan participants is recognized over a five-year vesting period, with 20% vesting on each of the five anniversaries from the date of the grant. During the nine months ended June 30, 2009, the Company awarded 19,758 MRDP shares to officers and directors. These shares had a weighted average grant date fair value of \$7.01 per share. During the nine months ended June 30, 2008 the Company awarded 20,315 MRDP shares to officers and directors. These shares had a weighted average grant date fair value of \$12.76 per share.

At June 30, 2009, there were a total of 52,258 unvested MRDP shares with an aggregated grant date fair value of \$620,000. There were 7,079 MRDP shares that vested during the nine months ended June 30, 2009 with an

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aggregated grant date fair value of \$104,000. There were 3,016 MRDP shares that vested during the nine months ended June 30, 2008 with an aggregated grant date fair value of \$53,000. At June 30, 2009, there were no shares available for future awards under the MRDP.

Expenses for Stock Compensation Plans

Compensation expenses for all stock-based plans were as follows:

|               | Nine Months Ended June 30, |               |              |  |
|---------------|----------------------------|---------------|--------------|--|
|               | 2009                       | 2008          |              |  |
|               | -----                      |               |              |  |
|               | (In thousands)             |               |              |  |
| Stock Options | Stock Grants               | Stock Options | Stock Grants |  |

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|   |      |        |      |       |
|---|------|--------|------|-------|
| Compensation expense recognized in income | \$ 2 | \$ 159 | \$ 4 | \$ 93 |
| Related tax benefit recognized            | --   | 34     | 1    | 32    |

The compensation expense yet to be recognized for stock based awards that have been awarded but not vested for the years ending September 30 is as follows (in thousands):

|                   | Stock<br>Options | Stock<br>Grants | Total<br>Awards |
|-------------------|------------------|-----------------|-----------------|
|                   | -----            | -----           | -----           |
| Remainder of 2009 | \$ --            | \$ 43           | \$ 43           |
| 2010              | --               | 171             | 171             |
| 2011              | --               | 165             | 165             |
| 2012              | --               | 112             | 112             |
| 2013              | --               | 38              | 38              |
| 2014              | --               | 2               | 2               |
|                   | -----            | -----           | -----           |
| Total             | \$ --            | \$531           | \$531           |

(10) INCOME TAXES

The Company files a consolidated federal income tax return with its subsidiary, the Bank. The Bank provides for income taxes separately and remits to the Company amounts currently due.

Deferred federal income taxes result from temporary differences between the tax basis of assets and liabilities, and their reported amounts in the consolidated financial statements. These will result in differences between income for tax purposes and income for financial reporting purposes in future years. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. Valuation allowances are established to reduce the net recorded amount of deferred tax assets if it is determined to be more likely than not, that all or some portion of the potential deferred tax asset will not be realized.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109 ("FIN 48"). The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company adopted the provisions of FIN 48 on October 1, 2007. It is the Company's policy to record any penalties or interest arising from federal or state taxes as a component of non-interest expense.

The Company is no longer subject to United States federal income tax examination by tax authorities for years ended on or before September 30, 2004.

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The components of the provision (benefit) for federal income taxes for the nine months ended June 30, 2009 and 2008 are as follows (in thousands):

|         | Nine Months Ended June 30, |          |
|---------|----------------------------|----------|
|         | 2009                       | 2008     |
|         | -----                      | -----    |
| Current | \$ 954                     | \$ 3,255 |

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|                            |          |          |
|----------------------------|----------|----------|
| Deferred                   | (1,263)  | 1,037    |
|                            | -----    | -----    |
| Total federal income taxes | (\$ 309) | \$ 2,218 |

The components of the Company's prepaid federal income taxes and net deferred tax assets included in other assets as of June 30, 2009 and September 30, 2008 are as follows (in thousands):

|                              | At June 30,<br>2009 | At September 30,<br>2008 |
|------------------------------|---------------------|--------------------------|
|                              | -----               | -----                    |
| Prepaid federal income taxes | \$ 627              | \$ 525                   |
| Net deferred tax assets      | 3,603               | 1,945                    |
|                              | -----               | -----                    |
| Total                        | \$4,230             | \$2,470                  |

The components of the Company's deferred tax assets and liabilities at June 30, 2009 and September 30, 2008 are as follows (in thousands):

|  | At June 30,<br>2009 | At September 30,<br>2008 |
|--|---------------------|--------------------------|
|  | -----               | -----                    |
| Deferred tax assets  |                     |                          |
| Accrued interest on loans                                  | \$ 37               | \$ 5                     |
| Accrued vacation   | 150                 | 115                      |
| Deferred compensation                                      | 35                  | 54                       |
| Unearned ESOP shares                                       | 454                 | 450                      |
| Allowance for loan losses                                  | 4,434               | 2,822                    |
| CDI  | 243                 | 226                      |
| Unearned MRDP shares                                       | 105                 | 61                       |
| Net unrealized securities losses                           | 643                 | 248                      |
| Capital loss carry-forward                                 | 928                 | 928                      |
| Reserve for deposit overdrafts                             | 3                   | -                        |
| Stock option compensation expense                          | 22                  | 21                       |
|  | -----               | -----                    |
| Total deferred tax assets                                  | 7,054               | 4,930                    |
| Deferred tax liabilities                                   |                     |                          |
| FHLB stock dividends                                       | 906                 | 906                      |
| Depreciation   | 299                 | 262                      |
| Goodwill   | 626                 | 527                      |
| Certificate of deposit valuation                           | 20                  | 21                       |
| Mortgage servicing rights                                  | 828                 | 457                      |
| Prepaid expenses   | 82                  | 122                      |
|  | -----               | -----                    |
| Total deferred tax liabilities                             | 2,761               | 2,295                    |
| Valuation allowance for capital loss on sale of securities | (690)               | (690)                    |
|  | -----               | -----                    |
| Net deferred tax assets                                    | \$3,603             | \$1,945                  |

The provision (benefit) for federal income taxes for the nine months ended



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June 30, 2009 and 2008 differs from that computed at the statutory corporate tax rate as follows (in thousands):

|                                | Nine Months Ended June 30, |          |         |         |
|--------------------------------|----------------------------|----------|---------|---------|
|                                | 2009                       |          | 2008    |         |
|                                | Amount                     | Percent  | Amount  | Percent |
|                                | -----                      | -----    | -----   | -----   |
| Taxes at statutory rate        | (\$ 97)                    | (35.0%)  | \$1,705 | 35.0%   |
| Non-taxable BOLI income        | (175)                      | (62.9%)  | (126)   | (2.6%)  |
| Non-deductible capital loss    |                            |          | 729     | 15.0%   |
| Other - net                    | (37)                       | (13.3%)  | (90)    | (1.9%)  |
| <br>                           |                            |          |         |         |
| Federal income taxes (benefit) | (\$309)                    | (111.2%) | \$2,218 | 45.5%   |

### (11) FAIR VALUE MEASUREMENTS

SFAS No. 107, Disclosures About Fair Value of Financial Instruments, requires disclosure of estimated fair values for financial instruments. Such estimates are subjective in nature, and significant judgment is required regarding the risk characteristics of various financial instruments at a discrete point in time. Therefore, such estimates could vary significantly if assumptions regarding uncertain factors were to change. Major assumptions, methods and fair value estimates for the Company's significant financial instruments are set forth below:

Cash and Due from Financial Institutions, Interest-Bearing Deposits in  
-----  
Banks, and Federal Funds Sold  
-----

The recorded amount is a reasonable estimate of fair value.

Investments and Mortgage-Backed Securities  
-----

The fair value of investments and mortgage-backed securities has been based on quoted market prices, dealer quotes, or discounted cash flows.

Federal Home Loan Bank Stock  
-----

The recorded value of stock holdings approximates fair value.

Loans Receivable and Loans Held for Sale  
-----

Fair value of loans at June 30, 2009 is estimated based on comparable market statistics. Loan portfolio sales reported by the FDIC for the period January 1, 2007 through June 30, 2009 were used as the basis for comparable market statistics. Fair value of loans at September 30, 2008 was estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers for the same remaining maturities. Prepayments are based on the historical experience of the Bank. The fair value calculation of loans at September 30, 2008 was prior to the Company's partial adoption of SFAS No. 157, Fair Value Measurements.

The effect of changing the fair value calculation method for loans receivable and loans held for sale as a result of partially adopting SFAS No. 157, Fair Value Measurements on October 1, 2008 is shown in the following table (in thousands):

June 30, 2009  
-----

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|   |            |
|---|------------|
| Estimated fair value using methodology in place prior to the partial adoption of SFAS 157 | \$ 544,766 |
| Change in estimated fair value due to partial adoption of SFAS 157                        | (170,154)  |
|   | -----      |
| Estimated fair value  | \$ 374,612 |

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### Deposits

-----

The fair value of deposits with no stated maturity date is included at the amount payable on demand. The fair value of fixed maturity certificates of deposit is estimated by discounting future cash flows using the rates currently offered by the Bank for deposits of similar remaining maturities.

### Federal Home Loan Bank Advances

-----

The fair value of borrowed funds is estimated by discounting the future cash flows of the borrowings at a rate which approximates the current offering rate of the borrowings with a comparable remaining life.

### Other Borrowings: Repurchase Agreements

-----

The recorded value of repurchase agreements approximates fair value.

### Accrued Interest

-----

The recorded amounts of accrued interest approximate fair value.

### Mortgage Servicing Rights ("MSRs")

-----

The fair value of the mortgage servicing rights was determined using a model, which incorporates the expected life of the loans, estimated cost to service the loans, servicing fees received and other factors. The Company calculates MSRs fair value by stratifying MSRs based on the predominant risk characteristics that include the underlying loan's interest rate, cash flows of the loan, origination date and term.

### Off-Balance-Sheet Instruments

-----

The fair value of commitments to extend credit was estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the customers. Since the majority of the Company's off-balance-sheet instruments consist of variable-rate commitments, the Company has determined they do not have a distinguishable fair value.

The estimated fair value of financial instruments were as follows (in thousands):

| June 30, 2009      |                            | September 30, 2008 |                            |
|--------------------|----------------------------|--------------------|----------------------------|
| Recorded<br>Amount | Estimated<br>Fair<br>Value | Recorded<br>Amount | Estimated<br>Fair<br>Value |

### Financial Assets

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|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Cash and due from financial institutions and interest-bearing deposits in banks | \$ 43,971 | \$ 43,971 | \$ 17,444 | \$ 17,444 |
| Federal funds sold  | - -       | - -       | 25,430    | 25,430    |
| Investments and mortgage-backed securities                                      | 24,452    | 20,394    | 31,331    | 29,072    |
| FHLB stock  | 5,705     | 5,705     | 5,705     | 5,705     |
| Loans receivable and loans held for sale (1)                                    | 544,766   | 374,612   | 557,687   | 550,329   |
| Accrued interest receivable   | 2,918     | 2,918     | 2,870     | 2,870     |
| Mortgage servicing rights   | 2,366     | 2,366     | 1,306     | 1,818     |
| Financial Liabilities   |           |           |           |           |
| Deposits  | \$487,419 | \$489,466 | \$498,572 | \$498,806 |
| FHLB advances - short term  | - -       | - -       | - -       | - -       |
| FHLB advances - long term   | 95,000    | 96,313    | 104,628   | 105,958   |
| Other borrowings: repurchase agreements   | 666       | 666       | 758       | 758       |
| Accrued interest payable  | 1,092     | 1,092     | 1,135     | 1,135     |

-----  
 (1) For additional information see major assumptions for "Loans Receivable and Loans Held for Sale" above the estimated fair value of financial instruments table.

SFAS No. 157 defines fair value and establishes a framework for measuring fair value in accordance with Generally Accepted Accounting Principles ("GAAP"). Fair value is the exchange price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date. SFAS No. 157 identifies three levels of inputs that may be used to measure fair value:

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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 following table summarizes the balances of assets and liabilities measured at fair value on a recurring basis at June 30, 2009 (in thousands):

|                               | Fair Value at June 30, 2009 |         |         |       | Nine Months Ended June 30, 2009 |
|-------------------------------|-----------------------------|---------|---------|-------|---------------------------------|
|                               | Level 1                     | Level 2 | Level 3 | Total | Losses                          |
|                               | -----                       | -----   | -----   | ----- | -----                           |
| Available for Sale Securities |                             |         |         |       |                                 |

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|                            |        |          |        |        |
|----------------------------|--------|----------|--------|--------|
| Mutual Funds               | \$ 954 | \$ - -   | \$ - - | \$ - - |
| Mortgage-backed securities | - -    | 12,944   | - -    | 124    |
| Total                      | \$ 954 | \$12,944 | \$ - - | \$ 124 |

The following table summarizes the balance of assets and liabilities measured at fair value on a nonrecurring basis at June 30, 2009, and the total losses resulting from these fair value adjustments for the nine months ended June 30, 2009 (in thousands):

|                                      | Fair Value at June 30, 2009 |         |          | Nine Months Ended June 30, 2009 |
|--------------------------------------|-----------------------------|---------|----------|---------------------------------|
|                                      | Level 1                     | Level 2 | Level 3  | Total Losses                    |
| Impaired Loans (1)                   | \$ - -                      | \$ - -  | \$10,695 | \$2,975                         |
| Mortgage-backed securities - HTM (2) | - -                         | 175     | - -      | 2,164                           |
| Total                                | \$ - -                      | \$ 175  | \$10,695 | \$5,139                         |

(1) The loss represents charge offs on collateral dependent loans for fair value adjustments based on the fair value of the collateral. A loan is considered to be impaired when, based on current information and events, it is probable the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement.

(2) The loss represents OTTI charges on held-to-maturity mortgage-backed securities.

(12) DIVIDEND / SUBSEQUENT EVENT

On July 31, 2009, the Company announced a quarterly cash dividend of \$0.06 per common share, payable August 28, 2009, to shareholders of record as of the close of business on August 14, 2009. There were no other subsequent events requiring disclosure as of the filing date of August 10, 2009.

(13) RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ("SFAS 157"), which defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. This Statement expands other accounting pronouncements that require or permit fair value measurements. This Statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In February 2008, the FASB issued Staff Position ("FSP") No. FAS 157-2 ("FSP 157-2"), which delays the effective date of SFAS 157 for certain nonfinancial assets and nonfinancial liabilities, to fiscal years beginning after November 15, 2008, and interim periods within those years. The delay is intended to allow additional time to consider the effect of various implementation issues that have arisen, or that may arise, from the

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application of SFAS 157. The Company has elected to apply the deferral provisions in FSP 157-2 and therefore only partially adopted the provisions of SFAS 157 on October 1, 2008. The Company's partial adoption of SFAS 157 on October 1, 2008 did not have a material impact on the Company's consolidated financial statements. See Footnote 11, "Fair Value Measurements," for further information. The Company has not adopted the provisions of SFAS 157 with respect to certain nonfinancial assets, such as other real estate owned. The Company will more fully adopt SFAS 157 with respect to these items effective October 1, 2009. The Company does not believe that the adoption of the additional provisions of SFAS 157 will have a material impact on its consolidated financial statements, but will result in additional disclosures related to the fair value of nonfinancial assets.

In June 2008, the FASB issued FSP Emerging Issues Task Force 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities. This FSP states that vested share-based payment awards that contain non-forfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. The FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those years. The adoption of this FSP is not expected to have a material impact on the Company's Consolidated Financial Statements.

In October 2008, the FASB issued FSP FAS No. 157-3, Determining Fair Value of a Financial Asset When the Market for That Asset Is Not Active ("FAS 157-3"). The FSP clarifies the application of SFAS 157 when the market for a financial asset is not active. The FSP was effective upon issuance, including reporting for prior periods for which financial statements have not been issued. The Company's adoption of FAS 157-3 in October 2008 did not have a material impact on the Company's consolidated financial statements.

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments ("FAS 115-2") This FSP amends the other-than-temporary guidance in U.S. GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of OTTIs on debt and equity securities in the financial statements. This FSP does not amend existing recognition and measurement guidance related to OTTIs of equity securities. FAS 115-2 provides for the bifurcation of OTTIs into (i) amounts related to credit losses, which are recognized through earnings, and (ii) amounts related to all other factors which are recognized as a component of other comprehensive income. The Company adopted FAS 115-2 as of January 1, 2009. As a result of adopting FAS 115-2, the Company recorded \$397,000 in impairments not related to credit losses through other comprehensive income rather than through earnings for the six months ended June 30, 2009.

In April 2009, the FASB issued FSP No. FAS 157-4, Determining Fair Value When the Volume and Level of Activity for an Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not

Orderly, ("FAS 157-4"). This FSP provides additional guidance for fair value measures under FAS 157 in determining if the market for an asset or liability is inactive and accordingly, if quoted market prices may not be indicative of fair value. The Company adopted FAS 157-4 as of January 1, 2009 and it did not have a material impact on the Company's Consolidated Financial Statements.

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In April 2009, the FASB issued FSP No. FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments ("FAS 107-1"). This FSP is designed to enhance consistency in financial reporting by increasing the frequency of fair value disclosures. The Company adopted the provisions of FAS 107-1 as of June 30, 2009 and it did not have a material impact on the Company's Consolidated Financial Statements.

In May 2009, the FASB issued SFAS No. 165, Subsequent Events. The objective of SFAS No. 165 is to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. Specifically, the Statement defines: (1) the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, (2) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and (3) the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. In accordance with this Statement, an entity should apply the requirements to interim or annual financial periods ending after June 15, 2009. The adoption of SFAS No. 165 as of June 30, 2009 did not have a material impact on the Company's condensed consolidated financial statements.

### Item 2. Management's Discussion and Analysis of Financial Condition and ----- Results of Operations -----

The following analysis discusses the material changes in the financial condition and results of operations of the Company at and for the three and nine months ended June 30, 2009. This analysis as well as other sections of this report contains certain "forward-looking statements."

Certain matters discussed in this Form 10-Q may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements relate to, among other things, expectations of the business environment in which we operate, projections of future performance, perceived opportunities in the market, potential future credit experience, and statements regarding our mission and vision. These forward-looking statements are based upon current management expectations and may, therefore, involve risks and uncertainties. Our actual results, performance, or achievements may differ materially from those suggested, expressed, or implied by forward-looking statements as a result of a wide variety or range of factors including, but not limited to: the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs that may be impacted by deterioration in the housing and commercial real estate markets and may lead to increased losses and nonperforming assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses, and require us to materially increase our reserves; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas; results of examinations of us by the Federal Reserve and our bank subsidiary by the Federal Deposit Insurance Corporation, the Washington State Department of Financial Institutions, Division of Banks or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our reserve for loan losses, write-down assets, change our regulatory capital position or affect

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our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings; our ability to control operating costs and expenses; the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our balance sheet; staffing fluctuations in response to

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product demand or the implementation of corporate strategies that affect our work force and potential associated charges; computer systems on which we depend could fail or experience a security breach; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired or may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; our ability to manage loan delinquency rates; costs and effects of litigation, including settlements and judgments; increased competitive pressures among financial services companies; changes in consumer spending, borrowing and savings habits; legislative or regulatory changes that adversely affect our business including changes in regulatory polices and principles, including the interpretation of regulatory capital or other rules; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; the economic impact of war or any terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations; pricing, products and services; and other risks detailed in our reports filed with the Securities and Exchange Commission, including our Annual Report on Form 10-K for the year ended September 30, 2008. Any of the forward-looking statements that we make in this Form 10-Q and in the other public statements we make may turn out to be wrong because of the inaccurate assumptions we might make, because of the factors illustrated above or because of other factors that we cannot foresee. Because of these and other uncertainties, our actual future results may be materially different from those expressed in any forward-looking statements made by or on our behalf. Therefore, these factors should be considered in evaluating the forward-looking statements, and undue reliance should not be placed on such statements. We undertake no responsibility to update or revise any forward-looking statements.

### Overview

Timberland Bancorp, Inc., a Washington corporation, was organized on September 8, 1997 for the purpose of becoming the holding company for Timberland Savings Bank, SSB upon the Bank's conversion from a Washington-chartered mutual savings bank to a Washington-chartered stock savings bank ("Conversion"). The Conversion was completed on January 12, 1998 through the sale and issuance of 13,225,000 shares of common stock by the Company. At June 30, 2009, the Company had total assets of \$675.49 million and total shareholders' equity of \$88.76 million. The Company's business activities generally are limited to passive investment activities and oversight of its investment in the Bank.

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Accordingly, the information set forth in this report relates primarily to the Bank.

The Bank was established in 1915 as "Southwest Washington Savings and Loan Association." In 1935, the Bank converted from a state-chartered mutual savings and loan association to a federally-chartered mutual savings and loan association, and in 1972 changed its name to "Timberland Federal Savings and Loan Association." In 1990, the Bank converted to a federally chartered mutual savings bank under the name "Timberland Savings Bank, FSB." In 1991, the Bank converted to a Washington-chartered mutual savings bank and changed its name to "Timberland Savings Bank, SSB." In 2000, the Bank changed its name to "Timberland Bank." The Bank's deposits are insured by the Federal Deposit Insurance Corporation ("FDIC") up to applicable legal limits. The Bank has been a member of the Federal Home Loan Bank System since 1937. The Bank is regulated by the Washington State Department of Financial Institutions, Division of Banks and the FDIC.

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The Bank is a community-oriented bank which offers a variety of deposit and loan products to its customers. The Bank operates 22 branches (including its main office in Hoquiam) in the following market areas in the state of Washington:

- \* Grays Harbor County
- \* Thurston County
- \* Pierce County
- \* King County
- \* Kitsap County
- \* Lewis County

Historically, the principal lending activity of the Bank has consisted of the origination of loans secured by first mortgages on owner-occupied, one- to four-family residences and loans for the construction of one- to four-family residences. Since 2001, the Bank has expanded its business banking capabilities and has emphasized the origination of commercial real estate and commercial business loans.

### Critical Accounting Policies and Estimates

The Company has identified several accounting policies that as a result of judgments, estimates and assumptions inherent in those policies, are critical to an understanding of the Company's Consolidated Financial Statements.

**Allowance for Loan Losses.** The allowance for loan losses is maintained at a level sufficient to provide for probable loan losses based on evaluating known and inherent risks in the portfolio. The allowance is based upon management's comprehensive analysis of the pertinent factors underlying the quality of the loan portfolio. These factors include changes in the amount and composition of the loan portfolio, actual loss experience, current economic conditions, and detailed analysis of individual loans for which the full collectability may not be assured. The appropriate allowance for loan loss level is estimated based upon factors and trends identified by management at the time consolidated financial statements are prepared.

While the Company believes it has established its existing allowance for loan losses in accordance with accounting principles generally accepted in the United States, there can be no assurance that regulators, in reviewing the Company's loan portfolio, will not request the Company to significantly



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increase or decrease its allowance for loan losses. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is adequate or that substantial increases will not be necessary should the quality of any loans deteriorate as a result of the factors discussed elsewhere in this document. Although management believes the levels of the allowance as of both June 30, 2009 and September 30, 2008 were adequate to absorb probable losses inherent in the loan portfolio, a decline in local economic conditions, results of examinations by the Company's or the Bank's regulators or other factors, could result in a material increase in the allowance for loan losses and may adversely affect the Company's financial condition and results of operations.

**Mortgage Servicing Rights.** Mortgage servicing rights ("MSRs") are capitalized when acquired through the origination of loans that are subsequently sold with servicing rights retained and are amortized to servicing income on loans sold in proportion to and over the period of estimated net servicing income. The value of MSRs at the date of the sale of loans is determined based on the discounted present value of expected future cash flows using key assumptions for servicing income and costs and prepayment rates on the underlying loans. The estimated fair value is periodically evaluated for impairment by comparing actual cash flows and estimated cash flows from the servicing assets to those estimated at the time servicing assets were originated. The effect of changes in market interest rates on estimated rates of loan prepayments represents the predominant risk characteristic underlying the MSRs portfolio. The Company's methodology for estimating the fair value of

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MSRs is highly sensitive to changes in assumptions. For example, the determination of fair value uses anticipated prepayment speeds. Actual prepayment experience may differ and any difference may have a material effect on the fair value. Thus, any measurement of MSRs' fair value is limited by the conditions existing and assumptions as of the date made. Those assumptions may not be appropriate if they are applied at different times.

**OTTIs (Other-Than-Temporary Impairments) in the Market Value of Investment Securities.** Unrealized investment securities losses on available for sale and held to maturity securities are evaluated at least quarterly to determine whether declines in value should be considered "other than temporary" and therefore be subject to immediate loss recognition through earnings for the portion related to credit losses. Although these evaluations involve significant judgment, an unrealized loss in the fair value of a debt security is generally deemed to be temporary when the fair value of the security is below the recorded value primarily as a result of changes in interest rates, when there has not been significant deterioration in the financial condition of the issuer, and the Company has the intent and the ability to hold the security for a sufficient time to recover the recorded value. An unrealized loss in the value of an equity security is generally considered temporary when the fair value of the security is below the recorded value primarily as a result of current market conditions and not a result of deterioration in the financial condition of the issuer or the underlying collateral (in the case of mutual funds) and the Company has the intent and the ability to hold the security for a sufficient time to recover the recorded value. Other factors that may be considered in determining whether a decline in the value of either a debt or equity security is "other than temporary" include ratings by recognized rating agencies; capital strength and near-term prospects of the issuer, and recommendation of investment advisors or market analysts.

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Therefore, continued deterioration of current market conditions could result in additional impairment losses recognized within the Company's investment portfolio.

### Comparison of Financial Condition at June 30, 2009 and September 30, 2008

The Company's total assets decreased by \$6.39 million, or 0.9%, to \$675.49 million at June 30, 2009 from \$681.88 million at September 30, 2008. The decrease was primarily attributable to a decrease in net loans receivable and investment securities, which were partially offset by increases in OREO, premises and equipment, cash equivalents and MSRs.

Net loans receivable decreased by \$11.92 million, or 2.1%, to \$545.77 million at June 30, 2009 from \$557.69 million at September 30, 2008 primarily as a result of a decrease in construction and land development loan balances, home equity loan balances, commercial business loan balances and an increase in the allowance for loan losses.

Total deposits decreased by \$11.15 million, or 2.2%, to \$487.42 million at June 30, 2009 from \$498.57 million at September 30, 2008, primarily as a result of a decrease in brokered certificate of deposit account balances and money market account balances. These decreases were partially offset by increases in N.O.W. checking account balances and non-brokered certificate of deposit account balances.

Shareholders' equity increased by \$13.91 million, or 18.6%, to \$88.76 million at June 30, 2009 from \$74.84 million at September 30, 2008. The increase in shareholders' equity was primarily a result of the sale of \$16.64 million in senior preferred stock to the U.S. Treasury Department as part of the Treasury's Capital Purchase Program.

A more detailed explanation of the changes in significant balance sheet categories follows:

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**Cash Equivalents:** Cash equivalents increased by \$1.10 million, or 2.6%, to \$43.97 million at June 30, 2009 from \$42.87 million at September 30, 2008, primarily as a result of an increase in interest bearing deposits in banks. The increase in interest bearing deposits in banks was partially offset by a decrease in federal funds sold.

**Investment Securities and Mortgage-backed Securities:** Investment and mortgage-backed securities decreased by \$7.24 million, or 23.1%, to \$24.09 million at June 30, 2009 from \$31.33 million at September 30, 2008. The decrease was primarily as a result of regular amortization and prepayments on mortgage-backed securities, a \$3.04 million OTTI charge recorded on private label mortgage-backed securities and a \$372,000 decrease in market value on available for sale securities adjusted through the other comprehensive loss equity account. The securities on which the OTTI charges were recognized were acquired from the in-kind redemption of the Bank's investment in the AMF family of mutual funds in June 2008.

At June 30, 2009, the Company's securities' portfolio was comprised of mortgage-backed securities of \$23.11 million (of which \$10.20 million were classified as held to maturity), mutual funds of \$954,000 and U.S. agency securities of \$27,000. For additional information, see Note 3 of the Notes to Condensed Consolidated Financial Statements contained in "Item 1, Financial Statements."

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Loans: Net loans receivable decreased by \$11.92 million, or 2.1% to \$545.77 million at June 30, 2009 from \$557.69 million at September 30, 2008. The decrease in the portfolio was primarily a result of a \$30.42 million decrease in construction loans (net of undisbursed portion of construction loans in process), a \$7.27 million decrease in consumer loans, a \$5.82 million decrease in commercial business loans, a \$1.96 million decrease in one- to four-family loans (including loans held for sale) and a \$4.39 million increase in the allowance for loan losses. These decreases to net loans receivable were partially offset by a \$32.72 million increase in commercial real estate loans and a \$5.04 million increase in land loans. The decrease in construction loans was primarily the result of a \$14.88 million decrease in multi-family and condominium construction loans, a \$12.80 million decrease in custom and owner / builder construction loans, an \$11.56 million decrease in one- to four-family speculative construction loans, and a \$7.54 million decrease in land development loans; which were partially offset by a \$2.44 million increase in commercial real estate construction loans.

Loan originations increased to \$236.99 million for the nine months ended June 30, 2009 from \$204.60 million for the nine months ended June 30, 2008. The increase in loan volume was primarily a result of increased demand to refinance one- to four-family mortgage loans at historically low interest rates. The Bank continued to sell longer-term fixed rate loans for asset liability management purposes and to generate non-interest income. The Bank sold fixed rate one- to four-family mortgage loans totaling \$140.88 million for the nine months ended June 30, 2009 compared to \$35.31 million for the nine months ended June 30, 2008.

For additional information, see Note 5 of the Notes to Condensed Consolidated Financial Statements contained in "Item 1, Financial Statements."

Premises and Equipment: Premises and equipment increased by \$1.29 million, or 7.6%, to \$18.17 million at June 30, 2009 from \$16.88 million at September 30, 2008. The increase was primarily a result of capitalized construction costs on the Bank's new branch facility in Lewis County, which opened in May 2009.

Goodwill and Core Deposit Intangible: The value of goodwill at \$5.65 million at June 30, 2009 remained unchanged from September 30, 2008. The amortized value of the core deposit intangible decreased to \$809,000 at June 30, 2009 from \$972,000 at September 30, 2008. The \$163,000 decrease is attributable to scheduled amortization of the CDI.

Deposits: Deposits decreased by \$11.15 million, or 2.2%, to \$487.42 million at June 30, 2009 from \$498.57 million at September 30, 2008. The decrease was primarily a result of a \$25.96 million decrease in brokered certificate of deposit account balances, an \$8.39 million decrease in money market account balances and a \$1.80

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million decrease in non-interest bearing account balances. These decreases were partially offset by an \$11.72 million increase in N.O.W. checking account balances and a \$13.37 million increase in non-brokered certificate of deposit account balances. For additional information, see the section entitled "Deposit Breakdown" included herein.

FHLB Advances and Other Borrowings: FHLB advances and other borrowings decreased by \$9.72 million, or 9.2%, to \$95.66 million at June 30, 2009 from

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\$105.39 million at September 30, 2008 as the Bank used a portion of its liquid assets to repay maturing FHLB advances. For additional information, see "FHLB Advance Maturity Schedule" included herein.

**Shareholders' Equity:** Total shareholders' equity increased by \$13.91 million, or 18.6%, to \$88.76 million at June 30, 2009 from \$74.84 million at September 30, 2008. The increase was primarily a result of the sale of \$16.64 million in senior preferred stock to the U.S. Treasury Department as part of the Treasury's Capital Purchase Program. As part of the transaction, the Company also issued warrants to the Treasury to purchase up to \$2.5 million in common stock. The transaction is part of the Treasury's program to encourage qualified financial institutions to build capital to increase the flow of financing to businesses and consumers and to support the U.S. economy.

Also impacting shareholders' equity during the nine months ended June 30, 2009 was the payment of \$2.64 million in cash dividends on common and preferred stock and an \$823,000 increase in the accumulated other comprehensive loss equity category.

The Company did not repurchase any shares of its common stock during the nine months ended June 30, 2009. As part of the Company's participation in the Treasury's Capital Purchase Program, the existing share repurchase plan announced on February 25, 2008 was suspended indefinitely. For additional information, see Item 2 of Part II of this Form 10-Q.

**Non-performing Assets:** Non-performing assets consist of non-accrual loans, non-accrual investment securities, and OREO and other repossessed assets. At June 30, 2009, three loans totaling \$830,000 were 90 days or more past due and still accruing interest. At September 30, 2008, no loans were 90 days or more past due and still accruing interest. Non-performing assets to total assets increased to 4.88% at June 30, 2009 from 1.83% at September 30, 2008, as non-accrual loans increased by \$13.12 million to \$25.11 million at June 30, 2009 from \$11.99 million at September 30, 2008, OREO and other repossessed assets increased by \$7.19 million to \$7.70 million at June 30, 2009 from \$511,000 at September 30, 2008 and non-accrual investment securities increased by \$175,000.

Total non-accrual loans of \$25.11 million at June 30, 2009 were comprised of 46 loans and 38 credit relationships. Included in these non-accrual loans were:

- \* Five land development loans totaling \$5.88 million (of which the largest had a balance of \$2.12 million)
- \* Two condominium construction loans totaling \$5.68 million (of which the largest had a balance of \$4.29 million)
- \* Eight commercial real estate loans totaling \$5.50 million (of which the largest had a balance \$1.65 million)
- \* 13 land loans totaling \$3.38 million (of which the largest had a balance of \$986,000)
- \* Seven single family home loans totaling \$2.32 million (of which the largest had a balance of \$995,000)
- \* Seven single family speculative loans totaling \$2.17 million (of which the largest had a balance of \$546,000)
- \* Two commercial business loans totaling \$93,000
- \* Two home equity loans totaling \$92,000.

The Company had net charge-offs totaling \$2.98 million for the nine months

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ended June 30, 2009. The charge-offs were primarily associated with construction and land development loans. In recognition of a real estate market that reflected lower valuations during the period, net charge-offs consisted of the following:

- \* \$1.38 million on land development loans
- \* \$1.02 million on single family speculative construction loans
- \* \$250,000 on one commercial business loan
- \* \$174,000 on loans secured by land
- \* \$100,000 on home equity loans
- \* \$41,000 on a single family home loan
- \* \$13,000 on other consumer loans.

OREO and other repossessed assets totaled \$7.70 million at June 30, 2009 and consisted of 27 individual properties representing 11 relationships. The properties consisted of 17 single family homes totaling \$4.77 million, one land development project with a balance of \$2.26 million and nine land loans totaling \$665,000.

For additional information, see Note 5 of the Notes to Condensed Consolidated Financial Statements contained in "Item 1, Financial Statements."

### Deposit Breakdown

The following table sets forth the composition of the Bank's deposit balances.

|  | At<br>June 30, 2009 | At<br>September 30, 2008 |
|--|---------------------|--------------------------|
|  | -----               | -----                    |
|  | (In thousands)      |                          |
| Non-interest bearing                   | \$ 50,153           | \$ 51,955                |
| N.O.W. checking                        | 102,186             | 90,468                   |
| Savings                                | 56,303              | 56,391                   |
| Money market accounts                  | 61,992              | 70,379                   |
| Certificates of deposit under \$100    | 140,924             | 130,313                  |
| Certificates of deposit \$100 and over | 75,861              | 73,107                   |
| Certificates of deposit - brokered     | - -                 | 25,959                   |
|  | -----               | -----                    |
| Total deposits                         | \$487,419           | \$498,572                |

### FHLB Advance Maturity Schedule

The Bank has short- and long-term borrowing lines with the FHLB of Seattle with total credit on the lines equal to 30% of the Bank's total assets, limited by available collateral. Borrowings are considered short-term when the original maturity is less than one year. FHLB advances consisted of the following:

|                     | At June 30,<br>2009    |         | At September 30,<br>2008 |         |
|---------------------|------------------------|---------|--------------------------|---------|
|                     | Amount                 | Percent | Amount                   | Percent |
|                     | -----                  | -----   | -----                    | -----   |
|                     | (Dollars in thousands) |         |                          |         |
| Short-term          | \$ - -                 | --%     | \$ - -                   | --%     |
| Long-term           | 95,000                 | 100.0   | 104,628                  | 100.0   |
|                     | -----                  | -----   | -----                    | -----   |
| Total FHLB advances | \$95,000               | 100.0%  | \$104,628                | 100.0%  |
|                     | =====                  | =====   | =====                    | =====   |

The Bank's FHLB borrowings mature at various dates through September 2017 and bear interest at rates ranging from 3.49% to 4.66%. The weighted average interest rate on FHLB borrowings at June 30, 2009 was 4.11%. Principal reduction amounts due for future years ending September 30 are as follows (in thousands):

|                   |          |
|-------------------|----------|
| Remainder of 2009 | \$ - -   |
| 2010              | 20,000   |
| 2011              | 20,000   |
| 2012              | 10,000   |
| 2013              | - -      |
| Thereafter        | 45,000   |
|                   | -----    |
| Total             | \$95,000 |
|                   | =====    |

A portion of these advances have a puttable feature and may be called by the FHLB earlier than the above schedule indicates.

#### Comparison of Operating Results for the Three and Nine Months Ended June 30, 2009 and 2008

The Company reported net income of \$1.06 million for the quarter ended June 30, 2009 compared to a net loss of \$(546,000) for the quarter ended June 30, 2008. Diluted earnings per common share increased to \$0.12 for the quarter ended June 30, 2009 from a loss of \$(0.08) for the quarter ended June 30, 2008. The increase in net income and earnings per diluted common share was primarily attributable to a \$3.57 million increase in non-interest income for the quarter ended June 30, 2009 as non-interest income for the quarter ended June 30, 2008 was reduced by a \$2.82 million loss on the redemption of mutual funds. Partially offsetting the increased non-interest income for the current quarter was a \$1.45 million increase in non-interest expense, a \$500,000 increase in provision for loan losses and a \$308,000 decrease in net interest income.

The Company reported net income of \$27,000 for the nine months ended June 30, 2009 compared to net income of \$2.66 million for the nine months ended June 30, 2008. However, income available to common shareholders after adjusting for the preferred stock dividend and the preferred stock discount accretion was a loss of \$(489,000) for the nine months ended June 30, 2009. Diluted earnings per common share decreased to a loss of \$(0.07) for the nine months ended June 30, 2009 from earnings of \$0.40 for the nine months ended June 30, 2008. The decrease in net income and earnings per diluted common share was primarily a result of a \$5.09 million increase in the provision for loan losses, a \$2.38 million increase in non-interest expense, a \$2.29 million OTTI charge on investment securities and a \$1.02 million decrease in net interest income. These items were partially offset by a \$2.80 million increase in non-interest income (excluding OTTI charges and loss on redemption of mutual funds).

A more detailed explanation of the income statement categories is presented below.

Net Income: Earnings for the quarter ended June 30, 2009 increased by \$1.60 million, or 293.8%, to \$1.06 million from a net loss of \$(546,000) for the quarter ended June 30, 2008. Earnings available to common shareholders for

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the quarter ended June 30, 2009, adjusted for preferred stock dividends of \$210,000 and preferred stock discount accretion of \$79,000 was \$769,000. Earnings per diluted common share increased to \$0.12 for the quarter ended June 30, 2009 from a net loss of \$(0.08) for the quarter ended June 30, 2008. The \$0.20 increase in diluted earnings per common share was primarily a result of a \$2.82 million (\$2.59 million net of income tax - \$0.40 per diluted common share) decrease in loss on redemption of mutual funds and an \$870,000 (\$574,000 net of income tax - \$0.09 per diluted common share) increase in non-interest income (excluding OTTI charges and loss on redemption of mutual funds). These increases to earnings per diluted common share were partially offset by a \$1.45 million (\$960,000 net of income tax - \$0.15 per diluted common share) increase non-interest expense, a \$500,000 (\$330,000 net of income tax - \$0.05 per diluted common share)

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increase in the provision for loan losses, a \$449,000 (\$296,000 net of income tax - \$0.04 per diluted common share) decrease in net interest income, a \$125,000 (\$83,000 net of income tax - \$0.01 per diluted common share) increase in OTTI charges and a \$289,000 (\$0.04 per diluted common share) increase in preferred stock dividends and preferred stock discount accretion.

Earnings for the nine months ended June 30, 2009 decreased by \$2.63 million, or 99.0%, to net income of \$27,000 from net income of \$2.66 million for the nine months ended June 30, 2008. Earnings available to common shareholders for the nine months ended June 30, 2009, adjusted for preferred stock dividends of \$437,000 and preferred stock discount accretion of \$79,000 was a net loss or \$(489,000). Earnings per diluted common share decreased to a loss of \$(0.07) for the nine months ended June 30, 2009 from earnings of \$0.40 for the nine months ended June 30, 2008. The \$0.47 decrease in diluted earnings per common share was primarily a result of a \$5.09 million (\$3.36 million net of income tax - \$0.51 per diluted common share) increase in the provision for loan losses, a \$2.29 million (\$1.51 million net of income tax - \$0.23 per diluted common share) increase in OTTI charges, a \$2.38 million (\$1.57 million net of income tax - \$0.24 per diluted common share) increase in non-interest expense, a \$1.02 million (\$671,000 net of income tax - \$0.10 per diluted common share) decrease in net interest income, and a \$516,000 (\$0.07 per diluted common share) increase in preferred stock dividends and preferred stock discount accretion. These decreases to earnings per diluted common share were partially offset by a \$2.82 million (\$2.59 million net of income tax - \$0.40 per diluted common share) decrease in loss on redemption of mutual funds and a \$2.80 million (\$1.85 million net of income tax - \$0.28 per diluted common share) increase in non-interest income (excluding OTTI charges and loss on redemption of mutual funds).

Net Interest Income: Net interest income decreased by \$308,000, or 4.7%, to \$6.19 million for the quarter ended June 30, 2009 from \$6.50 million for the quarter ended June 30, 2008. The decrease in net interest income was primarily attributable to an increase in non-accrual loans and lower overall market interest rates.

Total interest and dividend income decreased by \$757,000, or 7.3%, to \$9.61 million for the quarter ended June 30, 2009 from \$10.37 million for the quarter ended June 30, 2008 as the yield on interest earning assets decreased to 5.99% from 6.75%. Total average interest earning assets increased by \$27.09 million to \$641.47 million for the quarter ended June 30, 2009 from \$614.38 million for quarter ended June 30, 2008. Total interest expense decreased by \$449,000, or 11.6%, to \$3.42 million for the quarter ended June

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30, 2009 from \$3.87 million for the quarter ended June 30, 2008 as the average rate paid on interest bearing liabilities decreased to 2.51% for the quarter ended June 30, 2009 from 2.96% for the quarter ended June 30, 2008. Total average interest bearing liabilities increased by \$20.19 million to \$546.59 million for the quarter ended June 30, 2009 from \$526.40 million for the quarter ended June 30, 2008. The net interest margin decreased to 3.86% for the quarter ended June 30, 2009 from 4.23% for the quarter ended June 30, 2008. The margin compression was primarily attributable to the reversal of interest income on loans placed on non-accrual status during the quarter ended June 30, 2009 and lower overall market interest rates. The reversal of interest income on loans placed on non-accrual status during the quarter ended June 30, 2009 reduced the net interest margin by approximately 22 basis points.

Net interest income decreased by \$1.02 million or 5.1%, to \$19.07 million for the nine months ended June 30, 2009 from \$20.09 million for the nine months ended June 30, 2008. The decrease in net interest income was primarily attributable to overall market interest rate decreases, which compressed margins, and the reversal of interest on loans placed on non-accrual status. These decreases were, however, partially offset by a larger interest earning asset base.

Total interest and dividend income decreased by \$3.33 million, or 10.2%, to \$29.44 million for the nine months ended June 30, 2009 from \$32.77 million for the nine months ended June 30, 2008 as the yield on interest earning assets decreased to 6.23% from 7.21%. Total average interest earning assets increased by \$24.47 million to \$630.42 million for the nine months ended June 30, 2009 from \$605.95 million for nine months

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ended June 30, 2008. Total interest expense decreased by \$2.32 million, or 18.3%, to \$10.36 million for the nine months ended June 30, 2009 from \$12.68 million for the nine months ended June 30, 2008 as the average rate paid on interest bearing liabilities decreased to 2.58% for the nine months ended June 30, 2009 from 3.24% for the nine months ended June 30, 2008. Total average interest bearing liabilities increased by \$14.02 million to \$536.72 million for the nine months ended June 30, 2009 from \$522.70 million for the nine months ended June 30, 2008. The net interest margin decreased to 4.03% for the nine months ended June 30, 2009 from 4.42% for the nine months ended June 30, 2008. The margin compression was primarily attributable to interest rate decreases by the Federal Reserve which reduced the yield on interest earning assets at a faster pace than the Bank was able to reduce its funding costs. The reversal of interest income on loans placed on non-accrual status also contributed to the margin compression and reduced the net interest margin by approximately 17 basis points during the nine months ended June 30, 2009. For additional information, see the section below entitled "Rate Volume Analysis."

### Rate Volume Analysis

The following table sets forth the effects of changing rates and volumes on the net interest income on the Company. Information is provided with respect to the (i) effects on interest income attributable to change in volume (changes in volume multiplied by prior rate), and (ii) effects on interest income attributable to changes in rate (changes in rate multiplied by prior volume), and (iii) the net change (sum of the prior columns). Changes in rate/volume have been allocated to rate and volume variances based on the absolute values of each.



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|   | Three months ended<br>June 30, 2009<br>compared to three months<br>ended June 30, 2008<br>increase (decrease)<br>due to |        |            | Nine months ended<br>June 30, 2009<br>compared to nine months<br>ended June 30, 2008<br>increase (decrease)<br>due to |         |            |
|---|---|--------|------------|---|---------|------------|
|   | Rate  | Volume | Net Change | Rate  | Volume  | Net Change |
|   | -----   | -----  | -----      | -----   | -----   | -----      |
|   | (In thousands)  |        |            |   |         |            |
| Interest-earning assets:  |   |        |            |   |         |            |
| Loans receivable (1)  | \$(613)   | \$ 28  | \$(585)    | \$(2,647)   | \$ (72) | \$(2,719)  |
| Investments and<br>mortgage-backed<br>securities                                  | (107)   | 194    | 87         | 9   | 448     | 457        |
| FHLB stock and<br>equity securities   | (132)   | (131)  | (263)      | (541)   | (520)   | (1,061)    |
| Federal funds sold  | (40)  | 20     | (20)       | (50)  | (1)     | (51)       |
| Interest-bearing<br>deposits  | (11)  | 35     | 24         | (10)  | 50      | 40         |
|   | -----   | -----  | -----      | -----   | -----   | -----      |
| Total net increase<br>(decrease) in income<br>on interest-earning<br>assets       | (903)   | 146    | (757)      | (3,239)   | (95)    | (3,334)    |
|   | -----   | -----  | -----      | -----   | -----   | -----      |
| Interest-bearing<br>liabilities:  |   |        |            |   |         |            |
| Savings accounts  | --  | (4)    | (4)        | --  | (5)     | (5)        |
| NOW accounts  | 49  | 25     | 74         | 62  | 63      | 125        |
| Money market<br>Accounts  | (43)  | 60     | 17         | (110)   | 52      | (58)       |
| Certificate accounts  | (482)   | 132    | (350)      | (1,854)   | (39)    | (1,893)    |
| Short-term borrowings   | (31)  | (30)   | (61)       | (304)   | (303)   | (607)      |
| Long-term borrowings  | (66)  | (59)   | (125)      | (3)   | 124     | 121        |
|   | -----   | -----  | -----      | -----   | -----   | -----      |
| Total net increase<br>(decrease) in expense<br>on interest-bearing<br>liabilities | (573)   | 124    | (449)      | (2,209)   | (108)   | (2,317)    |
|   | -----   | -----  | -----      | -----   | -----   | -----      |
| Net increase (decrease)<br>in net interest<br>income                              | \$(330)   | \$ 22  | \$(308)    | \$(1,030)   | \$ 13   | \$(1,017)  |
|   | =====   | =====  | =====      | =====   | =====   | =====      |

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(1) Excludes interest on loans 90 days or more past due. Includes loans originated for sale.

Provision for Loan Losses: The provision for loan losses increased \$500,000, or 100.0%, to \$1.00 million for the quarter ended June 30, 2009 from \$500,000 for the quarter ended June 30, 2008. The provision for loan losses increased \$5.09 million, or 212.1%, to \$7.49 million for the nine months ended June 30, 2009 from \$2.40 million for the nine months ended June 30, 2008. The increased provisions for the three and nine months ended June 30, 2009 were made primarily as a result of an increase in the level of net charge-offs, an increase in the level of potential principal impairment on non-performing

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loans, an increase in the level of loans classified as substandard and uncertainties in the housing market in certain market areas of the Pacific Northwest.

The Bank has established a comprehensive methodology for determining the provision for loan losses. On a quarterly basis the Bank performs an analysis that considers pertinent factors underlying the quality of the loan portfolio. The factors include changes in the amount and composition of the loan portfolio, historic loss experience for various loan segments, changes in economic conditions, delinquency rates, a detailed analysis of impaired loans, and other factors to determine an appropriate level of allowance for loan losses. Management's analysis, however, for the three and nine months ended June 30, 2009, placed greater emphasis on the Bank's construction and land development loan portfolio and the effect of various factors such as geographic and loan type concentrations. The Bank also reviewed the national trend of declining home sales with potential housing market value depreciation. Based on its comprehensive analysis, management deemed the allowance for loan losses of \$12.44 million at June 30, 2009 (2.23% of loans receivable and 50% of non-performing loans) adequate to provide for probable losses based on an evaluation of known and inherent risks in the loan portfolio at that date. Impaired loans are subjected to an impairment analysis to determine an appropriate reserve amount to be held against each loan. The aggregate impairment amount determined at June 30, 2009 was \$2.39 million. The allowance for loan losses was \$7.08 million (1.26% of loans receivable and 75% of non-performing loans) at June 30, 2008. The Company had net charge-offs of \$2.98 million during the nine months ended June 30, 2009 and net charge-offs of \$121,000 for the nine months ended June 30, 2008.

Non-accrual and 90 day past due loans increased by \$13.95 million to \$25.94 million at June 30, 2009 from \$11.99 million at September 30, 2008. Non-accrual loans were comprised of 46 loans and 38 credit relationships. Management's evaluation of these 46 loans determined that there was potential principal impairment of \$2.39 million on these loans. For additional information, see the section entitled "Non-performing Assets" included herein.

Management believes that the allowance for loan losses as of June 30, 2009 was adequate to absorb the known and inherent risks of loss in the loan portfolio at that date. While management believes the estimates and assumptions used in its determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact the Company's financial condition and results of operations. In addition, the determination of the amount of the Bank's allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the establishment of additional reserves based upon their analysis of information available to them at the time of their examination. For

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additional information, see Note 5 of the Notes to Condensed Consolidated Financial Statements contained in "Item 1, Financial Statements."

Non-interest Income: Total non-interest income increased by \$3.57 million, or 399.4%, to \$2.67 million for the quarter ended June 30, 2009 from a loss of \$(893,000) for the quarter ended June 30, 2008. Excluding the \$125,000 OTTI charge recorded in the quarter ended June 30, 2009 and the \$2.82 million loss

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on redemption of mutual funds during the quarter ended June 30, 2008, non-interest income increased by \$870,000, or 45.1% to \$2.80 million for the quarter ended June 30, 2009 from \$1.93 million for the quarter ended June 30, 2008. This increase was primarily a result of a \$827,000 increase in gain on sale of loans and a \$118,000 increase in service charges on deposit accounts. The increased income from loan sales was primarily a result of an increase in the dollar value of residential mortgage loans sold in the secondary market during the quarter ended June 30, 2009. The sale of fixed rate one-to four-family mortgage loans totaled \$69.62 million for the quarter ended June 30, 2009 compared to \$16.02 million for the quarter ended June 30, 2008. The increase in loan sales was primarily attributable to lower interest rates for 30-year fixed rates loans which increased refinancing activity. The increase in service charge income was primarily a result of implementing an automated overdraft decision-making program in May 2008 and increasing the fees charged for overdrafts. These increases to non-interest income were partially offset by a \$169,000 valuation allowance on MSRs recorded during the quarter ended June 30, 2009. The valuation allowance adjusted the recorded value of MSRs to the current market value as determined by a third party valuation company.

Total non-interest income increased by \$3.33 million, or 154.3%, to \$5.49 million for the nine months ended June 30, 2009 from \$2.16 million for the nine months ended June 30, 2008. Excluding the \$2.29 million OTTI charge recorded in the nine months ended June 30, 2009 and the \$2.28 million loss on redemption of mutual funds during the nine months ended June 30, 2008, non-interest income increased by \$2.80 million, or 56.2% to \$7.78 million for the nine months ended June 30, 2009 from \$4.98 million for the nine months ended June 30, 2008. This increase was primarily a result of a \$1.64 million increase in gain on sale of loans, a \$932,000 increase in service charges on deposit accounts and a \$141,000 increase in BOLI net earnings. The increased income from loan sales was primarily a result of an increase in the dollar value of residential mortgage loans sold in the secondary market during the nine months ended June 30, 2009. The sale of fixed rate one-to four-family mortgage loans totaled \$140.88 million for the nine months ended June 30, 2009 compared to \$35.31 million for the nine months ended June 30, 2008. The increase in loan sales was primarily attributable to lower interest rates for 30-year fixed rates loans which increased refinancing activity. The increase in service charge income was primarily a result of implementing an automated overdraft decision-making program in May 2008 and increasing the fees charged for overdrafts. The increase in BOLI income was attributable to a \$134,000 non-recurring gain associated with transferring a portion of the BOLI portfolio to a new insurance company in March 2009. These increases to non-interest income were partially offset by a \$169,000 valuation allowance on MSRs recorded during the nine months ended June 30, 2009. The valuation allowance adjusted the recorded value of MSRs to the current market value as determined by a third party valuation company.

**Non-interest Expense:** Total non-interest expense increased by \$1.45 million, or 29.6%, to \$6.37 million for the quarter ended June 30, 2009 from \$4.92 million for the quarter ended June 30, 2008. The increase was primarily attributable to a \$375,000 increase in FDIC insurance expense (including a special FDIC assessment of \$300,000), a \$391,000 increase in OREO related expenses, a \$200,000 increase in premises and equipment expenses, a \$128,000 increase in loan monitoring and foreclosure related expenses (which are included in the other non-interest expense category), and a \$107,000 increase in salaries and employee benefits.

Total non-interest expense increased by \$2.38 million, or 15.9%, to \$17.35 million for the nine months ended June 30, 2009 from \$14.98 million for the nine months ended June 30, 2008. The increase was primarily attributable to a \$552,000 increase in OREO related expenses, a \$535,000 increase in FDIC insurance expense (including a \$300,000 special FDIC assessment), a \$445,000

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increase in premises and equipment expenses, a

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\$252,000 increase in deposit related expenses (which are included in the other non-interest expense category) and a \$210,000 increase in loan monitoring and foreclosure related expenses (which are included in the other non-interest expense category). The increases in OREO related expenses and foreclosure expenses were primarily a result of increased OREO properties held and an increase in foreclosure activity. The increase reflected in premises and equipment expenses was primarily a result of an insurance settlement received in December 2007 and the sale of a building in March 2008 that reduced expenses for the nine months ended June 30, 2008 by a combined \$295,000. Also contributing to the increase in premises and equipment expenses was the opening in May 2009 of a full service branch facility in Lewis County.

Provision (Benefit) for Income Taxes: The provision for income taxes decreased by \$299,000 to \$435,000 for the quarter ended June 30, 2009 from \$734,000 for the quarter ended June 30, 2008. The provision for income taxes for the quarter ended June 30, 2008 was impacted by the \$2.82 million loss on the redemption of mutual funds. The redemption of the mutual funds resulted in a capital loss which can only be deducted for tax purposes to the extent that capital gains are realized within a three year carry back period and a five year carry forward period. The Company estimated that it would have \$679,000 in capital gains during the allowable tax periods to offset the capital loss. Therefore, \$2.14 million of the \$2.82 million loss has been treated as non-deductible for tax purposes. The Company's effective tax rate was 29.1% for the quarter ended June 30, 2009 and 32.1% exclusive of the mutual fund redemption loss and associated tax benefit for the quarter ended June 30, 2008. The decrease in the effective tax rate was primarily attributable to an increased percentage of income before taxes that was non-taxable and an increase in tax credit items.

The provision (benefit) for income taxes decreased by \$2.52 million to a net benefit of \$305,000 for the nine months ended June 30, 2009 from a provision of \$2.22 million for the nine months ended June 30, 2008. The decrease was primarily a result of decreased earnings before taxes. For additional information, see Note 10 of the Notes to Condensed Consolidated Financial Statements contained in "Item 1, Financial Statements."

### Liquidity

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The Company's primary sources of funds are customer deposits, brokered deposits, proceeds from principal and interest payments on loans and mortgage-backed securities, proceeds from the sale of loans, proceeds from maturing securities, FHLB advances, and other borrowings. While maturities and the scheduled amortization of loans are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition.

An analysis of liquidity should include a review of the Condensed Consolidated Statement of Cash Flows for the nine months ended June 30, 2009. The condensed consolidated statement of cash flows includes operating, investing and financing categories. Operating activities include net income, which is adjusted for non-cash items, and increases or decreases in cash due to changes in assets and liabilities. Investing activities consist primarily of proceeds from maturities and sales of securities, purchases of securities, and the net change in loans. Financing activities present the cash flows associated with

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the Company's deposit accounts, other borrowings and stock related transactions.

The Company's total cash equivalents increased by \$1.1 million, or 2.6% to \$43.97 million at June 30, 2009 from \$42.87 million at September 30, 2008. The increase in liquid assets was primarily reflected in an increase in interest bearing deposits which was partially offset by a decrease in cash and due from financial institutions and federal funds sold.

The Bank must maintain an adequate level of liquidity to ensure the availability of sufficient funds for loan originations and deposit withdrawals, to satisfy other financial commitments and to take advantage of investment opportunities. The Bank generally maintains sufficient cash and short-term investments to meet short-term liquidity needs. At June 30, 2009, the Bank's regulatory liquidity ratio (net cash, and short-term and marketable assets, as a percentage of net deposits and short-term liabilities) was 8.12%. The Bank maintained

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an uncommitted credit facility with the FHLB of Seattle that provided for immediately available advances up to an aggregate amount equal to 30% of total assets, limited by available collateral, under which \$95.00 million was outstanding and \$83.10 million was available for additional borrowings at June 30, 2009. The Bank also has a \$10.00 million overnight credit line with Pacific Coast Bankers' Bank ("PCBB"). At June 30, 2009, the Bank did not have any outstanding advances on this credit line.

The Bank has also elected to participate in the FDIC's Temporary Liquidity Guaranty Program ("TLGP"). The TLGP includes the Debt Guarantee Program ("DGP") under which the FDIC guarantees certain senior unsecured debt of FDIC-insured institutions. The unsecured debt must be issued on or after October 14, 2008 and not later than October 31, 2009, and the guarantee is effective through the earlier of the maturity date or December 31, 2012. The DGP coverage limit is equal to 2% of the Bank's liabilities at September 30, 2008. At June 30, 2009, the Bank did not have any senior unsecured debt which was being guaranteed under the DGP.

Liquidity management is both a short and long-term responsibility of the Bank's management. The Bank adjusts its investments in liquid assets based upon management's assessment of (i) expected loan demand, (ii) projected loan sales, (iii) expected deposit flows, and (iv) yields available on interest-bearing deposits. Excess liquidity is invested generally in interest-bearing overnight deposits, federal funds sold, and other short-term investments. If the Bank requires funds that exceed its ability to generate them internally, it has additional borrowing capacity with the FHLB of Seattle and PCBB.

The Bank's primary investing activity is the origination of one- to four-family mortgage loans, commercial mortgage loans, construction loans, land loans, consumer loans, and commercial business loans. At June 30, 2009, the Bank had loan commitments totaling \$54.03 million and undisbursed loans in process totaling \$29.45 million. The Bank anticipates that it will have sufficient funds available to meet current loan commitments. Certificates of deposit that are scheduled to mature in less than one year from June 30, 2009 totaled \$180.03 million. Historically, the Bank has been able to retain a significant amount of its non-brokered certificates of deposit as they mature. At June 30, 2009, the Bank had no brokered certificate of deposit accounts.

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Capital Resources

Federally-insured state-chartered banks are required to maintain minimum levels of regulatory capital. Under current FDIC regulations, insured state-chartered banks generally must maintain (i) a ratio of Tier 1 leverage capital to total assets of at least 3.0% (4.0% to 5.0% for all but the most highly rated banks), (ii) a ratio of Tier 1 capital to risk weighted assets of at least 4.0% and (iii) a ratio of total capital to risk weighted assets of at least 8.0%. At June 30, 2009, the Bank was in compliance with all applicable capital requirements.

The following table compares the Company's and the Bank's actual capital amounts at June 30, 2009 to its minimum regulatory capital requirements at that date (dollars in thousands):

|  | Actual<br>Amount | Ratio  | Capital<br>Adequacy<br>Purposes<br>Amount | Ratio | To Be Well<br>Capitalized<br>Under Prompt<br>Corrective Action<br>Provisions<br>Amount | Ratio |
|--|------------------|--------|---|-------|--|-------|
| Tier 1 capital<br>(to average assets):       |                  |        |   |       |  |       |
| Consolidated                                 | \$83,923         | 12.30% | \$27,294                                  | 4.00% | N/A  | N/A   |
| Timberland Bank                              | 68,301           | 10.17  | 26,869                                    | 4.00  | \$33,587   | 5.00% |
| Tier 1 capital (to<br>risk-weighted assets): |                  |        |   |       |  |       |
| Consolidated                                 | 83,923           | 14.94  | 22,476                                    | 4.00  | N/A  | N/A   |
| Timberland Bank                              | 68,301           | 12.21  | 22,368                                    | 4.00  | 33,552   | 6.00  |
| Total capital (to<br>risk-weighted assets):  |                  |        |   |       |  |       |
| Consolidated                                 | 91,014           | 16.20  | 44,951                                    | 8.00  | N/A  | N/A   |
| Timberland Bank                              | 75,358           | 13.46  | 44,736                                    | 8.00  | 55,920   | 10.00 |

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TIMBERLAND BANCORP, INC. AND SUBSIDIARIES  
KEY FINANCIAL RATIOS AND DATA

(Dollars in thousands, except per share data)

|                                     | Three Months Ended<br>June 30, |               | Nine Months Ended<br>June 30, |          |
|-------------------------------------|--------------------------------|---------------|-------------------------------|----------|
|                                     | 2009                           | 2008          | 2009                          | 2008     |
| PERFORMANCE RATIOS:                 |                                |               |                               |          |
| Return (loss) on average assets (1) | 0.61%                          | (0.33%)       | 0.01%                         | 0.54%    |
| Return (loss) on average equity (1) | 4.79%                          | (2.91%)       | 0.04%                         | 4.73%    |
| Net interest margin (1)             | 3.86%                          | 4.23%         | 4.03%                         | 4.42%    |
| Efficiency ratio (2)                | 71.88%                         | 87.73%        | 70.64%                        | 67.31%   |
|                                     | At                             | At            | At                            | At       |
|                                     | June 30,                       | September 30, | June 30,                      | June 30, |

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|   | 2009     | 2008     | 2008     |
|---|----------|----------|----------|
| ASSET QUALITY RATIOS:                             |          |          |          |
| Non-performing loans                              | \$25,113 | \$11,990 | \$ 9,391 |
| Non-performing investment securities              | 175      | - -      | - -      |
| OREO & other repossessed assets                   | 7,698    | 511      | 879      |
| Total non-performing assets                       | \$32,986 | \$12,501 | \$10,270 |
| Non-performing assets to total assets (3)         | 4.88%    | 1.83%    | 1.55%    |
| Allowance for loan losses to non-performing loans | 50%      | 67%      | 75%      |
| Restructured loans                                | \$ - -   | \$ 272   | \$ - -   |
| Past due 90 days and still accruing               | \$ 830   | \$ - -   | \$ - -   |
| Book Values:                                      |          |          |          |
| Book value per share (4)                          | \$ 10.39 | \$ 10.74 | \$ 10.83 |
| Book value per share (5)                          | \$ 10.76 | \$ 11.34 | \$ 11.46 |
| Tangible book value per share (4) (5)             | \$ 9.33  | \$ 9.79  | \$ 9.87  |
| Tangible book value per share (5) (6)             | \$ 9.80  | \$ 10.34 | \$ 10.44 |

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- (1) Annualized
  - (2) Calculation includes the OTTI charge incurred during the period ended June 30, 2009. Excluding OTTI charges the efficiency ratio was 70.88% for three months ended June 30, 2009 and 64.62% for the nine months ended June 30, 2009.
  - (3) Non-performing assets include non-accrual loans, non-accrual investment securities, other real estate owned and other repossessed assets
  - (4) Calculation includes ESOP shares not committed to be released
  - (5) Calculation excludes ESOP shares not committed to be released
  - (6) Calculation subtracts goodwill and core deposit intangible from the equity component

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|   | Three Months Ended<br>June 30, |           | Nine Months Ended<br>June 30, |           |
|---|--------------------------------|-----------|-------------------------------|-----------|
|   | 2009                           | 2008      | 2009                          | 2008      |
| AVERAGE BALANCE SHEET:                    |                                |           |                               |           |
| Average total loans                       | \$562,105                      | \$560,515 | \$565,274                     | \$548,346 |
| Average total interest earning assets (1) | 641,468                        | 614,383   | 630,421                       | 605,949   |
| Average total assets                      | 688,411                        | 659,998   | 676,809                       | 652,804   |
| Average total interest bearing deposits   | 450,974                        | 415,495   | 438,762                       | 412,904   |
| Average FHLB advances & other borrowings  | 95,612                         | 110,903   | 97,954                        | 109,794   |
| Average shareholders' equity              | 88,433                         | 74,956    | 85,445                        | 74,901    |

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- (1) Includes loans on non-accrual status

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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There were no material changes in information concerning market risk from the

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information provided in the Company's Form 10-K for the fiscal year ended September 30, 2008.

### Item 4. Controls and Procedures

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- (a) **Evaluation of Disclosure Controls and Procedures:** An evaluation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act")) was carried out under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and several other members of the Company's senior management as of the end of the period covered by this report. The Company's Chief Executive Officer and Chief Financial Officer concluded that as of June 30, 2009 the Company's disclosure controls and procedures were effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is (i) accumulated and communicated to the Company's management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.
- (b) **Changes in Internal Controls:** There have been no changes in our internal control over financial reporting (as defined in 13a-15(f) of the Exchange Act) that occurred during the quarter ended June 30, 2009, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. The Company continued, however, to implement suggestions from its internal auditor and independent auditors to strengthen existing controls. The Company does not expect that its disclosure controls and procedures and internal controls over financial reporting will prevent all errors and fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns in controls or procedures can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any control procedure is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; as over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

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## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

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Neither the Company nor the Bank is a party to any material legal proceedings at this time. Further, neither the Company nor the Bank is aware of the threat of any such proceedings. From time to time, the Bank is involved in various claims and legal actions arising in the ordinary course of business.

### Item 1A. Risk Factors

Listed below are updates to the risk factors provided in the Company's Annual Report of Form 10-K for the fiscal year ended September 30, 2008 ("2008 Form 10-K"). These updates should be read in conjunction with the 2008 Form 10-K.

Downturns in the real estate markets in our primary market areas could hurt our business and require increased levels of allowance for loan losses.

Our business activities and credit exposures are primarily concentrated in our local market areas of Grays Harbor, Pierce, Thurston, King, Kitsap and Lewis Counties. Our residential loan portfolio, and our commercial real estate and multi-family loan portfolio and a certain number of our other loans have been affected by the downturn in the residential real estate market. Further declines in the real estate markets in our primary market areas may negatively impact our business. As of June 30, 2009, substantially all of our loan portfolio consisted of loans secured by real estate located in Washington. If real estate values continue to decline, the collateral for our loans will provide less security. As a result, our ability to recover on defaulted loans by selling the underlying real estate may be diminished, and we would be more likely to suffer losses on defaulted loans. Therefore if real estate values continue to decline and as updated appraisals are received, the Bank may have to increase its allowance for loan losses. The events and conditions described in this risk factor could therefore have a material adverse effect on our business, results of operations and financial condition.

Our provision for loan losses have increased significantly and we may be required to make further increases in our provision for loan losses and to charge off additional loans in the future, which could adversely affect our results of operations.

For the quarter and nine months ended June 30, 2009 we recorded a provision for loan losses of \$1.00 million and \$7.49 million, respectively, compared to \$500,000 and \$2.40 million for the comparable periods of fiscal 2008, respectively. We also recorded net loan charge-offs of \$609,000 and \$2.98 million for the quarter and nine months ended June 30, 2009, respectively, compared to \$121,000 for each of the comparable periods in fiscal 2008, respectively. We are experiencing increased loan delinquencies and credit losses this fiscal year. At June 30, 2009 our total non-performing assets had increased to \$32.99 million from \$12.50 million at September 30, 2008. Further, our portfolio is concentrated in construction and land loans and commercial real estate loans, most of which have a higher risk of loss than residential mortgage loans. If current trends in the housing and real estate markets continue, we expect that we will continue to experience higher than normal delinquencies and credit losses. Moreover, if a prolonged recession occurs we expect that it could severely impact economic conditions in our market areas and that we could experience significantly higher delinquencies and credit losses. As a result, we may be required to make further increases in our provision for loan losses and to charge off additional loans in the future, which could adversely affect our financial condition and results of operations, perhaps materially.

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If our allowance for loan losses is not sufficient to cover actual loan losses, our earnings could be reduced.

We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we review our loans and our loss and delinquency experience, and evaluate economic conditions. If our assumptions are incorrect, our allowance for loan losses may not be sufficient to cover actual losses, resulting in additions to our allowance. Material additions to our allowance could materially decrease our net income. Our allowance for loan losses was 2.23% of total loans, and 50% of non-performing loans at June 30, 2009. In addition, bank regulators periodically review our allowance for loan losses and may require us to increase our provision for loan losses or recognize additional loan charge-offs. Any increase in our allowance for loan losses or loan charge-offs as required by these regulatory authorities could have a material adverse effect on our financial condition and results of operations.

The securities purchase agreement between us and Treasury limits our ability to pay dividends on and repurchase our common stock.

The securities purchase agreement between us and Treasury provides that prior to the earlier of (i) December 23, 2011 and (ii) the date on which all of the shares of the Series A Preferred Stock have been redeemed by us or transferred by Treasury to third parties, we may not, without the consent of Treasury, (a) increase the cash dividend on our common stock or (b) subject to limited exceptions, redeem, repurchase or otherwise acquire shares of our common stock or preferred stock (other than the Series A Preferred Stock) or trust preferred securities. In addition, we are unable to pay any dividends on our common stock unless we are current in our dividend payments on the Series A Preferred Stock. These restrictions, together with the potentially dilutive impact of the warrant described in the next risk factor, could have a negative effect on the value of our common stock. Moreover, holders of our common stock are entitled to receive dividends only when, and if declared by our Board of Directors. Although we have historically paid cash dividends on our common stock, we are not required to do so and our Board of Directors could reduce or eliminate our common stock dividend in the future.

The Series A Preferred Stock impacts net income available to our common shareholders and earnings per common share, and the warrant we issued to Treasury may be dilutive to holders of our common stock.

The dividends declared on the Series A Preferred Stock will reduce the net income available to common shareholders and our earnings per common share. The Series A Preferred Stock will also receive preferential treatment in the event of liquidation, dissolution or winding up of Timberland Bancorp. Additionally, the ownership interest of the existing holders of our common stock will be diluted to the extent the warrant we issued to Treasury in conjunction with the sale to Treasury of the Series A Preferred Stock is exercised. The shares of common stock underlying the warrant represent approximately 5.0% of the shares of our common stock outstanding as of April 30, 2009 (including the shares issuable upon exercise of the warrant in total shares outstanding). Although Treasury has agreed not to vote any of the shares of common stock it receives upon exercise of the warrant, a transferee of any portion of the warrant or of any shares of common stock acquired upon exercise of the warrant is not bound by this restriction.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

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Not applicable

## Stock Repurchases

The following table sets forth the shares repurchased by the Company during the three months ended June 30, 2009:

| Period                     | Total<br>No. of<br>Shares<br>Purchased | Average<br>Price Paid<br>per Share | Total No.<br>of Shares<br>Purchased as<br>Part of<br>Publicly<br>Announced<br>Plan | Maximum No.<br>of Shares that<br>May Yet Be<br>Purchased Under<br>the Plan(1) |
|----------------------------|--|------------------------------------|--|---|
| 04/01/2009 -<br>04/30/2009 | - -                                    | - -                                | - -  | 343,468   |
| 05/01/2009 -<br>05/31/2009 | - -                                    | - -                                | - -  | 343,468   |
| 06/01/2009 -<br>06/30/2009 | - -                                    | - -                                | - -  | 343,468   |
| Total                      | - -                                    | \$ - -                             | - -  | 343,468   |

(1) On February 25, 2008, the Company announced a share repurchase plan authorizing the repurchase of up to 5% of its outstanding shares, or 343,468 shares. As of June 30, 2009 no shares under this plan had been repurchased. As part of the Company's participation in the Treasury's Capital Purchase Program this share repurchase program was suspended indefinitely.

## Item 3. Defaults Upon Senior Securities

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None to be reported.

## Item 4. Submission of Matters to a Vote of Security Holders

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None to be reported

## Item 5. Other Information

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None to be reported.

## Item 6. Exhibits

- (a) Exhibits
- 3.1 Articles of Incorporation of the Registrant (1)
  - 3.2 Certificate of Designation relating to the Company's Fixed Rate Cumulative Perpetual Preferred Stock Series A (2)
  - 3.3 Bylaws of the Registrant (1)

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- 3.4 Amendment to Bylaws (3)
- 4.1 Warrant to purchase shares of Company's common stock dated December 23, 2008 (2)
- 4.2 Letter Agreement (including Securities Purchase Agreement Standard Terms attached as Exhibit A) dated December 23, 2008 between the Company and the United States Department of the Treasury (2)

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- 10.1 Employee Severance Compensation Plan, as revised (4)
- 10.2 Employee Stock Ownership Plan (4)
- 10.3 1999 Stock Option Plan (5)
- 10.4 Management Recognition and Development Plan (5)
- 10.5 2003 Stock Option Plan (6)
- 10.6 Form of Incentive Stock Option Agreement (7)
- 10.7 Form of Non-qualified Stock Option Agreement (7)
- 10.8 Form of Management Recognition and Development Award Agreement (7)
- 10.9 Employment Agreement between the Company and the Bank and Michael R. Sand (8)
- 10.10 Employment Agreement between the Company and the Bank and Dean J. Brydon (8)
- 10.11 Form of Compensation Modification Agreements (2)
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes Oxley Act
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes Oxley Act
- 32 Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes Oxley Act

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- (1) Incorporated by reference to the Registrant's Registration Statement of Form S-1 (333- 35817).
  - (2) Incorporated by reference to the Registrant's Current Report on Form 8-K filed on December 23, 2008.
  - (3) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended September 30, 2002.
  - (4) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 1997; and to the Registrant's Current Report on Form 8-K dated April 13, 2007, and to the Registrant's Current Report on Form 8-K dated December 18, 2007.
  - (5) Incorporated by reference to the Registrant's 1999 Annual Meeting Proxy Statement dated December 15, 1998.
  - (6) Incorporated by reference to the Registrant's 2004 Annual Meeting Proxy Statement dated December 24, 2003.
  - (7) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended September 30, 2005.
  - (8) Incorporated by reference to the Registrant's Current Report on Form 8-K dated April 13, 2007.

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SIGNATURES

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Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Timberland Bancorp, Inc.

Date: August 10, 2009

By: /s/ Michael R. Sand

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Michael R. Sand  
Chief Executive Officer  
(Principal Executive Officer)

Date: August 10, 2009

By: /s/ Dean J. Brydon

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Dean J. Brydon  
Chief Financial Officer  
(Principal Financial Officer)

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### EXHIBIT INDEX

| Exhibit No. | Description of Exhibit   |
|-------------|--|
| 31.1        | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act |
| 31.2        | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act |
| 32          | Certification Pursuant to Section 906 of the Sarbanes-Oxley Act                            |

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