TIMBERLAND BANCORP INC
Form 10-K
December 13, 2006

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

FORM 10-K

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

For the Fiscal Year Ended September 30, 2006 OR

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

Commission File Number: 0-23333

TIMBERLAND BANCORP, INC.

(Exact name of registrant as specified in its charter)

Washington	91-1863696
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
624 Simpson Avenue, Hoquiam, Washington	98550
(Address of principal executive offices)	(Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, par value $.01 per share	The Nasdaq Stock Market LLC
(Title of Each Class)	(Name of Each Exchange on Which Registered)

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES ___ NO X

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 of Section 15(d) of the Act. YES ___ NO X

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any

amendment to this Form 10-K. X

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer [ ] Accelerated filer [X] Non-accelerated filer [ ]

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

The aggregate market value of the Common Stock outstanding held by nonaffiliates of the Registrant based on the closing sales price of the Registrant's Common Stock as quoted on The Nasdaq Stock Market LLC on March 31, 2006 was $106,436,303 (3,774,337 shares at $28.20 per share). For purposes of this calculation, Common Stock held by officers and directors of the Registrant and the Timberland Bank Employee Stock Ownership Plan and Trust are considered nonaffiliates.

DOCUMENTS INCORPORATED BY REFERENCE

1. Portions of Definitive Proxy Statement for the 2007 Annual Meeting of Stockholders (Part III).

TIMBERLAND BANCORP, INC.
2006 ANNUAL REPORT ON FORM 10-K
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PART I

Item 1. Business

General

Timberland Bancorp, Inc. ("Company"), a Washington corporation, was organized on September 8, 1997 for the purpose of becoming the holding company for Timberland Savings Bank, SSB ("Bank") 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 6,612,500 shares of common stock by the Company. At September 30, 2006, the Company had total assets of $577.1 million, total deposits of $431.1 million and total shareholders' equity of $79.4 million. The Company's business activities generally are limited to passive investment activities and oversight of its investment in the Bank.

Accordingly, the information set forth in this report, including consolidated financial statements and related data, relates primarily to the Bank and its subsidiary.

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." On December 29, 2000, the Bank changed its name to "Timberland Bank." The Bank's deposits are insured up to applicable legal limits by the Federal Deposit Insurance Corporation ("FDIC"). The Bank has been a member of the Federal Home Loan Bank ("FHLB") System since 1937. The Bank is regulated by the Washington Department of Financial Institutions, Division of Banks ("Division") and the FDIC.

The Bank is a community-oriented bank which has traditionally offered a variety of savings products to its retail customers while concentrating its lending activities on real estate mortgage loans. Lending activities have been focused primarily on the origination of loans secured by one- to four-family residential dwellings, including an emphasis on construction and land development loans, as well as the origination of multi-family and commercial real estate loans. The Bank originates adjustable-rate residential mortgage loans that do not qualify for sale in the secondary market under Federal Home Loan Mortgage Corporation ("FHLMC") guidelines. The Bank also originates commercial business loans and in 1998 established a business banking division to increase the origination of these loans.

Market Area

The Bank considered Grays Harbor, Thurston, Pierce, King, Kitsap and Lewis Counties as its primary market areas as of September 30, 2006. The Bank conducts operations from:

* its main office in Hoquiam (Grays Harbor County);

* five branch offices in Grays Harbor County (Ocean Shores, Montesano, Elma, and two branches in Aberdeen);

* a branch office in King County (Auburn);

* five branch offices in Pierce County (Edgewood, Puyallup, Spanaway, Tacoma, and Gig Harbor);

* five branch offices in Thurston County (Olympia, Yelm, Tumwater, and two branches in Lacey);

* two branch offices in Kitsap County (Poulsbo and Silverdale); and

* two branch offices and a loan production office in Lewis County (Winlock, Toledo and Centralia).

See "Item 2. Properties."

Hoquiam, with a population of approximately 9,000, is located in Grays Harbor County which is situated along Washington State's central Pacific coast. Hoquiam is located approximately 110 miles southwest of Seattle and 145 miles northwest of Portland, Oregon.

The Bank considers its primary market area to include six submarkets: primarily rural Grays Harbor County with its historical dependence on the timber and fishing industries; Pierce, Thurston and Kitsap Counties with their dependence on state and federal government; King County with its broadly diversified economic base; and Lewis County with its dependence on retail trade, manufacturing, industrial services and local government. Each of these markets presents operating risks to the Bank. The Bank's expansion into Pierce, Thurston, King, Kitsap and Lewis Counties represents the Bank's strategy to diversify its primary market area to become less reliant on the economy of Grays Harbor County.

Grays Harbor County has a population of 71,000 according to the U.S. Census Bureau 2005 estimates and a median family income of $48,900 according to 2006 HUD estimates. The economic base in Grays Harbor has been historically dependent on the timber and fishing industries. Other industries that support the economic base are tourism, agriculture, shipping, transportation and technology. According to the Washington State Employment Security Department, the unemployment rate in Grays Harbor County increased to 6.8% at September 30, 2006 from 6.6% at September 30, 2005. The Bank has six branches (including its home office) located throughout the county. A slowdown in the Grays Harbor County economy could negatively impact the Bank's profitability in this market area.

Pierce County is the second most populous county in the state and has a population of 754,000 according to the U.S. Census Bureau 2005 estimates. The county's median family income is $61,000 according to 2006 HUD estimates. The economy in Pierce County is diversified with the presence of military related government employment (Fort Lewis Army Base and McChord Air Force Base), transportation and shipping employment (Port of Tacoma), and aerospace related employment (Boeing). According to the Washington State Employment Security Department, the unemployment rate for the Pierce County area decreased to 5.4% at September 30, 2006 from 5.5% at September 30, 2005. The Bank has five branches in Pierce County. These branches have been responsible for a substantial portion of the Bank's construction lending activities. A slowdown in the Pierce County economy could negatively impact the demand for construction loans and could negatively impact the Bank's profitability.

Thurston County has a population of 229,000 according to the U.S. Census Bureau 2005 estimates and a median family income of $64,300 according to 2006 HUD estimates. Thurston County is home of Washington State's capital (Olympia) and its economic base is largely driven by state government related employment. According to the Washington State Employment Security Department, the unemployment rate for the Thurston County area had increased to 4.8% at September 30, 2006 from 4.6% at September 30, 2005. The Bank currently has five branches in Thurston County. This county has a stable economic base primarily attributable to the state government presence. A slowdown in the Thurston County economy could negatively impact the Bank's lending opportunities in this market.

Kitsap County has a population of 241,000 according to the U.S. Census Bureau 2005 estimates and a median family income of $63,200 according to 2006 HUD estimates. Timberland has two branches in Kitsap County. The economic base of Kitsap County is largely supported by military related government employment through the United States Navy. According to the Washington State Employment Security Department, the unemployment rate for the Kitsap County

area increased to 5.2% at September 30, 2006 from 4.8% at September 30, 2005. Reductions in the naval personnel stationed in Kitsap County could have a negative impact on the county's economy and could negatively impact the Bank's lending opportunities in this market.

King County is the most populous county in the state and has a population of 1.8 million according to the U.S. Census Bureau 2005 estimates. The county's median family income is $74,300 according to 2006 HUD estimates. King County's economic base is diversified with many industries including shipping, transportation, aerospace (Boeing), computer technology and biotech industries. According to the Washington State Employment Security Department, the

unemployment rate for the King County area decreased to 4.1% at September 30, 2006 from 4.8% at September 30, 2005. A slowdown in the King County economy could negatively impact the Bank's lending opportunities in this market.

Lewis County has a population of 72,000 according to the U.S. Census Bureau 2005 estimates and a median family income of $48,900 according to 2006 HUD estimates. The economic base in Lewis County is supported by manufacturing, retail trade, local government and industrial services. According to the Washington State Employment Security Department, the unemployment rate in Lewis County was 6.5% at September 30, 2006 and 2005. The Bank has two branches and a loan production office located in Lewis County. A slowdown in the Lewis County economy could negatively impact the Bank's lending opportunities in this market.

Lending Activities

General. 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 1998, the Bank has emphasized its origination of construction and land development loans and commercial real estate loans. The Bank's net loans receivable, including loans held for sale, totaled approximately $424.6 million at September 30, 2006, representing approximately 73.6% of consolidated total assets, and at that date construction and land development loans (including undisbursed loans in process), and loans secured by commercial properties were $284.5 million, or 58.0%, of total loans. Construction and land development loans and commercial real estate loans typically have higher rates of return than one- to four-family loans; however, they also present a higher degree of risk. See "- Lending Activities - Construction and Land Development Lending" and "- Lending Activities - Commercial Real Estate Lending."

The Bank's internal loan policy limits the maximum amount of loans to one borrower to 25% of its Tier 1capital. At September 30, 2006, the maximum amount which the Bank could have lent to any one borrower and the borrower's related entities was approximately $15.8 million under this policy. At September 30, 2006, the Bank had no loans to one borrower and the borrower's related entities with an aggregate outstanding balance in excess of this amount. At that date, the Bank had 60 borrowers or related borrowers with total loans outstanding in excess of $1.0 million. The largest amount outstanding to any one borrower and the borrower's related entities was approximately $9.0 million (including $4.9 million of undisbursed loans in process balance), which represents a commercial real estate loan and several commercial real estate construction loans in Thurston County. These loans were performing according to the required loan terms at September 30, 2006.

Loan Portfolio Analysis. The following table sets forth the composition of the Bank's loan by type of loan as of the dates indicated.

	At September 30,								
	2006		2005		2004		2003		
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amoun
	(Dollars in thousands)								
Mortgage Loans:									
One- to four-family(1)(2)..........	$ 98,709	20.11%	$101,763	23.24%	$ 99,835	25.25%	$ 95,371	26.21%	$113,1
Multi-family..	17,689	3.60	20,170	4.61	17,160	4.34	18,241	5.01	24,1
Commercial....	137,609	28.04	124,849	28.51	108,276	27.39	102,972	28.30	97,6
Construction and land development..	146,855	29.92	112,470	25.68	106,241	26.88	94,117	25.87	80,1
Land(2).......	29,598	6.03	24,981	5.71	19,895	5.03	15,628	4.30	15,4
Total mortgage loans.......	430,460	87.70	384,233	87.75	351,407	88.89	326,329	89.69	330,5
Consumer Loans:									
Home equity and second mortgage.....	37,435	7.63	32,298	7.38	23,549	5.96	19,233	5.29	13,7
Other.........	11,127	2.27	9,330	2.13	9,270	2.34	8,799	2.42	8,0
	48,562	9.90	41,628	9.51	32,819	8.30	28,032	7.71	21,8
Commercial business loans........	11,803	2.40	12,013	2.74	11,098	2.81	9,475	2.60	9,3
Total loans..	490,825	100.00%	437,874	100.00%	395,324	100.00%	363,836	100.00%	361,7
Less:									
Undisbursed portion of construction loans in process......	(59,260)		(42,771)		(43,563)		(34,785)		(32,3
Deferred loan origination fees.........	(2,798)		(2,895)		(3,176)		(2,924)		(3,2
Allowance for loan losses..	(4,122)		(4,099)		(3,991)		(3,891)		(3,6
Total loans receivable,									

net..........	$424,645	$388,109	$344,594	$322,236	$322,5
	========	========	========	========	======

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(8) Includes loans held-for-sale.
(9) Includes real estate contracts. See " - Lending Activities - Real Estate Contracts."

Residential One- to Four-Family Lending. At September 30, 2006, $98.7 million, or 20.1%, of the Bank's loan portfolio consisted of loans secured by one- to four-family residences. The Bank originates both fixed-rate loans and adjustable-rate loans.

Generally, fixed-rate loans, including 15, 20, 30, and five and seven year balloon reset loans are originated to meet the requirements for sale in the secondary market to the FHLMC. From time to time, however, a portion of these fixed-rate loans may be retained in the loan portfolio to meet the Bank's asset/liability management objectives. The Bank periodically retains fixed-rate five and seven year balloon reset loans in its loan portfolio and classifies them as held to maturity. The Bank uses an automated underwriting program, which preliminarily qualifies a loan as conforming to FHLMC underwriting standards when the loan is originated. At September 30, 2006, $56.1 million, or 57.5%, of the Bank's one- to four-family loan portfolio due after one year consisted of fixed-rate mortgage loans.

The Bank also offers adjustable-rate mortgage ("ARM") loans at rates and terms competitive with market conditions. All of the Bank's ARM loans are retained in its loan portfolio rather than intended for sale. The Bank offers several ARM products which adjust annually after an initial period ranging from one to five years subject to a limitation on the annual increase of 2% and an overall limitation of 6%. These ARM products are priced utilizing the weekly average yield on one year U.S. Treasury securities adjusted to a constant maturity of one year plus a margin of 3.00% to 4.00%. Loans tied to the prime rate or to LIBOR indices typically do not have periodic, or lifetime adjustment limits. Loans tied to these indices normally have margins ranging from 0.0% to 3.0%. ARM loans held in the Bank's portfolio do not permit negative amortization of principal. Borrower demand for ARM loans versus fixed-rate mortgage loans is a function of the level of interest rates, the expectations of changes in the level of interest rates and the difference between the initial interest rates and fees charged for each type of loan. The relative amount of fixed-rate mortgage loans and ARM loans that can be originated at any time is largely determined by the demand for each in a competitive

environment. At September 30, 2006, $41.8 million, or 42.4%, of the Bank's one- to four- family loan portfolio consisted of ARM loans.

A portion of the Bank's ARM loans are "non-conforming" because they do not satisfy acreage limits, or various other requirements imposed by the FHLMC. Some of these loans are also originated to meet the needs of borrowers who cannot otherwise satisfy the FHLMC credit requirements because of personal and financial reasons (i.e., divorce, bankruptcy, length of time employed, etc.), and other aspects, which do not conform to the FHLMC's guidelines. Many of these borrowers have higher debt-to-income ratios, or the loans are secured by unique properties in rural markets for which there are no

comparable sales of comparable properties to support value according to secondary market requirements. These loans are known as non-conforming loans and the Bank may require additional collateral or lower loan-to-value ratios to reduce the risk of these loans. The Bank believes that these loans satisfy a need in its local market area. As a result, subject to market conditions, the Bank intends to continue to originate these types of loans.

The retention of ARM loans in the Bank's loan portfolio helps reduce the Bank's exposure to changes in interest rates. There are, however, unquantifiable credit risks resulting from the potential of increased interest to be paid by the customer as a result of increases in interest rates. It is possible that during periods of rising interest rates the risk of default on ARM loans may increase as a result of repricing and the increased costs to the borrower. Furthermore, because the ARM loans originated by the Bank generally provide, as a marketing incentive, for initial rates of interest below the rates which would apply were the adjustment index used for pricing initially, these loans are subject to increased risks of default or delinquency. The Bank attempts to reduce the potential for delinquencies and defaults on ARM loans by qualifying the borrower based on the borrower's ability to repay the ARM loan assuming that the maximum interest rate that could be charged at the first adjustment period remains constant during the loan term. Another consideration is that although ARM loans allow the Bank to increase the sensitivity of its asset base due to changes in the interest rates, the extent of this interest sensitivity is limited by the periodic and lifetime interest rate adjustment limits. Because of these considerations, the Bank has no assurance that yield increases on ARM loans will be sufficient to offset increases in the Bank's cost of funds.

While fixed-rate, single-family residential mortgage loans are normally originated with 15 to 30 year terms, these loans typically remain outstanding for substantially shorter periods because borrowers often prepay their loans in full upon sale of the property pledged as security or upon refinancing the original loan. In addition, substantially all mortgage loans in the Bank's loan portfolio contain due-on-sale clauses providing that the Bank may declare the unpaid amount due and payable upon the sale of the property securing the loan. Typically, the Bank enforces these due-on-sale clauses to the extent permitted by law and as business judgment dictates. Thus, average loan maturity is a function of, among other factors, the level of purchase and sale activity in the real estate market, prevailing interest rates and the interest rates received on outstanding loans.

The Bank requires that fire and extended coverage casualty insurance be maintained on all of its real estate secured loans. Loans originated since 1994 also require flood insurance, if appropriate.

The Bank's lending policies generally limit the maximum loan-to-value ratio on mortgage loans secured by owner-occupied properties to 95% of the lesser of the appraised value or the purchase price. However, the Bank usually obtains private mortgage insurance ("PMI") on the portion of the principal amount that exceeds 80% of the appraised value of the security property. The maximum loan-to-value ratio on mortgage loans secured by non-owner-occupied properties is generally 80% (90% for loans originated for sale in the secondary market to the FHLMC).

Construction and Land Development Lending. Prompted by unfavorable economic conditions in its primary market area in the 1980s, the Bank sought to establish a market niche and, as a result, began originating construction loans outside of Grays Harbor County. In recent periods, construction lending activities have been primarily in the Pierce, King, Thurston, and Kitsap County markets. Competition from other financial institutions has increased in recent periods and it is possible that margins on construction loans may be reduced in the future.

The Bank currently originates three types of residential construction loans: (i) speculative construction loans, (ii) custom construction loans and (iii) owner/builder construction loans. The Bank initiated its construction lending with

the origination of speculative construction loans. As a result, the Bank began to establish contacts with the building community and increased the origination of custom construction and land development loans in rural and suburban market areas. The Bank believes that its computer tracking system has enabled it to establish processing and disbursement procedures to meet the needs of these borrowers. To a lesser extent, the Bank also originates construction loans for the development of multi-family and commercial properties. Subject to market conditions, the Bank intends to continue to emphasize its construction lending activities.

At September 30, 2006, the composition of the Bank's construction and land development loan portfolio was as follows:

	Outstanding Balance	Percent of Total
	(In thousands)	
Speculative construction..............	$ 34,363	23.40%
Custom and owner/builder construction..	46,346	31.56
Multi-family..........................	7,662	5.22
Land development......................	16,086	10.95
Commercial real estate................	42,398	28.87
Total................................	$146,855	100.00%

Speculative construction loans are made to home builders and are termed "speculative" because the home builder does not have, at the time of loan origination, a signed contract with a home buyer who has a commitment for permanent financing with either the Bank or another lender for the finished home. The home buyer may be identified either during or after the construction period, with the risk that the builder will have to debt service the speculative construction loan and finance real estate taxes and other carrying costs of the completed home for a significant time after the completion of construction until the home buyer is identified and a sale is consummated. The Bank lends to approximately 50 builders located in the Bank's primary market area, each of which generally have two to eight speculative loans outstanding from the Bank during a 12 month period. Rather than originating lines of credit to home builders to construct several homes at once, the Bank originates and underwrites a separate loan for each home. Speculative construction loans are generally originated for a term of 12 months, with current rates ranging from prime rate plus 1.0% to 1.5%, and with a loan-to-value ratio of no more than 80% of the appraised estimated value of the completed property. During this 12 month period, the borrower is required to make monthly payments of accrued interest on the outstanding loan balance. At September 30, 2006, speculative construction loans totaled $34.4 million, or 23.4%, of the total construction loan portfolio. At September 30, 2006, the Bank had 16 borrowers each with aggregate outstanding speculative loan balances of more than $500,000. The largest aggregate outstanding balance to

one borrower amounted to $5.1 million (including $2.1 million of undisbursed loans in process balance), and the largest outstanding balance for a single speculative loan was $1.1 million (including $409,000 of undisbursed loans in process balance). At September 30, 2006, all speculative construction loans were performing according to their terms.

Unlike speculative construction loans, custom construction loans are made to home builders who, at the time of construction, have a signed contract with a home buyer who has a commitment for permanent financing for the finished home with the Bank or another lender. Custom construction loans are generally originated for a term of six to 12 months, with fixed interest rates currently ranging from 7.0% to 7.5% and with loan-to-value ratios of 80% of the appraised estimated value of the completed property or sales price, whichever is less. During the construction period, the borrower is required to make monthly payments of accrued interest on the outstanding loan balance.

Owner/builder construction loans are originated to the home owner rather than the home builder as a single loan that automatically converts to a permanent loan at the completion of construction. The construction phase of a owner/builder construction loan generally lasts up to 12 months with fixed interest rates currently ranging from 7.0% to 7.5%, and with loan-to-value ratios of 80% (or up to 95% with PMI) of the appraised estimated value of the completed property or cost, whichever is less. During the construction period, the borrower is required to make monthly payments

of accrued interest on the outstanding loan balance. At the completion of construction, the loan converts automatically to either a fixed-rate mortgage loan, which conforms to secondary market standards, or an ARM loan for retention in the Bank's portfolio. At September 30, 2006, custom and owner/builder construction loans totaled $46.3 million, or 31.6%, of the total construction loan portfolio. At September 30, 2006, the largest outstanding custom and owner/builder construction loan had an outstanding balance of $998,000 (including $108,000 of undisbursed loans in process balance) and was performing according to its terms.

The Bank originates loans to local real estate developers with whom it has established relationships for the purpose of developing residential subdivisions (i.e., installing roads, sewers, water and other utilities) (generally with ten to 50 lots). At September 30, 2006, subdivision development loans totaled $16.1 million, or 11.0% of construction and land development loans receivable. Land development loans are secured by a lien on the property and made for a period of two to five years with fixed or variable interest rates, and are made with loan-to-value ratios generally not exceeding 75%. Monthly interest payments are required during the term of the loan. Land development loans are structured so that the Bank is repaid in full upon the sale by the borrower of approximately 80% of the subdivision lots. Substantially all of the Bank's land development loans are secured by property located in its primary market area. In addition, in the case of a corporate borrower, the Bank also generally obtains personal guarantees from corporate principals and reviews their personal financial statements. At September 30, 2006, the largest land development loan had an outstanding loan balance of $3.9 million (including $1.8 million of undisbursed loans in process balance), and was performing according to its terms.

Land development loans secured by land under development involve greater risks than one- to four-family residential mortgage loans because these loans

are advanced upon the predicted future value of the developed property. If the estimate of the future value proves to be inaccurate, in the event of default and foreclosure the Bank may be confronted with a property the value of which is insufficient to assure full repayment. The Bank attempts to minimize this risk by generally limiting the maximum loan-to-value ratio on land loans to 75% of the estimated developed value of the secured property.

The Bank also provides construction financing for multi-family and commercial properties. At September 30, 2006, these loans amounted to $50.1 million, or 34.1% of construction loans. These loans are secured by motels, apartment buildings, condominiums, office buildings and retail rental space located in the Bank's primary market area and currently range in amount from $25,000 to $8.0 million. At September 30, 2006, the largest outstanding multi- family construction loan had a balance of $3.2 million (including $727,000 of undisbursed loans in process balance). At September 30, 2006, the largest outstanding commercial real estate construction loan had a balance of $8.0 million (including $7.7 million of undisbursed loans in process balance). This loan was secured by a condominium project in Grays Harbor County and was performing according to its terms.

All construction loans must be approved by one of the Bank's Loan Committees or the Bank's Board of Directors. See "- Lending Activities - Loan Solicitation and Processing." Prior to preliminary approval of any construction loan application, an independent fee appraiser inspects the site and the Bank reviews the existing or proposed improvements, identifies the market for the proposed project and analyzes the pro forma data and assumptions on the project. In the case of a speculative or custom construction loan, the Bank reviews the experience and expertise of the builder. After preliminary approval has been given, the application is processed, which includes obtaining credit reports, financial statements and tax returns on the borrowers and guarantors, an independent appraisal of the project, and any other expert reports necessary to evaluate the proposed project. In the event of cost overruns, the Bank generally requires that the borrower increase the funds available for construction by depositing its own funds into a secured savings account, the proceeds of which are used to pay construction costs.

Loan disbursements during the construction period are made to the builder, materials' supplier or subcontractor, based on a line item budget. Periodic on-site inspections are made by qualified inspectors to document the reasonableness of the draw request. For most builders, the Bank disburses loan funds by providing vouchers to suppliers, which when used by the builder to purchase supplies are submitted by the supplier to the Bank for payment.

The Bank regularly monitors the construction loan disbursements using an internal computer program. The Bank believes that its internal monitoring system helps reduce many of the risks inherent with construction lending.

The Bank originates construction loan applications primarily through customer referrals, contacts in the business community and occasionally real estate brokers seeking financing for their clients.

Construction lending affords the Bank the opportunity to achieve higher interest rates and fees with shorter terms to maturity than does its single-family permanent mortgage lending. Construction lending, however, is generally considered to involve a higher degree of risk than single-family

permanent mortgage lending because of the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost of the project. The nature of these loans is such that they are generally more difficult to evaluate and monitor. If the estimate of construction cost proves to be inaccurate, the Bank may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value upon completion proves to be inaccurate, the Bank may be confronted with a project whose value is insufficient to assure full repayment. Projects may also be jeopardized by disagreements between borrowers and builders and by the failure of builders to pay subcontractors. Loans to builders to construct homes for which no purchaser has been identified carry more risk because the payoff for the loan depends on the builder's ability to sell the property prior to the time that the construction loan is due. The Bank has sought to address these risks by adhering to strict underwriting policies, disbursement procedures, and monitoring practices. In addition, because the Bank's construction lending is primarily secured by properties in its primary market area, changes in the local and state economies and real estate markets could adversely affect the Bank's construction loan portfolio.

Real Estate Contracts. The Bank purchases real estate contracts and deeds of trust from individuals who have privately sold their homes or property. These contracts are generally secured by one- to four-family properties, building lots and undeveloped land and range in principal amount from $10,000 to $200,000, but typically are in amounts between $20,000 and $40,000. Properties securing real estate contracts purchased by the Bank are generally located within its primary market area. Prior to purchasing the real estate contract, the Bank reviews the contract and analyzes and assesses the collateral for the loan, the down payment made by the borrower and the credit history on the loan. As of September 30, 2006, the Bank had outstanding real estate contracts of $729,000.

Multi-Family Lending. At September 30, 2006, the Bank had $17.7 million, or 3.6% of the Bank's total loan portfolio, secured by multi-family dwelling units (more than four units) located primarily in the Bank's primary market area. Multi-family loans are generally originated with variable rates of interest ranging from 2.00% to 3.50% over the one-year constant maturity U.S. Treasury Bill Index or a matched term FHLB advance, with principal and interest payments fully amortizing over terms of up to 30 years. Multi-family loans currently range in principal balance from $40,000 to $5.8 million. At September 30, 2006, the largest multi-family loan had an outstanding principal balance of $5.8 million and was secured by an apartment building located in the Bank's primary market area. At September 30, 2006, this loan was performing according to its terms.

The maximum loan-to-value ratio for multi-family loans is generally 75%. The Bank generally requests its multi-family loan borrowers to submit financial statements and rent rolls on the subject property annually. The Bank also inspects the subject property annually. The Bank generally imposes a minimum debt coverage ratio of approximately 1.10 times for loans secured by multi-family properties.

Multi-family mortgage lending affords the Bank an opportunity to receive interest at rates higher than those generally available from one- to four-family residential lending. However, loans secured by multi-family properties usually are greater in amount, more difficult to evaluate and monitor and, therefore, involve a greater degree of risk than one- to four-family residential mortgage loans. Because payments on loans secured by multi-family properties are often dependent on the successful operation and management of the properties, repayment of such loans may be affected by adverse conditions in the real estate market or the economy. The Bank seeks to minimize these risks by strictly scrutinizing the financial condition of the borrower, the

quality of the collateral and the management of the property securing the loan. If the borrower is other than an individual, the Bank also generally obtains personal guarantees from the principals based on a review of personal financial statements.

Commercial Real Estate Lending. Commercial real estate loans totaled $137.6 million, or 28.0% of the total loan portfolio at September 30, 2006, and consisted of 312 loans. The Bank originated $32.2 million of commercial mortgage loans during the year ended September 30, 2006 compared to $32.3 million originated during the year ended September 30, 2005. The Bank originates commercial real estate loans generally at variable interest rates and these loans are secured by properties, such as restaurants, motels, office buildings and retail/wholesale facilities, located in the Bank's primary market area. The principal balances of commercial real estate loans currently ranges between $10,000 and $4.7 million. At September 30, 2006, the largest commercial real estate loan was secured by a commercial property located in Olympia, Washington, had a balance of $4.7 million and was performing according to its terms. At September 30, 2006, all commercial real estate loans were performing according to their terms. See "- Lending Activities - Nonperforming Assets and Delinquencies."

The Bank requires appraisals of all properties securing commercial real estate loans. Appraisals are performed by independent appraisers designated by the Bank, all of which are reviewed by management. The Bank considers the quality and location of the real estate, the credit history of the borrower, the cash flow of the project and the quality of management involved with the property. The Bank generally imposes a minimum debt coverage ratio of approximately 1.10 for originated loans secured by income producing commercial properties. Loan-to-value ratios on commercial real estate loans are generally limited to not more than 80%. The Bank generally obtains loan guarantees from financially capable parties and reviews their personal financial statements.

Commercial real estate lending affords the Bank an opportunity to receive interest at rates higher than those generally available from one- to four-family residential lending. However, loans secured by such properties usually are greater in amount, more difficult to evaluate and monitor and, therefore, involve a greater degree of risk than one- to four-family residential mortgage loans. Because payments on loans secured by commercial properties often depend upon the successful operation and management of the properties, repayment of these loans may be affected by adverse conditions in the real estate market or the economy. The Bank seeks to minimize these risks by generally limiting the maximum loan-to-value ratio to 80% and strictly scrutinizing the financial condition of the borrower, the quality of the collateral and the management of the property securing the loan. The Bank also requests annual financial information and rent rolls on the subject property from the borrowers.

Land Lending. The Bank originates loans for the acquisition of land upon which the purchaser can then build or make improvements necessary to build or to sell as improved lots. At September 30, 2006, land loans totaled $29.6 million, or 6.0% of the Bank's total loan portfolio. Land loans originated by the Bank are generally fixed-rate loans and have maturities of five to ten years. Land loans generally range in principal amount from $5,000 to $800,000. The largest land loan had an outstanding balance of $779,000 at September 30, 2006 and was performing according to its terms. At September 30, 2006, all land loans were performing according to their terms. See "-

Lending Activities - Nonperforming Assets and Delinquencies."

Loans secured by undeveloped land or improved lots involve greater risks than one- to four-family residential mortgage loans because these loans are more difficult to evaluate. If the estimate of value proves to be inaccurate, in the event of default and foreclosure the Bank may be confronted with a property the value of which is insufficient to assure full repayment. The Bank attempts to minimize this risk by generally limiting the maximum loan-to-value ratio on land loans to 75%.

Consumer Lending. Consumer lending has traditionally been a small part of the Bank's business. Consumer loans generally have shorter terms to maturity and higher interest rates than mortgage loans. Consumer loans include home equity lines of credit, second mortgage loans, savings account loans, automobile loans, boat loans, motorcycle loans, recreational vehicle loans and unsecured loans. Consumer loans are made with both fixed and variable interest rates and with varying terms. At September 30, 2006, consumer loans amounted to $48.6 million, or 9.9%, of the total loan portfolio.

At September 30, 2006, the largest component of the consumer loan portfolio consisted of second mortgage loans and home equity lines of credit, which totaled $37.4 million, or 7.6%, of the total loan portfolio. Home equity lines of credit and second mortgage loans are made for purposes such as the improvement of residential properties, debt

consolidation and education expenses, among others. The majority of these loans are made to existing customers and are secured by a first or second mortgage on residential property. The Bank occasionally solicits these loans. The loan-to-value ratio is typically 80% or less, when taking into account both the first and second mortgage loans. Second mortgage loans typically carry fixed interest rates with a fixed payment over a term between five and 15 years. Home equity lines of credit are generally made at interest rates tied to the 26 week Treasury Bill or the prime rate. Second mortgage loans and home equity lines of credit have greater credit risk than one- to four-family residential mortgage loans because they are secured by mortgages subordinated to the existing first mortgage on the property, which may or may not be held by the Bank.

Consumer loans entail greater risk than do residential mortgage loans, particularly in the case of consumer loans that are unsecured or secured by rapidly depreciating assets such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. The remaining deficiency often does not warrant further substantial collection efforts against the borrower beyond obtaining a deficiency judgment. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount that can be recovered on such loans. The Bank believes that these risks are not as prevalent in the case of the Bank's consumer loan portfolio because a large percentage of the portfolio consists of second mortgage loans and home equity lines of credit that are underwritten in a manner such that they result in credit risk that is substantially similar

to one- to four-family residential mortgage loans. At September 30, 2006, the Bank did not have any consumer loans delinquent in excess of 90 days. See "Lending Activities - Non-performing Assets and Delinquencies."

Commercial Business Lending. Commercial business loans totaled $11.8 million, or 2.4% of the loan portfolio at September 30, 2006, and consisted of 45 loans. In July 1998, the Bank established a business banking division staffed by three experienced commercial lenders to increase the Bank's origination of commercial business loans and commercial real estate loans. Currently, the division is staffed by a Division Manager and seven commercial lenders. Commercial business loans are generally secured by business equipment, accounts receivable, inventory or other property and are made at variable rates of interest equal to a negotiated margin above the prime rate. The Bank also generally obtains personal guarantees from financially capable applicants based on a review of personal financial statements. At September 30, 2006, all commercial business loans were performing according to terms. See "Lending Activities-Nonperforming Assets and Delinquencies."

Commercial business lending generally involves greater risk than residential mortgage lending and involves risks that are different from those associated with residential and commercial real estate lending. Real estate lending is generally considered to be collateral based lending with loan amounts based on predetermined loan to collateral values and liquidation of the underlying real estate collateral is viewed as the primary source of repayment in the event of borrower default. Although commercial business loans are often collateralized by equipment, inventory, accounts receivable or other business assets, the liquidation of collateral in the event of a borrower default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories and equipment may be obsolete or of limited use, among other things. Accordingly, the repayment of a commercial business loan depends primarily on the creditworthiness of the borrower (and any guarantors), while liquidation of collateral is a secondary and often insufficient source of repayment.

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Loan Maturity. The following table sets forth certain information at September 30, 2006 regarding the dollar amount of loans maturing in the Bank's portfolio based on their contractual terms to maturity, but does not include scheduled payments or potential prepayments. Demand loans, loans having no stated schedule of repayments and no stated maturity, and overdrafts are reported as due in one year or less.

	Within One Year	After One Year Through 3 Years	After 3 Years Through 5 Years	After 5 Years Through 10 Years	After 10 Years	Total
			(In thousands)			
Mortgage loans:						
One- to four-family (1)......	$ 992	$ 1,580	$ 5,705	$ 6,147	$ 84,285	$ 98,709
Multi-family.....	1,281	532	3	12,964	2,909	17,689
Commercial.......	6,395	12,035	6,167	87,539	25,473	137,609
Construction and land development(2)..	106,073	2,557	458	9,446	28,321	146,855

Land............	6,429	6,834	14,296	379	1,660	29,598
Consumer loans:						
Home equity and second mortgage........	9,052	1,427	1,009	2,191	23,756	37,435
Other...........	2,294	707	1,993	1,155	4,978	11,127
Commercial business loans...........	3,533	3,031	1,142	2,267	1,830	11,803
Total...........	$136,049	$28,703	$30,773	$122,088	$173,212	$490,825
Less:						
Undisbursed portion of construction loans in process.........						59,260
Deferred loan origination fees...........						2,798
Allowance for loan losses.....						4,122
Loans receivable, net............						$424,645

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(1) Includes loans held-for-sale.

(2) Includes construction/permanent loans that convert to permanent mortgage loans once construction is completed.

The following table sets forth the dollar amount of all loans due after one year from September 30, 2006, which have fixed interest rates and have floating or adjustable interest rates.

	Fixed Rates	Floating or Adjustable Rates	Total
		(In thousands)	
Mortgage loans:			
One- to four-family(1)....................	$ 56,139	$ 41,579	$ 97,718
Multi-family.............................	6,051	10,357	16,408
Commercial...............................	13,246	117,968	131,214
Construction and land development.........	25,377	15,405	40,782
Land.....................................	19,856	3,313	23,169
Consumer loans:			
Home equity and second mortgage...........	23,243	5,140	28,383
Other....................................	8,720	113	8,833
Commercial business loans.................	3,471	4,798	8,269
Total.................................	$156,103	$198,673	$354,776

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(1) Includes loans held-for-sale.

Scheduled contractual principal repayments of loans do not reflect the actual life of these assets. The average life of loans is substantially less than their contractual terms because of prepayments. In addition, due-on-sale clauses on loans generally give the Bank the right to declare loans immediately due and payable in the event, among other things, that the borrower sells the real property subject to the mortgage and the loan is not repaid. The average life of mortgage loans tends to increase, however, when current mortgage loan interest rates are substantially higher than interest rates on existing mortgage loans and, conversely, decrease when interest rates on existing mortgage loans are substantially higher than current mortgage loan interest rates.

Loan Solicitation and Processing. Loan originations are obtained from a variety of sources, including walk-in customers, and referrals from builders and realtors. Upon receipt of a loan application from a prospective borrower, a credit report and other data are obtained to verify specific information relating to the loan applicant's employment, income and credit standing. An appraisal of the real estate offered as collateral generally is undertaken by an appraiser retained by the Bank and certified by the State of Washington.

Loan applications are initiated by loan officers and are required to be approved by one of the Bank's Loan Committees or the Bank's Board of Directors. The Bank's Consumer Loan Committee, which consists of two underwriters, can approve one-to four-family mortgage loans and other consumer loans up to and including $417,000. Certain consumer loans up to and including $25,000 may be approved by individual loan officers and the Bank's Consumer Lending Department Manager may approve consumer loans up to and including $75,000. The Bank's Commercial Loan Committee, which consists of the Bank's President, Chief Lending Officer, Executive Vice President of Commercial Lending, Executive Vice President of Community Lending and Senior Vice President of Administration, may approve commercial real estate loans and commercial business loans up to and including $1.5 million. The Bank's President, Chief Lending Officer, Executive Vice President of Commercial Lending, Executive Vice President of Community Lending and Senior Vice President of Administration also have individual lending authority for loans up to and including $500,000. The Bank's Board Loan Committee, which consists of two rotating non-employee Directors and the Bank's President, may approve loans up to and including $3.0 million. Loans in excess of $3.0 million, as well as loans of any amount granted to a single borrower whose aggregate loans exceed $3.0 million, must be approved by the Bank's Board of Directors.

Loan Originations, Purchases and Sales. During the years ended September 30, 2006 and 2005, the Bank's total gross loan originations were $256.3 million and $230.0 million, respectively. Periodically, the Bank purchases participation interests in construction and land development loans and multi-family loans, secured by properties generally located in the Bank's primary market area, from other lenders. These purchases are underwritten to the Bank's underwriting guidelines and are without recourse to the seller other than for fraud. See "- Lending Activities - Construction and Land Development Lending" and "- Lending Activities - Multi-Family Lending."

Consistent with its asset/liability management strategy, the Bank's policy generally is to retain in its portfolio all ARM loans originated and to sell fixed rate one-to four-family mortgage loans in the secondary market to the FHLMC; however, from time to time, a portion of fixed-rate loans may be retained in the Bank's portfolio to meet its asset-liability objectives. Loans sold in the secondary market are generally sold on a servicing retained basis. At September 30, 2006, the Bank's loan servicing portfolio totaled $156.2 million.

The following table shows total loans originated, purchased, sold and repaid during the periods indicated.

	Year Ended September 30,		
	2006	2005	2004
	(In thousands)		
Loans originated:			
Mortgage loans:			
One- to four-family....................	$ 33,483	$ 33,290	$ 36,824
Multi-family...........................	3,037	4,685	1,150
Commercial.............................	32,174	32,266	29,056
Construction and land development.......	129,623	104,714	94,373
Land...................................	17,518	15,330	11,033
Consumer.................................	29,858	29,287	18,952
Commercial business loans................	10,559	10,233	9,754
Total loans originated.................	256,252	229,805	201,142
Loans purchased:			
Mortgage loans:			
One- to four-family....................	48	209	30
Commercial.............................	79	--	--
Land...................................	28	--	--
Total loans purchased.................	155	209	30
Total loans originated and purchased..	256,407	230,014	201,172
Loans sold:			
Whole loans sold........................	(26,445)	(25,358)	(35,741)
Credit card loans sold..................	--	(1,523)	--
Total loans sold........................	(26,445)	(26,881)	(35,741)
Loan principal repayments................	(177,011)	(160,583)	(133,943)
Decrease (increase) in other items, net...	(16,415)	965	(9,130)
Net increase in loans receivable..........	$ 36,536	$ 43,515	$ 22,358

Loan Origination Fees. The Bank generally receives loan origination fees. Loan fees are a percentage of the principal amount of the loan which are charged to the borrower for funding the loan. The amount of fees charged by the Bank is generally 0.5% to 2.0% of the loan amount. Current accounting principles generally accepted in the United States of American require fees received and certain loan origination costs for originating loans to be deferred and amortized into interest income over the contractual life of the loan. Net deferred fees or costs associated with loans that are prepaid are recognized as income at the time of prepayment. Deferred loan origination fees totaled $2.8 million at September 30, 2006.

Non-performing Assets and Delinquencies. The Bank assesses late fees or penalty charges on delinquent loans of approximately 5% of the monthly loan payment amount. Substantially all fixed-rate and ARM loan payments are due on the first day of the month; however, the borrower is given a 15 day grace period to make the loan payment. When a mortgage loan borrower fails to make a required payment when due, the Bank institutes collection procedures. A

notice is mailed to the borrower 16 days after the date the payment is due. Attempts to contact the borrower by telephone generally begin on or before the 30th day of delinquency. If a satisfactory response is not obtained, continuous follow-up contacts are attempted until the loan has been brought current. Before the 90th day of delinquency, attempts to interview the borrower, preferably in person, are made to establish (i) the cause of the delinquency, (ii) whether the cause is temporary, (iii) the attitude of the borrower toward the debt, and (iv) a mutually satisfactory arrangement for curing the default.

If the borrower is chronically delinquent and all reasonable means of obtaining payment on time have been exhausted, foreclosure is initiated according to the terms of the security instrument and applicable law. Interest income on loans in foreclosure is reduced by the full amount of accrued and uncollected interest.

When a consumer loan borrower or commercial business borrower fails to make a required payment on a loan by the payment due date, the Bank institutes similar collection procedures as for its mortgage loan borrowers. Loans becoming 90 days or more past due are placed on non-accrual status, with any accrued interest reversed against interest income, unless they are well secured and in the process of collection.

The Bank's Board of Directors is informed monthly as to the status of loans that are delinquent by more than 30 days, the status of all loans currently in foreclosure, and the status of all foreclosed and repossessed property owned by the Bank.

The following table sets forth information with respect to the Company's nonperforming assets at the dates indicated.

	At September 30,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Loans accounted for on a non-accrual basis:					
Mortgage loans:					
One- to four-family........	$ 80	$ 2,208	$ 430	$ 1,409	$ 1,138
Commercial.................	--	261	640	538	688
Construction and land development..............	--	--	--	1,185	1,571
Land.......................	--	23	322	521	251
Consumer loans..............	--	133	23	212	49
Commercial business loans...	--	301	27	30	44
Total..................	80	2,926	1,442	3,895	3,741
Accruing loans which are contractually past due 90 days or more...............	--	--	--	--	--
Total of non-accrual and 90 days past due loans........	80	2,926	1,442	3,895	3,741

Other real estate owned and other repossessed assets...	15	509	421	1,258	680
Total nonperforming assets.................	$ 95	$ 3,435	$ 1,863	$ 5,153	$ 4,421
Restructured loans..........	$ --	$ --	$ --	$ --	$ --
Non-accrual and 90 days or more past due loans as a percentage of loans receivable, net...........	0.02%	0.75%	0.41%	1.19%	1.15%
Non-accrual and 90 days or more past due loans as a percentage of total assets.....................	0.01%	0.53%	0.31%	0.87%	0.87%
Nonperforming assets as a percentage of total assets.....................	0.02%	0.62%	0.40%	1.15%	1.03%
Loans receivable, net(1)....	$428,767	$392,208	$348,585	$326,127	$326,158
Total assets................	$577,087	$552,765	$460,419	$449,633	$431,054

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(1) Includes loans held-for-sale and is before the allowance for loan losses.

The Bank's non-accrual loans decreased by $2.8 million to $80,000 at September 30, 2006 from $2.9 million at September 30, 2005, primarily as a result of a $2.1 million decrease in one- to four-family mortgage loans on non-accrual status, a $301,000 decrease in commercial business loans on non-accrual status, and a $261,000 decrease in commercial real estate loans on non-accrual status.

Additional interest income which would have been recorded for the year ended September 30, 2006 had non-accruing loans been current in accordance with their original terms totaled approximately $2,000.

Other Real Estate Owned and Other Repossessed Items. Real estate acquired by the Bank as a result of foreclosure or by deed-in-lieu of foreclosure is classified as other real estate owned until sold. When property is acquired, it is recorded at the lower of its cost, which is the unpaid principal balance of the related loan plus foreclosure costs, or fair market value. Subsequent to foreclosure, the property is recorded at the lower of the foreclosed amount or fair value, less estimated selling costs. At September 30, 2006, the Bank had $15,000 in other real estate owned, which consisted of one land parcel.

Restructured Loans. Under accounting principles generally accepted in the United States of America, the Bank is required to account for certain loan

modifications or restructuring as a "troubled debt restructuring." In general, the modification or restructuring of a debt constitutes a troubled debt restructuring if the Bank for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrowers that the Bank would not otherwise consider. Debt restructuring or loan modifications for a borrower does not necessarily always constitute troubled debt restructuring, however, and troubled debt restructurings do not necessarily result in non-accrual loans. The Bank had no restructured loans at September 30, 2006.

Other Loans of Concern. Loans not reflected in the table above, but where known information about possible credit problems of borrowers causes management to have doubts as to the ability of the borrower to comply with present repayment terms and that may result in disclosure of such loans and leases as underperforming assets in the future are commonly referred to as "potential problem loans." The amount included in potential problem loans results from an evaluation, on a loan-by-loan basis, of loans classified as "substandard" and "special mention," as those terms are defined under "Asset Classification" below. The amount of potential problem loans was $12.9 million at September 30, 2006 and $11.3 million at September 30, 2005. The vast majority of these loans, as well as our nonperforming assets, are collateralized.

Asset Classification. Applicable regulations require that each insured institution review and classify its assets on a regular basis. In addition, in connection with examinations of insured institutions, regulatory examiners have authority to identify problem assets and, if appropriate, require them to be classified. There are three classifications for problem assets: substandard, doubtful and loss. Substandard assets have one or more defined weaknesses and are characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected. Doubtful assets have the weaknesses of substandard assets with the additional characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. An asset classified as loss is considered uncollectible and of such little value that continuance as an asset of the institution is not warranted. When an insured institution classifies problem assets as either substandard or doubtful, it is required to establish general allowances for loan losses in an amount deemed prudent by management. These allowances represent loss allowances which have been established to recognize the inherent risk associated with lending activities and the risks associated with particular problem assets. When an insured institution classifies problem assets as loss, it charges off the balance of the asset against the allowance for loan losses. Assets which do not currently expose the insured institution to sufficient risk to warrant classification in one of the aforementioned categories but possess weaknesses are required to be designated as special mention. The Bank's determination of the classification of its assets and the amount of its valuation allowances is subject to review by the FDIC and the Division which can order the establishment of additional loss allowances.

The aggregate amounts of the Bank's classified and special mention loans (as determined by the Bank), and of the Bank's allowances for loan losses at the dates indicated, were as follows:

At September 30,

	2006	2005	2004
	(In thousands)		
Loss........................	$ --	$ --	$ --
Doubtful....................	--	--	--
Substandard(1)...............	3,985	9,876	11,847
Special mention(1)...........	9,015	4,320	3,676
Total classified and special mention loans...............	$13,000	$14,196	$15,523
Allowance for loan losses....	$ 4,122	$ 4,099	$ 3,991

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(1) For further information concerning the change in classified assets, see "- Lending Activities - Nonperforming Assets and Delinquencies."

The Bank's classified and special mention loans decreased by $1.2 million from September 30, 2005 to September 30, 2006, primarily as a result of a $5.9 million decrease in loans classified as substandard. This decrease was partially offset by a $4.7 million increase in loans classified as special mention.

Special mention loan are defined as those credits deemed by management to have some potential weakness that deserve management's close attention. If left uncorrected these potential weaknesses may result in the deterioration of the payment prospects of the loan. Assets in this category are not adversely classified and currently do not expose the Bank to sufficient risk to warrant a substandard classification. Three loans comprise a majority of the amount classified as special mention. They include a $3.4 million loan secured by a commercial office building in Thurston County, a $3.2 million loan secured by a motel in Pierce County, and a $729,000 land development loan in Grays Harbor County. At September 30, 2006 these loans were current and paying in accordance with the required loan terms.

Substandard loans are classified as those loans that are inadequately protected by the current net worth, and paying capacity of the obligor, or of the collateral pledged. Assets classified as substandard have a well-defined weakness, or weaknesses that jeopardize the repayment of the debt. If the weakness, or weaknesses are not corrected there is the distinct possibility that some loss will be sustained. The aggregate amount of loans classified as substandard at September 30, 2006 decreased by $5.9 million to $4.0 million from $9.9 million at September 30, 2005. At September 30, 2006, 23 loans were classified as substandard compared to 37 at September 30, 2005. The largest loan currently classified as substandard is a $1.4 million commercial business loan on two mini-storage facility operations in Pierce County. At September 30, 2006, this loan was current. The next largest loans classified as substandard include a $666,000 loan secured by a single-family home in King County and a $365,000 loan secured by a single-family home in Thurston County. At September 30, 2006, the $666,000 single-family home loan was 60 days delinquent and the $365,000 single-family home loan was 30 days delinquent.

Allowance for Loan Losses. The allowance for loan losses is maintained to cover estimated losses in the loan portfolio. The Bank has established a comprehensive methodology for the determination of provisions for loan losses that takes into consideration the need for an overall general valuation allowance. The Bank's methodology for assessing the adequacy of its allowance for loan losses is based on its historic loss experience for various loan segments; adjusted for changes in economic conditions, delinquency rates, and

other factors. Using these loss estimate factors, management develops a range of probable loss for each loan category. Certain individual loans for which full collectibility may not be assured are evaluated individually with loss exposure based on estimated discounted cash flows or collateral values. The total estimated range of loss based on these two components of the analysis is compared to the loan loss allowance

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balance. Based on this review, management will adjust the allowance as necessary to maintain directional consistency with trends in the loan portfolio.

In originating loans, the Bank recognizes that losses will be experienced and that the risk of loss will vary with, among other things, the type of loan being made, the creditworthiness of the borrower over the term of the loan, general economic conditions and, in the case of a secured loan, the quality of the security for the loan. The Bank increases its allowance for loan losses by charging provisions for loan losses against the Bank's income.

The Board of Directors reviews the adequacy of the allowance for loan losses at least quarterly based on management's assessment of current economic conditions, past loss and collection experience, and risk characteristics of the loan portfolio.

At September 30, 2006, the Bank's allowance for loan losses totaled $4.1 million. This represents 0.96% of the total loans receivable and 5,152.50% of non-performing loans. The Bank's allowance for loan losses as a percentage of total loans receivable has decreased to 0.96% at September 30, 2006 from 1.11% at September 2002 primarily due to improved historical loss performance (which have translated into lower loss factors assigned to certain loan categories), decreased levels of non-performing loans, and decreased levels of classified loans. Partially offsetting the improved credit quality ratios in recent years, has been a shift in the loan portfolio into a higher percentage of construction and land development loans, which typically involve more risk than one- to four-family loans.

Management believes that the amount maintained in the allowance is adequate to absorb probable losses in the portfolio. Although management believes that it uses the best information available to make its determinations, future adjustments to the allowance for loan losses may be necessary and results of operations could be significantly and adversely affected if circumstances differ substantially from the assumptions used in making the determinations.

While the Bank believes it has established its existing allowance for loan losses in accordance with accounting principles generally accepted in the United States of America, there can be no assurance that regulators, in reviewing the Bank's loan portfolio, will not request the Bank to increase significantly 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 above. Any material increase in the allowance for loan losses may adversely affect the Bank's financial condition and results of operations.

The following table sets forth an analysis of the Bank's allowance for

loan losses for the periods indicated.

	Year Ended September 30,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Allowance at beginning of year......................	$4,099	$3,991	$ 3,891	$ 3,630	$ 3,050
Provision for loan losses...	--	141	167	347	992
Recoveries:					
Mortgage loans:					
One- to four-family.......	--	--	6	--	--
Consumer loans:					
Home equity and second mortgage.................	--	5	--	--	--
Other.....................	5	3	16	12	13
Commercial business loans...	20	9	3	70	96
Total recoveries........	25	17	25	82	109

(table continued on following page)

	Year Ended September 30,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Charge-offs:					
Mortgage loans:					
One- to four-family.......	--	--	6	30	16
Multi-family..............	--	1	--	--	--
Consumer....................	--	--	--	--	32
Commercial business loans...	--	--	3	--	--
Land........................	--	1	--	10	--
Consumer loans:					
Home equity and second mortgage.................	--	--	9	40	--
Other.....................	2	12	68	88	143
Commercial business loans...	--	36	6	--	330
Total charge-offs.........	2	50	92	168	521
Net charge-offs (recoveries)............	(23)	33	67	86	412
Balance at end of year..	$4,122	$4,099	$3,991	$3,891	$3,630

Allowance for loan losses
as a percentage of

total loans receivable (net)(1) outstanding at the end of the year.....	0.96%	1.05%	1.14%	1.19%	1.11%
Net charge-offs (recoveries) as a percentage of average loans outstanding during the year..................	(0.01%)	0.01%	0.02%	0.03%	0.13%
Allowance for loan losses as a percentage of non-performing loans at end of year................	5,152.50%	140.09%	276.77%	99.90%	97.03%

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(1) Total loans receivable (net) includes loans held for sale and is before the allowance for loan losses.

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The following table sets forth the allocation of the allowance for loan losses by loan categ dates indicated.

	At September 30,								
	2006		2005		2004		2003		
	Amount	Percent of Loans in Category to Total Loans	Amount	Percent of Loans in Category to Total Loans	Amount	Percent of Loans in Category to Total Loans	Amount	Percent of Loans in Category to Total Loans	Amount
	(Dollars in thousands)								
Mortgage loans:									
One- to four-family.......	$ 502	20.11%	$ 494	23.24%	$ 386	25.25%	$ 317	26.21%	$ 32
Multi-family..	112	3.60	194	4.61	242	4.34	374	5.01	21
Commercial....	1,222	28.04	1,544	28.51	1,443	27.39	1,041	28.30	1,07
Construction..	761	29.92	652	25.68	538	26.88	583	25.87	53
Land..........	275	6.03	255	5.71	226	5.03	169	4.30	15
Non-mortgage loans:									
Consumer loans........	497	9.90	255	9.51	427	8.30	458	7.71	51
Commercial business loans........	753	2.40	705	2.74	729	2.81	949	2.60	82
Total allowance for loan losses......	$4,122	100.00%	$4,099	100.00%	$3,991	100.00%	$3,891	100.00%	$3,63

Investment Activities

The investment policies of the Company are established and monitored by the Board of Directors. The policies are designed primarily to provide and maintain liquidity, to generate a favorable return on investments without incurring undue interest rate and credit risk, and to compliment the Bank's lending activities. These policies dictate the criteria for classifying securities as either available-for-sale or held-to-maturity. The policies permit investment in various types of liquid assets permissible under applicable regulations, which includes U.S. Treasury obligations, securities of various federal agencies, certain certificates of deposit of insured banks, banker's acceptances, federal funds, mortgage-backed securities, and mutual funds. The Company's investment policy also permits investment in equity securities in certain financial service companies.

At September 30, 2006, the Company's investment portfolio totaled $81.5 million, primarily consisting of $32.1 million of mutual funds available for sale, $17.6 million of mortgage-backed securities available-for-sale, $31.7 million of U.S. agency securities available-for-sale, and $75,000 of securities held-to-maturity. This compares with a total portfolio of $89.7 million at September 30, 2005, comprised of $32.2 million of mutual funds available-for-sale, $23.7 million of mortgage-backed securities available-for-sale, $33.7 million of U.S. agency securities available-for-sale and $104,000 of securities held-to-maturity. The mutual funds invest primarily in mortgage-backed products and U.S. agency securities. The composition of the portfolios by type of security, at each respective date is presented in the table, which follows.

	At September 30,					
	2006		2005		2004	
	Recorded Value	Percent of Total	Recorded Value	Percent of Total	Recorded Value	Percent of Total
	(Dollars in thousands)					
Held-to-Maturity:						
Mortgage-backed securities.........	$ 75	0.09%	$ 104	0.12%	$ 174	0.29%
Available-for-Sale (at fair value):						
U.S. agency securities........	31,718	38.93	33,695	37.56	8,983	14.96
Mortgage-backed securities........	17,603	21.60	23,735	26.46	18,329	30.52
Municipal bonds....	--	--	--	--	--	--
Mutual funds.......	32,087	39.38	32,165	35.86	32,577	54.23
Total portfolio.....	$81,483	100.00%	$89,699	100.00%	$60,063	100.00%

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The following table sets forth the maturities and weighted average yields of the investment and mortgage-backed securities in the Company's investment securities portfolio at September 30, 2006. Mutual funds, which by their nature do not have maturities, are classified in the less than one year category.

	One Year or Less		After One to Five Years		After Five to Ten Years		After Year
	Amount	Yield	Amount	Yield	Amount	Yield	Amount
	(Dollars in thousands)						
Held-to-Maturity:							
Mortgage-backed securities............	$ --	--%	$ --	--%	$ --	--%	$ 75
Available-for-Sale:							
U.S. agency securities..	5,964	3.43	23,787	4.12	1,968	4.04	--
Mortgage-backed securities............	--	--	520	5.67	128	5.89	16,954
Mutual funds...........	32,087	5.16	--	--	--	--	--
Total portfolio........	$38,051	4.89%	$24,307	4.15%	$2,096	4.15%	$17,029

The following table sets forth certain information with respect to each security which had an aggregate book value in excess of 10% of the Company's total equity at the date indicated.

	At September 30, 2006	
	Amortized Cost	Fair Value
	(In thousands)	
Asset Management Fund-Ultra Short Mortgage Fund (ASARX).................	$16,600	$16,195
Asset Management Fund-Ultra Short Fund (AULTX)..............................	10,000	9,779
Total................................	$26,600	$25,974

Deposit Activities and Other Sources of Funds

General. Deposits and loan repayments are the major sources of the Bank's funds for lending and other investment purposes. Scheduled loan repayments are a relatively stable source of funds, while deposit inflows and outflows and loan prepayments are influenced significantly by general interest rates and money market conditions. Borrowings through the FHLB-Seattle may be used to compensate for reductions in the availability of funds from other sources.

Deposit Accounts. Substantially all of the Bank's depositors are residents of Washington. Deposits are attracted from within the Bank's market area through the offering of a broad selection of deposit instruments, including money market deposit accounts, checking accounts, regular savings accounts and certificates of deposit. Deposit account terms vary, according to the minimum balance required, the time periods the funds must remain on deposit and the interest rate, among other factors. In determining the terms of its deposit accounts, the Bank considers current market interest rates, profitability to the Bank, matching deposit and loan products and its customer preferences and concerns. In recent periods, the Bank has used deposit interest rate promotions in connection with the opening of new branch offices. The Bank actively seeks consumer and commercial checking accounts through a checking account acquisition marketing program that was implemented in 2000. At September 30, 2006, the Bank had 34.2% of total deposits in non-interest bearing accounts and NOW checking accounts.

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At September 30, 2006 the Bank had $52.9 million of jumbo certificates of deposit of $100,000 or more. The Bank does not have any brokered deposits and believes that its jumbo certificates of deposit, which represented 12.3% of total deposits at September 30, 2006, present similar interest rate risk compared to its other deposit products.

The following table sets forth information concerning the Bank's deposits at September 30, 2006.

Category	Weighted Average Interest Rate	Amount	Percentage of Total Deposits
		(In thousands)	
Non-Interest Bearing....................	--%	$ 57,905	13.43%
Negotiable order of withdrawal ("NOW") Checking..............................	0.69	89,509	20.77
Savings................................	0.71	60,235	13.97
Money Market Accounts..................	2.11	42,378	9.83
Subtotal..............................	0.79	250,027	58.00
Certificates of Deposit(1)			
Maturing within 1 year.................	4.23	153,939	35.71
Maturing after 1 year but within 2 years................................	3.91	20,037	4.65
Maturing after 2 years but within 5 years................................	3.92	7,010	1.63

Maturing after 5 years.................	3.85	48	0.01
Total certificates of deposit.........	4.19	181,034	42.00
Total deposits.....................	2.24	$431,061	100.00%

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(1) Based on remaining maturity of certificates.

The following table indicates the amount of the Bank's jumbo certificates of deposit by time remaining until maturity as of September 30, 2006. Jumbo certificates of deposit have principal balances of $100,000 or more and the rates paid on these accounts are generally negotiable.

Maturity Period	Amount
	(In thousands)
Three months or less................	$17,871
Over three through six months.......	15,436
Over six through twelve months......	14,142
Over twelve months.................	5,402
Total............................	$52,851

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Deposit Flow. The following table sets forth the balances of deposits in the various types o offered by the Bank at the dates indicated.

	At September 30,						
	2006			2005			2
	Amount	Percent of Total	Increase (Decrease)	Amount	Percent of Total	Increase (Decrease)	Amount
	(Dollars in thousands)						
Non-interest-bearing...	$ 57,905	13.43%	$ 6,114	$ 51,791	12.58%	$14,641	$ 37,15
NOW checking...........	89,509	20.77	(3,969)	93,478	22.71	16,236	77,24
Savings accounts.......	60,235	13.97	(4,039)	64,274	15.61	16,074	48,20
Money market deposit...	42,378	9.83	(6,917)	49,295	11.98	7,643	41,65
Certificates of deposit which mature:							
Within 1 year........	153,939	35.71	49,776	104,163	25.30	17,736	86,42
After 1 year, but within 2 years......	20,037	4.65	(10,732)	30,769	7.47	12,711	18,05
After 2 years, but within 5 years......	7,010	1.63	(10,735)	17,745	4.31	7,582	10,16
Certificates maturing thereafter..........	48	0.01	(102)	150	0.04	(528)	67
Total.................	$431,061	100.00%	$19,396	$411,665	100.00%	$92,095	$319,57

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Certificates of Deposit by Rates. The following table sets forth the certificates of deposit in the Bank classified by rates as of the dates indicated.

	At September 30,		
	2006	2005	2004
	(In thousands)		
0.00 - 1.99%.........	$ 2,176	$ 24,765	$ 60,258
2.00 - 3.99%.........	69,736	125,541	46,482
4.00 - 5.99%.........	108,636	2,034	7,890
6.00% - and over.....	486	487	696
Total................	$181,034	$152,827	$115,326

Certificates of Deposit by Maturities. The following table sets forth the amount and maturities of certificates of deposit at September 30, 2006.

	Amount Due				
	Less Than One Year	One to Two Years	After Two to Five Years	After Five Years	Total
	(In thousands)				
0.00 - 1.99%...........	$ 2,023	$ 85	$ 68	$--	$ 2,176
2.00 - 3.99%...........	53,555	11,373	4,760	48	69,736
4.00 - 5.99%...........	98,302	8,520	1,814	--	108,636
6.00% and over.........	59	59	368	--	486
Total..................	$153,939	$20,037	$7,010	$48	$181,034

Deposit Activities. The following table sets forth the savings activities of the Bank for the periods indicated.

	Year Ended September 30,		
	2006	2005	2004
	(In thousands)		
Beginning balance......................	$411,665	$319,570	$307,672
Net deposits before interest credited...	11,491	86,673	7,730
Interest credited......................	7,905	5,422	4,168
Net increase in deposits...............	19,396	92,095	11,898

Ending balance.........................	$431,061	$411,665	$319,570

Borrowings. Deposits are the primary source of funds for the Bank's lending and investment activities and for general business purposes. The Bank has the ability to use advances from the FHLB-Seattle to supplement its supply of lendable funds and to meet deposit withdrawal requirements. The FHLB-Seattle functions as a central reserve bank providing credit for member financial institutions. As a member of the FHLB-Seattle, the Bank is required to own capital stock in the FHLB-Seattle and is authorized to apply for advances on the security of such stock and certain mortgage loans and other assets (principally securities which are obligations of, or guaranteed by, the United States government) provided certain creditworthiness standards have been met. Advances are made pursuant to several different credit programs. Each credit program has its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based on the financial condition of the member institution and the adequacy of collateral pledged to secure the credit. At September 30, 2006, the Bank maintained an uncommitted credit facility with the FHLB-adequacy of collateral pledged to secure the credit. At September 30, 2006, the Bank maintained an uncommitted credit facility with the FHLB-Seattle that provided for immediately available advances up to an aggregate amount of 30% of the Bank's total assets, limited by available collateral, under which $62.8 million was outstanding. The Bank also utilizes overnight repurchase

agreements with customers. These overnight repurchase agreements are classified as other borrowings and totaled $947,000 at September 30, 2006 and $781,000 at September 30, 2005. There were no repurchase agreements in effect at September 30, 2004. At September 30, 2006, the Bank also maintained a $10.0 million overnight borrowing line with Pacific Coast Banker's Bank ("PCBB") under which there was no outstanding balance.

The following table sets forth certain information regarding borrowings by the Bank at the end of and during the periods indicated:

	At or For the Year Ended September 30,		
	2006	2005	2004
	(Dollars in thousands)		
Average total borrowings......................	$55,773	$60,537	$57,778
Weighted average rate paid on total borrowings..	5.22%	5.26%	5.46%
Total borrowings outstanding at end of period...	$63,708	$63,134	$65,421

The following table sets forth certain information regarding short-term borrowings by the Bank at the end of and during the periods indicated. Borrowings are considered short-term when the original maturity is less than one year.

At or For the Year Ended September 30,

	2006	2005	2004
	(Dollars in thousands)		
Maximum amount outstanding at any month end:			
FHLB advances	$29,000	$ 9,000	$10,485
Repurchase agreements	1,895	2,102	--
PCBB advances	--	--	--
Average outstanding during period:			
FHLB advances	$ 3,516	$ 4,529	$ 631
Repurchase agreements	1,148	1,345	--
PCBB advances	--	1	2
Total average outstanding during period	$ 4,664	$ 5,875	$ 633
Weighted average rate paid during period:			
FHLB advances	4.81%	4.53%	1.89%
Repurchase agreements	4.27	2.30	--
PCBB advances	--	4.80	3.35
Total weighted average rate paid during period	4.67%	4.02%	1.90%
Outstanding at end of period:			
FHLB advances	$29,000	$ 8,000	$10,485
Repurchase agreements	947	781	--
Total outstanding at end of period	$29,947	$ 8,781	$10,485
Weighted average rate at end of period:			
FHLB advances	5.49%	3.79%	1.86%
Repurchase agreements	5.01	3.14	--
Total weighted average rate at end of period	5.47%	3.73%	1.86%

Bank Owned Life Insurance

The Bank has purchased life insurance policies covering certain officers. These policies are recorded at their cash surrender value, net of any policy premium charged. Increases in cash surrender value, net of policy premiums, and proceeds from death benefits are recorded in non-interest income. At September 30, 2006, the Bank had $12.0 million in bank owned life insurance.

REGULATION OF THE BANK

General

The Bank, as a state-chartered savings bank, is subject to regulation and oversight by the Division and the applicable provisions of Washington law and regulations of the Division adopted thereunder. The Bank also is subject to regulation and examination by the FDIC, which insures the deposits of the Bank to the maximum extent permitted by law, and requirements established by the Federal Reserve. State law and regulations govern the Bank's ability to take deposits and pay interest thereon, to make loans on or invest in residential and other real estate, to make consumer loans, to invest in securities, to offer various banking services to its customers, and to establish branch offices. Under state law, savings banks in Washington also generally have all

of the powers that federal savings banks have under federal laws and regulations. The Bank is subject to periodic examination and reporting requirements by and of the Division.

Federal Deposit Insurance Reform Act of 2005

The Federal Deposit Insurance Reform Act of 2005 ("Reform Act") was signed into law on February 8, 2006 and amended current laws regarding the federal deposit insurance system. The legislation merged the Bank Insurance Fund and the Savings Association Insurance Fund to form the Deposit Insurance Fund, eliminated any disparities in bank and thrift risk-based premium assessments, reduced the administrative burden of maintaining and operating two separate funds and established certain new insurance coverage limits and a mechanism for possible periodic increases. The legislation also gave the FDIC greater discretion to identify the relative risks all institutions present to the Deposit Insurance Fund and set risk-based premiums.

Major provisions in the legislation include:

* merging the Savings Association Insurance Fund and Bank Insurance Fund, which became effective March 31, 2006;

* maintaining basic deposit and municipal account insurance coverage at $100,000 but providing for a new basic insurance coverage for retirement accounts of $250,000. Insurance coverage for basic deposit and retirement accounts could be increased for inflation every five years in $10,000 increments beginning in 2011;

* providing the FDIC with the ability to set the designated reserve ratio within a range of between 1.15% and 1.50%, rather than maintaining 1.25% at all times regardless of prevailing economic conditions;

* providing a one-time assessment credit of $4.7 billion to banks and savings associations in existence on December 31, 1996, which may be used to offset future premiums with certain limitations;

* requiring the payment of dividends of 100% of the amount that the insurance fund exceeds 1.5% of the estimated insured deposits and the payment of 50% of the amount that the insurance fund exceeds 1.35% of the estimated insured deposits (when the reserve is greater than 1.35% but no more than 1.5%); and

* providing for a new risk-based assessment system and allows the FDIC to establish separate risk-based assessment systems for large and small members of the Deposit Insurance Fund.

On November 2, 2006, the FDIC set the designated reserve ratio for the deposit insurance fund at 1.25% of estimated insured deposits, and adopted final regulations to implement the risk-based deposit insurance assessment system mandated by the Reform Act , which is intended to more closely tie each bank's deposit insurance assessments to the risk it poses to the deposit insurance fund. Under the new risk-based assessment system, the FDIC will evaluate each institution's risk based on three primary factors -- supervisory

ratings for all insured institution, financial ratios for most institutions, and long-term debt issuer ratings for large institutions that have them. An institution's assessment rate will depend upon the level of risk it poses to the deposit insurance system as measured by these factors. The new rates for most institutions will vary between 5 and 7 cents for every $100 of domestic insurable deposits.

The new assessment rates will take effect at the beginning of 2007. However, the Reform Act provides credits to institutions that paid high premiums in the past to bolster the FDIC's insurance reserves, as a result of which the FDIC has announced that a majority of banks will have assessment credits to initially offset all of their premiums in 2007. Management does not believe it is possible at this time to reliably estimate the net assessment cost, if any that may be imposed on Timberland Bank. There are a number of uncertain factors that could affect the assessment rate that the FDIC will decide to apply to Timberland Bank and the actual assessment credit that will be available to Timberland Bank in 2007.

Insurance of Accounts and Regulation by the FDIC

The Bank is a member of the DIF, which is administered by the FDIC. The FDIC insures deposits up to the applicable limits and this insurance is backed by the full faith and credit of the United States government. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of and to require reporting by FDIC-insured institutions. It also may prohibit any FDIC-insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious risk to the FDIC. The FDIC also has the authority to initiate enforcement actions against savings institutions, after giving the FDIC an opportunity to take such action, and may terminate the deposit insurance if it determines that the institution has engaged in unsafe or unsound practices or is in an unsafe or unsound condition.

The FDIC's deposit insurance premiums are assessed through a risk-based system under which all insured depository institutions are placed into one of nine categories and assessed insurance premiums based upon their level of capital and supervisory evaluation. Under the system, institutions classified as well capitalized (i.e., a core capital ratio of at least 5%, a ratio of Tier 1 or core capital to risk-weighted assets ("Tier 1 risk-based capital") of at least 6% and a risk-based capital ratio of at least 10%) and considered healthy pay the lowest premiums while institutions that are less than adequately capitalized (i.e., core or Tier 1 risk-based capital ratios of less than 4% or a risk-based capital ratio of less than 8%) and considered of substantial supervisory concern pay the highest premiums. Risk classification of all insured institutions is made by the FDIC for each semi-annual assessment period. The Reform Act authorizes the FDIC to revise its current risk-based system, subject to public notice and comment, although no deadline was given by Congress for the creation or implementation of such regulations.

DIF-insured institutions are required to pay a Financing Corporation ("FICO") assessment, in order to fund the interest on bonds issued to resolve thrift failures in the 1980s. The assessment rate for the third quarter of 2006 was 0.0126% of insured deposits and is adjusted quarterly. These assessments, which may be revised based upon the level of DIF deposits, will continue until the FICO bonds mature in the years 2017 through 2019.

Prompt Corrective Action

The FDIC is required to take certain supervisory actions against undercapitalized savings institutions, the severity of which depends upon the institution's degree of undercapitalization. Generally, an institution that has a ratio of total capital to risk-weighted assets of less than 8%, a ratio

of Tier I (core) capital to risk-weighted assets of less than 4%, or a ratio of core capital to total assets of less than 4% (3% or less for institutions with the highest examination rating) is considered to be undercapitalized. An institution that has a total risk-based capital ratio less than 6%, a Tier I capital ratio of less than 3% or a leverage ratio that is less than 3% is considered to be significantly undercapitalized and an institution that has a tangible capital to assets ratio equal to or less than 2% is deemed to be critically

undercapitalized. Subject to a narrow exception, the FDIC is required to appoint a receiver or conservator for a savings institution that is critically undercapitalized. FDIC regulations also require that a capital restoration plan be filed with the FDIC within 45 days of the date a savings institution receives notice that it is undercapitalized, significantly undercapitalized or critically undercapitalized. Compliance with the plan must be guaranteed by any parent holding company in an amount of up to the lesser of 5% of the institution's assets or the amount which would bring the institution into compliance with all capital standards. In addition, numerous mandatory supervisory actions become immediately applicable to an undercapitalized institution, including, but not limited to, increased monitoring by regulators and restrictions on growth, capital distributions and expansion. The FDIC also could take any one of a number of discretionary supervisory actions, including the issuance of a capital directive and the replacement of senior executive officers and directors.

At September 30, 2006, the Bank was categorized as "well capitalized" under the prompt corrective action regulations of the FDIC.

Standards for Safety and Soundness

The federal banking regulatory agencies have prescribed, by regulation, guidelines for all insured depository institutions relating to: internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, asset quality, earnings, and compensation, fees and benefits. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. If the FDIC determines that the Bank fails to meet any standard prescribed by the guidelines, the agency may require the Bank to submit to the agency an acceptable plan to achieve compliance with the standard. FDIC regulations establish deadlines for the submission and review of such safety and soundness compliance plans. Management of the Bank is not aware of any conditions relating to these safety and soundness standards which would require submission of a plan of compliance.

Capital Requirements

FDIC regulations recognize two types or tiers of capital: core ("Tier 1") capital and supplementary ("Tier 2") capital. Tier 1 capital generally includes common shareholders' equity and noncumulative perpetual preferred stock, less most intangible assets. Tier 2 capital, which is limited to 100% of Tier 1 capital, includes such items as qualifying general loan loss reserves, cumulative perpetual preferred stock, mandatory convertible debt, term subordinated debt and limited life preferred stock; however, the amount of term subordinated debt and intermediate term preferred stock (original maturity of at least five years but less than 20 years) that may be included

in Tier 2 capital is limited to 50% of Tier 1 capital.

The FDIC currently measures an institution's capital using a leverage limit together with certain risk-based ratios. The FDIC's minimum leverage capital requirement specifies a minimum ratio of Tier 1 capital to average total assets. Most banks are required to maintain a minimum leverage ratio of at least 4% to 5% of total assets. At September 30, 2006, the Bank had a Tier 1 leverage capital ratio of 11.5%. The FDIC retains the right to require an institution to maintain a higher capital level based on the institution's particular risk profile.

FDIC regulations also establish a measure of capital adequacy based on ratios of qualifying capital to risk-weighted assets. Assets are placed in one of four categories and given a percentage weight based on the relative risk of that category. In addition, certain off-balance-sheet items are converted to balance-sheet credit equivalent amounts, and each amount is then assigned to one of the four categories. Under the guidelines, the ratio of total capital (Tier 1 capital plus Tier 2 capital) to risk-weighted assets must be at least 8%, and the ratio of Tier 1 capital to risk-weighted assets must be at least 4%. In evaluating the adequacy of a bank's capital, the FDIC may also consider other factors that may affect a bank's financial condition. Such factors may include interest rate risk exposure, liquidity, funding and market risks, the quality and level of earnings, concentration of credit risk, risks arising from nontraditional activities, loan and investment quality, the effectiveness of loan and investment policies, and management's ability to monitor and control financial operating risks. At September 30, 2006, the Bank's ratio of total capital to risk-weighted assets was 15.6% and the ratio of Tier 1 capital to risk-weighted assets was 14.6%.

The Division requires that net worth equal at least 5% of total assets. Intangible assets must be deducted from net worth and assets when computing compliance with this requirement. At September 30, 2006, the Bank had a net worth of 11.0% of total assets.

The table below sets forth the Bank's capital position relative to its FDIC capital requirements at September 30, 2006. The definitions of the terms used in the table are those provided in the capital regulations issued by the FDIC, and the Bank has not been notified by the FDIC of any higher capital requirements specifically applicable to it.

	At September 30, 2006	
	Amount	Percent of Adjusted Total Assets (1)
	(Dollars in thousands)	
Tier 1 (leverage) capital (2)	$63,222	11.5%
Tier 1 (leverage) capital requirement	22,017	4.0
Excess	$41,205	7.5%
Tier 1 risk adjusted capital	$63,222	14.6%
Tier 1 risk adjusted capital requirement	17,314	4.0

Excess	$45,908	10.6%
Total risk-based capital	$67,344	15.6%
Total risk-based capital requirement	34,627	8.0
Excess	$32,717	7.6%

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(1) For the Tier 1 (leverage) capital and Washington regulatory capital calculations, percent of total average assets of $550.4 million. For the Tier 1 risk-based capital and total risk-based capital calculations, percent of total risk-weighted assets of $432.8 million.

(2) As a Washington-chartered savings bank, the Bank is subject to the capital requirements of the FDIC and the Division. The FDIC requires state-chartered savings banks, including the Bank, to have a minimum leverage ratio of Tier 1 capital to total assets of at least 3%, provided, however, that all institutions, other than those (i) receiving the highest rating during the examination process and (ii) not anticipating any significant growth, are required to maintain a ratio of 1% to 2% above the stated minimum, with an absolute total capital to risk-weighted assets of at least 8%. The Bank has not been notified by the FDIC of any leverage capital requirement specifically applicable to it.

The Bank's management believes that, under the current regulations, the Bank will continue to meet its minimum capital requirements in the foreseeable future. However, events beyond the control of the Bank, such as a downturn in the economy in areas where the Bank has most of its loans, could adversely affect future earnings and, consequently, the ability of the Bank to meet its capital requirements.

Activities and Investments of Insured State-Financial Institutions

Federal law generally limits the activities and equity investments of FDIC-insured, state-chartered banks to those that are permissible for national banks. An insured state bank is not prohibited from, among other things, (i) acquiring or retaining a majority interest in a subsidiary, (ii) investing as a limited partner in a partnership the sole purpose of which is direct or indirect investment in the acquisition, rehabilitation or new construction of a qualified housing project, provided that such limited partnership investments may not exceed 2% of the bank's total assets, (iii) acquiring up to 10% of the voting stock of a company that solely provides or reinsures directors', trustees' and officers' liability insurance coverage or bankers' blanket bond group insurance coverage for insured depository institutions, and (iv) acquiring or retaining the voting shares of a depository institution if certain requirements are met.

Washington law provides financial institution parity between commercial banks and savings banks. Primarily, the law affords Washington-chartered commercial banks the same powers as Washington-chartered savings banks. In order for a bank to exercise these powers, it must provide 30 days notice to the Director of Washington Division of Financial Institutions and the Director must authorize the requested activity. In addition, the law provides that Washington-chartered commercial banks may exercise any of the powers that the

Federal Reserve has determined to be closely related to the business of banking and the powers of national banks, subject to the approval of the Director in certain situations. The law also provides that Washington-chartered savings banks may exercise any of the powers of Washington-chartered commercial banks, national banks and federally-chartered savings banks, subject to the approval of the Director in certain situations. Finally, the law provides additional flexibility for Washington-chartered commercial and savings banks with respect to interest rates on loans and other extensions of credit. Specifically, they may charge the maximum interest rate allowable for loans and other extensions of credit by federally-chartered financial institutions to Washington residents.

Environmental Issues Associated With Real Estate Lending

The Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), a federal statute, generally imposes strict liability on all prior and present "owners and operators" of hazardous waste sites. However, the U.S. Congress created a safe harbor provision to protect secured creditors by providing that the term "owner and operator" excludes a person whose ownership is limited to protecting its security interest in the site. Since the enactment of the CERCLA, this "secured creditor exemption" has been the subject of judicial interpretations which have left open the possibility that lenders could be liable for cleanup costs on contaminated property that they hold as collateral for a loan.

To the extent that legal uncertainty exists in this area, all creditors, including the Bank, that have made loans secured by properties with potential hazardous waste contamination (such as petroleum contamination) could be subject to liability for cleanup costs, which costs often substantially exceed the value of the collateral property.

Federal Reserve System

The Federal Reserve Board requires under Regulation D that all depository institutions, including savings banks, maintain reserves on transaction accounts or non-personal time deposits. These reserves may be in the form of cash or non-interest-bearing deposits with the regional Federal Reserve Bank. Negotiable order of withdrawal accounts and other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are subject to Regulation D reserve requirements, as are any non-personal time deposits at a savings bank. As of September 30, 2006, the Bank's deposit with the Federal Reserve and vault cash exceeded its Regulation D reserve requirements.

Affiliate Transactions

The Company and the Bank are separate and distinct legal entities. Various legal limitations restrict the Bank from lending or otherwise supplying funds to the Company (an "affiliate"), generally limiting such transactions with the affiliate to 10% of the bank's capital and surplus and limiting all such transactions to 20% of the bank's capital and surplus. These transactions, including extensions of credit, sales of securities or assets and provision of services, also must be on terms and conditions consistent with safe and sound banking practices, including credit standards, that are substantially the same or at least as favorable to the bank as those prevailing at the time for transactions with unaffiliated companies.

Federally insured banks are subject, with certain exceptions, to certain restrictions on extensions of credit to their parent holding companies or other affiliates, on investments in the stock or other securities of affiliates and on the taking of such stock or securities as collateral from any borrower. In addition, such banks are prohibited from engaging in certain

tie-in arrangements in connection with any extension of credit or the providing of any property or service.

Community Reinvestment Act

Banks are also subject to the provisions of the Community Reinvestment Act of 1977 ("CRA"), which requires the appropriate federal bank regulatory agency, in connection with its regular examination of a bank, to assess the bank's record in meeting the credit needs of the community serviced by the bank, including low and moderate income neighborhoods. The regulatory agency's assessment of the bank's record is made available to the public. Further, such assessment is required of any bank which has applied, among other things, to establish a new branch office that will accept deposits, relocate an existing office or merge or consolidate with, or acquire the assets or assume the liabilities of, a federally regulated financial institution. The Bank received a "satisfactory" rating during its most recent CRA examination.

Dividends

Dividends from the Bank constitute the major source of funds for dividends which may be paid by the Company. The amount of dividends payable by the Bank to the Company depends upon the Bank's earnings and capital position, and is limited by federal and state laws, regulations and policies. According to Washington law, the Bank may not declare or pay a cash dividend on its capital stock if it would cause its net worth to be reduced below (i) the amount required for liquidation accounts or (ii) the net worth requirements, if any, imposed by the Director of the Division. In addition, dividends on the Bank's capital stock may not be paid in an aggregate amount greater than the aggregate retained earnings of the Bank, without the approval of the Director of the Division.

The amount of dividends actually paid during any one period will be strongly affected by the Bank's management policy of maintaining a strong capital position. Federal law further provides that no insured depository institution may make any capital distribution (which would include a cash dividend) if, after making the distribution, the institution would be "undercapitalized," as defined in the prompt corrective action regulations. Moreover, the federal bank regulatory agencies also have the general authority to limit the dividends paid by insured banks if such payments should be deemed to constitute an unsafe and unsound practice.

Privacy Standards

The Gramm-Leach-Bliley Financial Services Modernization Act of 1999 ("GLBA"), which was enacted in 1999, modernized the financial services industry by establishing a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms and other financial service providers. The Bank is subject to FDIC regulations implementing the privacy protection provisions of the GLBA. These regulations require the Bank to disclose its privacy policy, including identifying with whom it shares "non-public personal information," to customers at the time of establishing the customer relationship and annually thereafter.

Anti-Money Laundering and Customer Identification

Congress enacted the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "USA Patriot Act") on October 26, 2001 in response to the terrorist events of September 11, 2001. The USA Patriot Act gives the federal government new powers to address terrorist threats through enhanced domestic security measures, expanded surveillance powers, increased information sharing, and broadened anti-money laundering requirements. In March 2006, Congress re-enacted certain expiring provisions of the USA Patriot Act.

REGULATION OF THE COMPANY

General

The Company, as the sole shareholder of the Bank is a bank holding company and is registered as such with the Federal Reserve. Bank holding companies are subject to comprehensive regulation by the Federal Reserve under the Bank Holding Company Act of 1956, as amended ("BHCA"), and the regulations of the Federal Reserve. As a bank

holding company, the Company is required to file with the Federal Reserve annual reports and such additional information as the Federal Reserve may require and will be subject to regular examinations by the Federal Reserve. The Federal Reserve also has extensive enforcement authority over bank holding companies, including, among other things, the ability to assess civil money penalties, to issue cease and desist or removal orders and to require that a holding company divest subsidiaries (including its bank subsidiaries). In general, enforcement actions may be initiated for violations of law and regulations and unsafe or unsound practices.

The Bank Holding Company Act

Under the Bank Holding Company Act, the Company is supervised by the Federal Reserve. The Federal Reserve has a policy that a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, the Federal Reserve provides that bank holding companies should serve as a source of strength to its subsidiary banks by being prepared to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity, and should maintain the financial flexibility and capital raising capacity to obtain additional resources for assisting its subsidiary banks. A bank holding company's failure to meet its obligation to serve as a source of strength to its subsidiary banks will generally be considered by the Federal Reserve to be an unsafe and unsound banking practice or a violation of the Federal Reserve's regulations or both.

The Company is required to file quarterly and periodic reports with the Federal Reserve and provide additional information as the Federal Reserve may require. The Federal Reserve may examine the Company, and any of its subsidiaries, and charge the Company for the cost of the examination.

The Company and any subsidiaries that it may control are considered "affiliates" within the meaning of the Federal Reserve Act, and transactions between our bank subsidiary and affiliates are subject to numerous

restrictions. With some exceptions, the Company and its subsidiaries, are prohibited from tying the provision of various services, such as extensions of credit, to other services offered by the Company, or its affiliates.

Acquisitions

The BHCA prohibits a bank holding company, with certain exceptions, from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company that is not a bank or bank holding company and from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or providing services for its subsidiaries. Under the BHCA, the Federal Reserve is authorized to approve the ownership of shares by a bank holding company in any company, the activities of which the Federal Reserve has determined to be so closely related to the business of banking or managing or controlling banks as to be a proper incident thereto. The list of activities determined by regulation to be closely related to banking within the meaning of the BHCA includes, among other things: operating a savings institution, mortgage company, finance company, credit card company or factoring company; performing certain data processing operations; providing certain investment and financial advice; underwriting and acting as an insurance agent for certain types of credit-related insurance; leasing property on a full-payout, non-operating basis; selling money orders, travelers' checks and U.S. Savings Bonds; real estate and personal property appraising; providing tax planning and preparation services; and, subject to certain limitations, providing securities brokerage services for customers.

Interstate Banking

The Federal Reserve must approve an application of an adequately capitalized and adequately managed bank holding company to acquire control of, or acquire all or substantially all of the assets of, a bank located in a state other than such holding company's home state, without regard to whether the transaction is prohibited by the laws of any state. The Federal Reserve may not approve the acquisition of a bank that has not been in existence for the minimum time period, not exceeding five years, specified by the statutory law of the host state. Nor may the Federal Reserve approve an application if the applicant, and its depository institution affiliates, controls or would control more than 10% of the insured deposits in the United States or 30% or more of the deposits in the target bank's home state or in any state in

which the target bank maintains a branch. Federal law does not affect the authority of states to limit the percentage of total insured deposits in the state which may be held or controlled by a bank holding company to the extent such limitation does not discriminate against out-of-state banks or bank holding companies. Individual states may also waive the 30% state-wide concentration limit contained in the federal law.

The Federal banking agencies are authorized to approve interstate merger transactions without regard to whether such transaction is prohibited by the law of any state, unless the home state of one of the banks adopted a law prior to June 1, 1997 which applies equally to all out-of-state banks and expressly prohibits merger transactions involving out-of-state banks. Interstate acquisitions of branches will be permitted only if the law of the state in which the branch is located permits such acquisitions. Interstate mergers and branch acquisitions will also be subject to the nationwide and

statewide insured deposit concentration amounts described above.

Dividends

The Federal Reserve has issued a policy statement on the payment of cash dividends by bank holding companies, which expresses the Federal Reserve's view that a bank holding company should pay cash dividends only to the extent that the company's net income for the past year is sufficient to cover both the cash dividends and a rate of earning retention that is consistent with the company's capital needs, asset quality and overall financial condition. The Federal Reserve also indicated that it would be inappropriate for a company experiencing serious financial problems to borrow funds to pay dividends.

Stock Repurchases

Bank holding companies, except for certain "well-capitalized" and highly rated bank holding companies, are required to give the Federal Reserve prior written notice of any purchase or redemption of its outstanding equity securities if the gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of their consolidated net worth. The Federal Reserve may disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe or unsound practice or would violate any law, regulation, Federal Reserve order, or any condition imposed by, or written agreement with, the Federal Reserve.

Capital Requirements

The Federal Reserve has established capital adequacy guidelines for bank holding companies that generally parallel the capital requirements of the FDIC for the Bank. The Federal Reserve regulations provide that capital standards will be applied on a consolidated basis in the case of a bank holding company with $150 million or more in total consolidated assets.

The Company's total risk based capital must equal 8% of risk-weighted assets and one half of the 8%, or 4%, must consist of Tier 1 (core) capital. As of September 30, 2006, the Company's total risk based capital was 17.5% of risk-weighted assets and its risk based capital of Tier 1 (core) capital was 16.6% of risk-weighted assets.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act") was signed into law on July 30, 2002 in response to public concerns regarding corporate accountability in connection with certain accounting scandals. The stated goals of the Sarbanes-Oxley Act are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws. The Sarbanes-Oxley Act generally applies to all companies, both U.S. and non-U.S., that file or are required to file periodic reports with the Securities and Exchange Commission ("SEC"), under the Securities Exchange Act of 1934 ("Exchange Act"), including the Company.

The Sarbanes-Oxley Act includes very specific additional disclosure requirements and new corporate governance rules, requires the SEC and

securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules and mandates. The Sarbanes-Oxley Act represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees.

TAXATION

Federal Taxation

General. The Company and the Bank report their income on a fiscal year basis using the accrual method of accounting and are subject to federal income taxation in the same manner as other corporations with some exceptions, including particularly the Bank's reserve for bad debts discussed below. The following discussion of tax matters is intended only as a summary and does not purport to be a comprehensive description of the tax rules applicable to the Bank or the Company.

Bad Debt Reserve. Historically, savings institutions such as the Bank which met certain definitional tests primarily related to their assets and the nature of their business ("qualifying thrift") were permitted to establish a reserve for bad debts and to make annual additions thereto, which may have been deducted in arriving at their taxable income.

The provisions repealing the current thrift bad debt rules were passed by Congress as part of "The Small Business Job Protection Act of 1996." These rules required that all institutions recapture all or a portion of their bad debt reserves added since the base year (last taxable year beginning before January 1, 1988). The Bank had previously recorded deferred taxes equal to the bad debt recapture and as such the new rules had no effect on the net income or federal income tax expense. For taxable years beginning after December 31, 1995, the Bank's bad debt deduction is determined under the experience method using a formula based on actual bad debt experience over a period of years or, if the Bank is a "large" association (assets in excess of $500 million) on the basis of net charge-offs during the taxable year. The unrecaptured base year reserves will not be subject to recapture as long as the institution continues to carry on the business of banking. In addition, the balance of the pre-1988 bad debt reserves continue to be subject to provisions of present law referred to below that require recapture in the case of certain excess distributions to shareholders. As of September 30, 2005, the Bank has recaptured all federal tax bad debt reserves that had been accumulated since October 1, 1988.

Distributions. To the extent that the Bank makes "nondividend distributions" to the Company, such distributions will be considered to result in distributions from the balance of its bad debt reserve as of December 31, 1987 (or a lesser amount if the Bank's loan portfolio decreased since December 31, 1987) and then from the supplemental reserve for losses on loans ("Excess Distributions"), and an amount based on the Excess Distributions will be included in the Bank's taxable income. Nondividend distributions include distributions in excess of the Bank's current and accumulated earnings and profits, distributions in redemption of stock and distributions in partial or complete liquidation. However, dividends paid out of the Bank's current or accumulated earnings and profits, as calculated for federal income tax purposes, will not be considered to result in a distribution from the Bank's bad debt reserve. The amount of additional taxable income created from an Excess Distribution is an amount that, when reduced by the tax attributable to the income, is equal to the amount of the distribution. Thus, if the Bank makes a "nondividend distribution," then approximately one and one-half times the Excess Distribution would be includable in gross income for federal income tax purposes, assuming a 35% corporate income tax rate (exclusive of state and

local taxes). See "Regulation of the Bank - Dividends" for limits on the payment of dividends by the Bank. The Bank does not intend to pay dividends that would result in a recapture of any portion of its tax bad debt reserve.

Corporate Alternative Minimum Tax. The Code imposes a tax on alternative minimum taxable income ("AMTI") at a rate of 20%. In addition, only 90% of AMTI can be offset by net operating loss carryovers. AMTI is increased by an amount equal to 75% of the amount by which the Bank's adjusted current earnings exceeds its AMTI (determined without regard to this preference and prior to reduction for net operating losses).

Dividends-Received Deduction. The Company may exclude from its income 100% of dividends received from the Bank as a member of the same affiliated group of corporations. The corporate dividends-received deduction is generally 70% in the case of dividends received from unaffiliated corporations with which the Company and the Bank will not file a consolidated tax return, except that if the Company or the Bank owns more than 20% of the stock of a corporation distributing a dividend, then 80% of any dividends received may be deducted.

Audits. The Bank's federal income tax returns have been audited through September 30, 1997.

Washington Taxation

The Bank is subject to a business and occupation tax imposed under Washington law at the rate of 1.50% of gross receipts. Interest received on loans secured by mortgages or deeds of trust on residential properties is exempt from such tax.

Competition

The Bank operates in an intensely competitive market for the attraction of deposits (its primary source of lendable funds) and in the origination of loans. Historically, its most direct competition for deposits has come from large commercial banks, thrift institutions and credit unions in its primary market area. In times of high interest rates, the Bank experiences additional significant competition for investors' funds from short-term money market securities and other corporate and government securities. The Bank's competition for loans comes principally from mortgage bankers, commercial banks and other thrift institutions. Such competition for deposits and the origination of loans may limit the Bank's future growth and earnings prospects.

Subsidiary Activities

The Bank has one wholly-owned subsidiary, Timberland Service Corporation ("Timberland Service"), whose primary function is to act as the Bank's escrow department and offer non-deposit investment services.

Personnel

As of September 30, 2006, the Bank had 236 full-time employees and 28 part-time employees. The employees are not represented by a collective bargaining unit and the Bank believes its relationship with its employees is good.

Executive Officers of the Registrant

The following table sets forth certain information with respect to the executive officers of the Company and the Bank.

Executive Officers of the Company and Bank

Name	Age at September 30, 2006	Position: Company	Position: Bank
Clarence E. Hamre	72	Chairman of the Board	Chairman of the Board
Michael R. Sand	52	President and Chief Executive Officer	President and Chief Executive Officer

(table continued on following page)

Name	Age at September 30, 2006	Position: Company	Position: Bank
Dean J. Brydon	39	Executive Vice President, Chief Financial Officer and Secretary	Executive Vice President, Chief Financial Officer and Secretary
Robert A. Drugge	55	Executive Vice President	Executive Vice President and Business Banking Division Manager
Roger A. Johansen	56	Executive Vice President	Executive Vice President and Chief Lending Officer
John P. Norawong	41	Executive Vice President	Executive Vice President and Community Banking Division Manager
Marci A. Basich	37	Senior Vice President and Treasurer	Senior Vice President and Treasurer
Kathie M. Bailey	55	Senior Vice President	Senior Vice President and Chief Operations Officer
Michael J. Rasmusson	60	Senior Vice President	Senior Vice President

Biographical Information.

Clarence E. Hamre is Chairman of the Board of the Company and the Bank.

He has been affiliated with the Bank since 1969 and served as President and Chief Executive Officer of the Bank since 1969 and as President and Chief Executive Officer of the Company since 1997. On January 23, 2003, Mr. Hamre retired as President of the Bank and the Company and on September 30, 2003, he retired as Chief Executive Officer of the Bank and the Company.

Michael R. Sand has been affiliated with the Bank since 1977 and has served as President of the Bank and the Company since January 23, 2003. On September 30, 2003, he was appointed as Chief Executive Officer of the Bank and Company. Prior to appointment as President and Chief Executive Officer, Mr. Sand had served as Executive Vice President and Secretary of the Bank since 1993 and as Executive Vice President and Secretary of the Company since its formation in 1997.

Dean J. Brydon has been affiliated with the Bank since 1994 and has served as the Chief Financial Officer of the Company and the Bank since January 2000 and Secretary of the Company and Bank since January 2004. Mr. Brydon is a Certified Public Accountant.

Robert A. Drugge has been affiliated with the Bank since April 2006 and has served as Executive Vice President and Business Banking Manager since September 2006. Prior to joining Timberland, Mr. Drugge was employed at Bank of America as an executive officer and most recently served as Senior Vice President. Mr. Drugge began his banking career at Seafirst in 1974, which was acquired by Bank America Corp. and became known as Bank of America.

Roger A. Johansen has been affiliated with the Bank since 2000 and has served as Executive Vice President and Chief Lending Officer since September 2006. Prior to being appointed Chief Lending Officer, Mr. Johansen had served as the Bank's Business Banking Manager.

John P. Norawong has been affiliated with the Bank since July 2006 and has served as Executive Vice President and Community Banking Division Manager since September 2006. Prior to joining Timberland, Mr. Norawong served as Senior Vice President and Commercial Bank Manager at United Commercial Bank from February 2006 to July 2006, and as Vice President and Senior Vice President at Key Bank from 1999 through 2006.

Marci A. Basich has been affiliated with the Bank since 1999 and has served as Treasurer of the Company and the Bank since January 2002. Ms. Basich is a Certified Public Accountant.

Kathie M. Bailey has been affiliated with the Bank since 1984 and has served as Senior Vice President and Chief Operations Officer since 2003.

Michael J. Rasmusson has been affiliated with the Bank since 2001 and has served as Senior Vice President since 2003. Prior to his current position as the administrative supervisor of the Bank's data processing and loan servicing departments, Mr. Rasmusson was the Bank's Chief Credit Administrator.

Item 1A. Risk Factors

We assume and manage a certain degree of risk in order to conduct our business strategy. In addition to the risk factors described below, other risks and uncertainties not specifically mentioned, or that are currently

known to, or deemed by, management to be immaterial also may materially and adversely affect our financial position, results of operation and/or cash flows. Before making an investment decision, you should carefully consider the risks described below together with all of the other information included in this Form 10-K. If any of the circumstances described in the following risk factors actually occur to a significant degree, the value of our common stock could decline, and you could lose all or part of your investment.

Fluctuations in interest rates could reduce our profitability and affect the value of our assets.

Like other financial institutions, we are subject to interest rate risk. Our primary source of income is net interest income, which is the difference between interest earned on loans and investment securities and the interest paid on deposits and borrowings. We expect that we will periodically experience imbalances in the interest rate sensitivities of our assets and liabilities and the relationships of various interest rates to each other. Over any period of time, our interest-earning assets may be more sensitive to changes in market interest rates than our interest-bearing liabilities, or vice versa. In addition, the individual market interest rates underlying our loan and deposit products may not change to the same degree over a given time period. In any event, if market interest rates should move contrary to our position, our earnings may be negatively affected. In addition, loan volume and quality and deposit volume and mix can be affected by market interest rates. Changes in levels of market interest rates could materially adversely affect our net interest spread, asset quality, origination volume and overall profitability.

Interest rates have recently been at historically low levels. However, since June 30, 2004, the U.S. Federal Reserve has increased its target for the federal funds rate 17 times, from 1.00% to 5.25%, and the most recent interest rate increase was on June 29, 2006. While these short-term market interest rates have increased the pricing of our loans, it has been partially offset by the rise in our funding costs. In a sustained rising interest rate environment the asset yields may not match rising funding costs, which may negatively impact interest margins. A sustained falling interest rate environment would negatively impact margins.

We manage our assets and liabilities in order to achieve long-term profitability while limiting our exposure to the fluctuation of interest rates. We anticipate periodic imbalances in the interest rate sensitivity of our assets and liabilities and the relationship of various interest rates to each other. At any reporting period, we may have earning assets which are more sensitive to changes in interest rates than interest-bearing liabilities, or vice versa. The fluctuation of market interest rates can materially affect our net interest spread, interest margin, loan originations, deposit volumes and overall profitability. In addition, we may have valuation risk in measuring our interest rate risk position. The valuation risk is attributable to calculation methods (modeling risks) and assumptions used in the model, including loan prepayments and forward interest rates.

For further information on our interest rate risks, see the discussion included in "Item 7A. Quantitative and Qualitative Disclosure About Market Risk" of this Form 10-K.

Our loan portfolio includes increased risk due to changes in category

composition of the portfolio. The percentage of loans secured by first mortgages on one-to four-family residential properties has decreased as the portfolio has shifted into higher-yielding loan categories that typically involve a higher degree of risk.

From September 30, 2002, through September 30, 2006, our total loans have grown by 31.7%. During this period the percentage of one- to four-family loans in the loan portfolio has decreased to 20.1% from 31.3%. Our commercial real estate loans, construction and land development loans, multi-family loans, land loans, commercial business loans, and consumer loans accounted for approximately 79.9% of our total loan portfolio as of September 30, 2006. We consider these types of loans to involve a higher degree of risk compared to first mortgage loans on one- to four-family, owner-occupied residential properties, and therefore, may cause higher future loan losses. Accordingly, as a result of the inherent risks associated with these types of loans, and the unseasoned nature of a portion these loans, it may become necessary to increase the level of our provision for loan losses. An increase in our provision for loan losses would reduce our profits.

For further information concerning the risks associated with multi-family, and commercial real estate loans, construction loans, and consumer loans, see "Item 1. Business - Lending Activities."

We may be required to maintain a higher capital ratio because of our level of commercial real estate loans.

The FDIC, along with the Federal Reserve and the Office of the Comptroller of the Currency, has recently promulgated proposed regulations governing financial institutions with concentrations in commercial real estate lending. The proposed regulations provide that a bank has a concentration in commercial real estate lending if (i) total reported loans for construction, land development, and other land represent 100% or more of total capital or (ii) total reported loans secured by multi-family and non-farm residential properties and loans for construction, land development, and other land represent 300% or more of total capital. If a concentration is present, management must employ heightened risk management practices including board and management oversight and strategic planning, development of underwriting standards, risk assessment and monitoring through market analysis and stress testing, and increasing capital requirements. Based on the Bank's projected commercial real estate lending levels, we may be subject to these regulations should they become effective.

We have increased our construction lending which presents greater risk than one- to four-family and consumer lending.

Construction lending is generally considered to involve a higher level of risk as compared to single-family residential or consumer lending, as a result of the concentration of principal in a limited number of loans and borrowers, and the effects of general economic conditions on developers and builders. Moreover, a construction loan can involve additional risks because of the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost (including interest) of the project. The nature of these loans is such that they are generally more difficult to evaluate and monitor. In addition, speculative construction loans to a builder are often associated with homes that are not pre-sold, and thus pose a greater potential risk to us than construction loans to individuals on their personal residences. Construction loans on land under development or held for future construction also poses additional risk because of the lack of income being produced by the property and the potential illiquid nature of the security.

Our commercial business lending activities involves greater risk than other types of lending.

Our commercial business lending has increased since 2003 and we intend to continue to offer commercial business loans to small and medium sized businesses. Our ability to originate commercial business loans is determined by the demand for these loans and our ability to attract and retain qualified commercial lending personnel. Because payments on commercial business loans generally depend on the successful operation of the business involved, repayment of commercial business loans may be subject to a greater extent to adverse conditions in the economy than

other types of lending. Although commercial business loans often have equipment, inventory, accounts receivable or other business assets as collateral, the sale of the collateral in the event the borrower does not repay the loan is often not sufficient to repay the loan because the collateral may be uncollectible and inventories and equipment may be obsolete or of limited use, among other things. Consequently, there can be no assurance that we will continue to be successful in these efforts.

Our funding sources may prove insufficient to replace deposits and support our future growth.

We rely on customer deposits and advances from the FHLB of Seattle and other borrowings to fund our operations. Although we have historically been able to replace maturing deposits and advances if desired, no assurance can be given that we would be able to replace such funds in the future if our financial condition or the financial condition of the FHLB of Seattle or market conditions were to change. Our financial flexibility will be severely constrained if we are unable to maintain our access to funding or if adequate financing is not available to accommodate future growth at acceptable interest rates. Finally, if we are required to rely more heavily on more expensive funding sources to support future growth, our revenues may not increase proportionately to cover our costs. In this case, our profitability would be adversely affected.

Although we consider such sources of funds adequate for our liquidity needs, we may seek additional debt in the future to achieve our long-term business objectives. There can be no assurance additional borrowings, if sought, would be available to us or, if available, would be on favorable terms. If additional financing sources are unavailable or are not available on reasonable terms, our growth and future prospects could be adversely affected.

If our allowance for loan losses is not sufficient to cover future loan losses, our earnings could decrease.

We make various assumptions and judgments about the collectibility 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 several factors including our loan loss and delinquency experience, underwriting practices, and economic conditions. If our assumptions are incorrect, our allowance for loan losses may not be sufficient to cover future losses in the loan portfolio, resulting in the need for greater additions to our allowance. Material additions to the allowance could materially decrease our net income. Our allowance for loan losses was 0.96% of total loans and 5,152.50% of non-performing loans at September 30, 2006.

In addition, bank regulators periodically review our allowance for loan losses and may require us to increase our provision for loan losses or recognize further loan charge-offs. Any increase in our allowance for loan losses or loan charge-offs as required by these regulatory authorities may have a material adverse effect on our financial condition and results of operations.

Our profitability depends significantly on economic conditions in the State of Washington.

Our success depends primarily on the general economic conditions of the State of Washington and the specific local markets in which we operate. Adverse economic conditions unique to the Washington markets could have a material adverse effect on our financial condition and results of operations. Further, a significant decline in general economic conditions, caused by inflation, recession, unemployment, changes in securities markets or other factors could impact our state and local markets and, in turn, also have a material adverse effect on our financial condition and results of operations. Of particular concern are the rising real estate values, which may prove unsustainable in our current rising interest rate environment and may lead to higher loan losses since the majority of our loans are secured by real estate located within Washington. Similarly, if Washington were to experience significant declines in real estate values, this decline may inhibit our ability to recover on defaulted loans by selling the underlying real estate.

Competition with other financial institutions could adversely affect our profitability.

The banking and financial services industry is very competitive. Legal and regulatory developments have made it easier for new and sometimes unregulated competitors to compete with us. Consolidation among financial service

providers has resulted in fewer very large national and regional banking and financial institutions holding a large accumulation of assets. These institutions generally have significantly greater resources, a wider geographic presence or greater accessibility. Our competitors sometimes are also able to offer more services, more favorable pricing or greater customer convenience than we do. In addition, our competition has grown from new banks and other financial services providers that target our existing or potential customers. As consolidation continues among large banks, we expect additional institutions to try to exploit our market.

Technological developments have allowed competitors including some non-depository institutions, to compete more effectively in local markets and have expanded the range of financial products, services and capital available to our target customers. If we are unable to implement, maintain and use such technologies effectively, we may not be able to offer products or achieve the cost-efficiencies necessary to compete in our industry. In addition, some of these competitors have fewer regulatory constraints and lower cost structures.

The loss of key members of our senior management team could adversely affect our business.

We believe that our success depends largely on the efforts and abilities of our senior management. Their experience and industry contacts

significantly benefit us. The competition for qualified personnel in the financial services industry is intense, and the loss of any of our key personnel or an inability to continue to attract, retain and motivate key personnel could adversely affect our business.

We are subject to extensive government regulation and supervision.

We are subject to extensive federal and state regulation and supervision, primarily through the Bank and certain non-bank subsidiaries. Banking regulations are primarily intended to protect depositors' funds, federal deposit insurance funds and the banking system as a whole, not shareholders. These regulations affect our lending practices, capital structure, investment practices, dividend policy and growth, among other things. Congress and federal regulatory agencies continually review banking laws, regulations and policies for possible changes. Changes to statutes, regulations or regulatory policies, including changes in interpretation or implementation of statutes, regulations or policies, could affect us in substantial and unpredictable ways. Such changes could subject us to additional costs, limit the types of financial services and products we may offer and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on our business, financial condition and results of operations. While we have policies and procedures designed to prevent any such violations, there can be no assurance that such violations will not occur. For further information, see "Item 1. Business - REGULATION OF THE COMPANY."

We rely heavily on the proper functioning of our technology.

We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer relationship management, general ledger, deposit, loan and other systems. While we have policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

We rely on third-party service providers for much of our communications, information, operating and financial control systems technology. If any of our third-party service providers experience financial, operational or technological difficulties, or if there is any other disruption in our relationships with them, we may be required to locate alternative sources of such services, and we cannot assure that we could negotiate terms that are as favorable to us, or could obtain

services with similar functionality, as found in our existing systems, without the need to expend substantial resources, if at all. Any of these circumstances could have an adverse effect on our business.

Terrorist activities could cause reductions in investor confidence and substantial volatility in real estate and securities markets.

It is impossible to predict the extent to which terrorist activities may occur in the United States or other regions, or their effect on a particular security issue. It is also uncertain what effects any past or future terrorist activities and/or any consequent actions on the part of the United States government and others will have on the United States and world financial markets, local, regional and national economics, and real estate markets across the United States. Among other things, reduced investor confidence could result in substantial volatility in securities markets, a decline in general economic conditions and real estate related investments and an increase in loan defaults. Such unexpected losses and events could materially affect our results of operations.

We rely on dividends from subsidiaries for most of our revenue.

The Company is a separate and distinct legal entity from its subsidiaries. We receive substantially all of our revenue from dividends from our subsidiaries. These dividends are the principal source of funds to pay dividends on our common stock and interest and principal on our debt. Various federal and/or state laws and regulations limit the amount of dividends that the Bank may pay to the Company. Also, our right to participate in a distribution of assets upon a subsidiary's liquidation or reorganization is subject to the prior claims of the subsidiary's creditors. In the event the Bank is unable to pay dividends to the Company, we may not be able to service our debt, pay obligations or pay dividends on our common stock. The inability to receive dividends from the Bank could have a material adverse effect on our business, financial condition and results of operations

If we fail to maintain an effective system of internal control over financial reporting, we may not be able to accurately report our financial results or prevent fraud, and, as a result, investors and depositors could lose confidence in our financial reporting, which could adversely affect our business, the trading price of our stock and our ability to attract additional deposits.

In connection with the enactment of the Sarbanes-Oxley Act of 2002 and the implementation of the rules and regulations promulgated by the SEC, we document and evaluate our internal control over financial reporting in order to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act. This requires us to prepare an annual management report on our internal control over financial reporting, including among other matters, management's assessment of the effectiveness of internal control over financial reporting and an attestation report by our independent auditors addressing these assessments. If we fail to identify and correct any significant deficiencies in the design or operating effectiveness of our internal control over financial reporting or fail to prevent fraud, current and potential shareholders and depositors could lose confidence in our internal controls and financial reporting, which could adversely affect our business, financial condition and results of operations, the trading price of our stock and our ability to attract additional deposits.

Changes in accounting standards may affect our performance.

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. From time to time there are changes in the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be difficult to predict and can materially impact how we report and record our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, resulting in

restating prior period financial statements.

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

At September 30, 2006 the Bank operated 21 full service facilities and one loan production office. The following table sets forth certain information regarding the Bank's offices, all of which are owned, except for the Tacoma office, the Gig Harbor office, the Lacey office at 1751 Circle Lane SE, the Centralia loan production office, and the Data Center office at 504 8th Street, which are leased.

Location	Year Opened	Approximate Square Footage	Deposits at September 30, 2006
			(In thousands)
Main Office:			
624 Simpson Avenue Hoquiam, Washington 98550	1966	7,700	$79,482
Branch Offices:			
300 N. Boone Street Aberdeen, Washington 98520	1974	3,400	30,678
201 Main Street South(1)(2) Montesano, Washington 98563	2004	3,200	37,439
361 Damon Road Ocean Shores, Washington 98569	1977	2,100	22,331
2418 Meridian East Edgewood, Washington 98371	1980	2,400	38,551
202 Auburn Way South Auburn, Washington 98002	1994	4,200	17,853
12814 Meridian East (South Hill) Puyallup, Washington 98373	1996	4,200	25,638
1201 Marvin Road, N.E. Lacey, Washington 98516	1997	4,400	12,454
101 Yelm Avenue W. Yelm, Washington 98597	1999	1,800	12,637
20464 Viking Way NW Poulsbo, Washington 98370	1999	3,400	7,236

2419 224th Street E. Spanaway, Washington 98387	1999	3,900	18,588
801 Trosper Road SW Tumwater, Washington 98512	2001	3,300	16,523

(table continued on following page)

Location	Year Opened	Approximate Square Footage	Deposits at September 30, 2006
			(In thousands)
7805 South Hosmer Street Tacoma, Washington 98408	2001	5,000	9,552
2401Bucklin Hill Road Silverdale, Washington 98383	2003	4,000	9,735
423 Washington Street SE Olympia, Washington 98501	2003	3,000	13,993
3105 Judson St Gig Harbor, Washington 98335	2004	2,700	7,289
117 N. Broadway(1) Aberdeen, Washington 98520	2004	3,700	9,219
313 West Waldrip(1) Elma, Washington 98541	2004	5,900	21,415
1751 Circle Lane SE(1) Lacey, Washington 98503	2004	900	10,117
101 2nd Street Toledo, Washington 98591	2004	1,800	17,404
209 NE 1st Street(1) Winlock, Washington 98586	2004	3,400	12,927
Loan Production Office:			
1641 Kresky Avenue, Suite 2 Centralia, Washington 98531	2006	800	
Data Centers:			
422 6th Street Hoquiam, Washington 98550	1990	2,700	
504 8th Street Hoquiam, Washington 98550	2003	5,400	
Loan Center:			
120 Lincoln Street	2003	5,000	

Hoquiam, Washington 98550

(table continued on following page)

Location	Year Opened	Approximate Square Footage	Deposits at September 30, 2006
			(In thousands)
Other Properties:			
305 8th Street(1)(3) Hoquiam, Washington 98550	2004	4,100	
314 Main Street South(2) Montesano, Washington 98563	1975	2,800	

(1) Acquired from Venture Bank on October 9, 2004.
(2) Office at 314 Main Street South, Montesano, Washington was consolidated into the office at 201 Main Street South, Montesano, Washington on November 15, 2004.
(3) Office at 305 8th Street, Hoquiam, Washington was consolidated into the office at 624 Simpson Avenue, Hoquiam, Washington on November 15, 2004.

Management believes that all facilities, except for the Data Center building located at 422 6th Street in Hoquiam are appropriately insured and are adequately equipped for carrying on the business of the Bank. The Data Center building at 422 6th Street in Hoquiam has sustained structural damage and is not currently occupied. A pending claim has been filed with the Bank's previous insurance company.

At September 30, 2006 the Bank operated 22 proprietary ATMs that are part of a nationwide cash exchange network.

Item 3. Legal Proceedings

Periodically, there have been various claims and lawsuits involving the Bank, such as claims to enforce liens, condemnation proceedings on properties in which the Bank holds security interests, claims involving the making and servicing of real property loans and other issues incident to the Bank's business. The Bank is not a party to any pending legal proceedings that it believes would have a material adverse effect on the financial condition or operations of the Bank.

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

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended September 30, 2006.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

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The Company's common stock is traded on the Nasdaq National Market under the symbol "TSBK". As of November 30, 2006, there were 3,725,311 shares of common stock issued and approximately 639 shareholders of record, excluding persons or entities who hold stock in nominee or "street name" accounts with brokers. The following table sets forth the market price range of the Company's common stock for the years ended September 30, 2006 and 2005. This information was provided by the Nasdaq Stock Market.

	High	Low	Dividends
Fiscal 2006			
First Quarter...............	$23.96	$23.04	$0.16
Second Quarter..............	28.20	23.25	0.16
Third Quarter...............	31.60	28.00	0.16
Fourth Quarter..............	39.03	31.22	0.18
Fiscal 2005			
First Quarter...............	$25.00	$22.85	$0.15
Second Quarter..............	24.00	21.85	0.15
Third Quarter...............	23.47	22.02	0.15
Fourth Quarter..............	23.80	22.30	0.16

Dividends

Dividend payments by the Company are dependent primarily on dividends received by the Company from the Bank. Under federal regulations, the dollar amount of dividends the Bank may pay is dependent upon its capital position and recent net income. Generally, if the Bank satisfies its regulatory capital requirements, it may make dividend payments up to the limits prescribed in the FDIC regulations. However, institutions that have converted to a stock form of ownership may not declare or pay a dividend on, or repurchase any of, its common stock if the effect thereof would cause the regulatory capital of the institution to be reduced below the amount required for the liquidation account which was established in connection with the mutual to stock conversion.

Equity Compensation Plan Information

The equity compensation plan information presented under subparagraph (d) in Part III, Item 12. of this Form 10-K is incorporated herein by reference.

Stock Repurchases

The Company has had various buy-back programs since January 1998. On April 7, 2005, the Company announced a plan to repurchase 187,955 shares of the Company's common stock. This marked the Company's 13th stock repurchase plan. As of September 30, 2006, the Company has repurchased 136,450 of these shares at an average price of $31.85 per share. Cumulatively, the Company has repurchased 3,475,721 shares at an average price of $15.97 per share. This represents 52.6% of the 6,612,500 shares that were issued when the Company went public in January 1998.

The following table sets forth the Company's repurchases of its outstanding Common Stock during the fourth quarter of the year ended September 30, 2006.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans
July 1, 2006 - July 31, 2006..................	--	$ --	--	101,905
August 1, 2006 - August 31, 2006.............	31,000	38.87	31,000	70,905
September 1, 2006 - September 30, 2006....	19,400	38.66	19,400	51,505
Total..................	50,400	$38.79	50,400	

Item 6. Selected Financial Data

The following table sets forth certain information concerning the consolidated financial position and results of operations of the Company and subsidiaries at and for the dates indicated. The consolidated data is derived in part from, and should be read in conjunction with, the Consolidated Financial Statements of the Company and its subsidiary presented herein.

	At September 30,				
	2006	2005	2004	2003	2002
	(In thousands)				
SELECTED FINANCIAL CONDITION DATA:					
Total assets................	$577,087	$552,765	$460,419	$449,633	$431,054
Loans receivable and loans held for sale, net.........	424,645	388,109	344,594	322,236	322,528
Investment securities available-for-sale.........	63,805	65,860	41,560	36,933	23,694
Mortgage-backed securities held to maturity...........	75	104	174	279	--
Mortgage-backed securities available-for-sale.........	17,603	23,735	18,329	17,098	17,888
FHLB Stock..................	5,705	5,705	5,682	5,454	5,139
Cash and due from financial					

institutions, interest-bearing deposits in banks and fed funds sold.........	22,889	28,718	19,833	38,098	36,073
Deposits....................	431,061	411,665	319,570	307,672	292,316
FHLB advances...............	62,761	62,353	65,421	61,605	61,759
Shareholders' equity........	79,365	74,642	72,817	77,611	74,396

	Year Ended September 30,				
	2006	2005	2004	2003	2002
	(In thousands, except per share data)				
SELECTED OPERATING DATA:					
Interest and dividend income.....................	$35,452	$30,936	$26,571	$27,345	$29,975
Interest expense............	10,814	8,609	7,325	8,946	10,890
Net interest income.........	24,638	22,327	19,246	18,399	19,085
Provision for loan losses...	--	141	167	347	992
Net interest income after provision for loan losses..	24,638	22,186	19,079	18,052	18,093
Noninterest income..........	6,244	6,073	4,576	6,385	4,946
Noninterest expense.........	18,896	18,536	15,575	14,832	12,716
Income before income taxes..	11,986	9,723	8,080	9,605	10,323
Federal income taxes........	3,829	3,105	2,492	2,966	3,432
Net income..................	$ 8,157	$ 6,618	$ 5,588	$ 6,639	$ 6,891
Earnings per common share:					
Basic.....................	$ 2.32	$ 1.90	$ 1.54	$ 1.74	$ 1.76
Diluted...................	$ 2.24	$ 1.82	$ 1.46	$ 1.66	$ 1.71
Dividends per share.........	$ 0.66	$ 0.61	$ 0.57	$ 0.50	$ 0.45
Dividend payout ratio.......	28.45%	32.11%	37.01%	28.74%	25.57%

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	At September 30,				
	2006	2005	2004	2003	2002
OTHER DATA:					
Number of real estate loans outstanding..................	3,005	3,022	2,857	2,824	2,911
Deposit accounts..............	51,392	51,496	40,348	39,313	36,896
Full-service offices..........	21	21	16	15	13

	At or For the Year Ended September 30,				
	2006	2005	2004	2003	2002
KEY FINANCIAL RATIOS:					
Performance Ratios:					
Return on average assets (1).	1.47%	1.23%	1.24%	1.52%	1.73%
Return on average equity (2).	10.59	9.08	7.52	8.67	9.42
Interest rate spread (3).....	4.49	4.30	4.30	4.02	4.27
Net interest margin (4)......	4.91	4.60	4.67	4.52	4.96

Average interest-earning assets to average interest-bearing liabilities.........	119.20	116.56	120.68	122.74	125.73
Noninterest expense as a percent of average total assets......................	3.41	3.44	3.46	3.39	3.19
Efficiency ratio (5).........	61.19	65.27	65.38	59.85	52.91
Book value per share (6).....	$21.12	$19.85	$18.76	$18.25	$17.14
Book value per share (7).....	22.44	21.30	20.28	19.77	18.69
Tangible book value per share (6)(8)................	19.22	17.86	18.76	18.25	17.14
Tangible book value per share (7)(8)................	20.41	19.16	20.28	19.77	18.69
Asset Quality Ratios:					
Nonaccrual and 90 days or more past due loans as a percent of total loans receivable, net.........................	0.02%	0.75%	0.41%	1.19%	1.15%
Nonperforming assets as a percent of total assets.....	0.02	0.62	0.40	1.15	1.03
Allowance for loan losses as a percent of total loans receivable, net (9).........	0.96	1.05	1.14	1.19	1.11
Allowance for losses as a percent of nonperforming loans......................	5,152.50	140.09	276.77	99.90	97.03
Net charge-offs (recoveries) to average outstanding loans......................	(0.01)	0.01	0.02	0.03	0.13
Capital Ratios:					
Total equity-to-assets ratio......................	13.75	13.50	15.82	17.26	17.26
Tangible equity-to-assets ratio......................	12.51	12.15	15.82	17.26	17.26
Average equity to average assets (10).................	13.90	13.53	16.52	17.49	18.37

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(1) Net income divided by average total assets.
(2) Net income divided by average total equity.
(3) Difference between weighted average yield on interest-earning assets and weighted average cost of interest-bearing liabilities.
(4) Net interest income (before provision for loan losses) as a percentage of average interest-earning assets.
(5) Other expenses (excluding federal income tax expense) divided by the sum of net interest income and noninterest income.
(6) Calculation includes Employee Stock Ownership Plan ("ESOP") shares not committed to be released.
(7) Calculation excludes ESOP shares not committed to be released.
(8) Calculation subtracts goodwill and core deposit intangible from the equity component.
(9) Loans receivable includes loans held for sale and is before the allowance for loan losses.
(10) Average total equity divided by average total assets.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

Management's Discussion and Analysis of Financial Condition and Results of Operations is intended to assist in understanding the consolidated financial condition and results of operations of the Company. The information contained in this section should be read in conjunction with the Consolidated Financial Statements and accompanying notes thereto included in Item 8 of this Annual Report on Form 10-K.

Special Note Regarding Forward-Looking Statements

Management's Discussion and Analysis and Results of Operations and other portions of this Form 10-K contain certain "forward-looking statements" concerning future operations of the Company. Management desires to take advantage of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 and is including this statement for the express purpose of availing the Company of the protections of such safe harbor with respect to all "forward-looking statements" contained in this Annual Report. The Company has used "forward-looking statements" to describe future plans and strategies, including its expectations of the Company's future financial results. Management's ability to predict results or the effect of future plans or strategies is inherently uncertain. Factors which could affect actual results include interest rate trends, the general economic climate in the Company's market area and the country as a whole, the ability of the Company to control expenses, deposit flows, demand for mortgages and other loans, real estate values, vacancy rates, competition, loan delinquency rates, and changes in federal and state regulation. These factors should be considered in evaluating the "forward-looking statements," and undue reliance should not be placed on such statements. The Company does not undertake to update any "forward-looking statement" that may be made on behalf of the Company.

Critical Accounting Policies

The Company has established various accounting policies that govern the application of accounting principles generally accepted in the United States of America ("GAAP") in the preparation of the Company's Consolidated Financial Statements. The Company has identified two 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. These policies relate to the methodology for the determination of the allowance for loan losses and the valuation of mortgage servicing rights ("MSRs"). These policies and the judgments, estimates and assumptions are described in greater detail in subsequent sections of Management's Discussion and Analysis contained herein and in the notes to the Consolidated Financial Statements contained in Item 8 of this Form 10-K. In particular, Note 1 of the Notes to Consolidated Financial Statements, "Summary of Significant Accounting Policies," generally describes the Company's accounting policies. Management believes that the judgments, estimates and assumptions used in the preparation of the Company's Consolidated Financial Statements are appropriate given the factual circumstances at the time. However, given the sensitivity of the Company's Consolidated Financial Statements to these critical policies, the use of other judgments, estimates and assumptions could result in material differences in the Company's results of operations or financial condition.

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 loan loss experience, current economic conditions, and detailed analysis of individual loans for which full collectibility may not be assured. The detailed analysis includes methods to estimate the fair value of loan collateral and the existence of potential alternative sources of repayment. The appropriate allowance for loan loss level is estimated based upon factors and trends identified by management at the time the consolidated financial statements are prepared.

Mortgage Servicing Rights. Mortgage servicing rights 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 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.

New Accounting Pronouncements

For a discussion of new accounting pronouncements and their impact on the Company, see Note 1 of the Notes to the Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

Operating Strategy

The Company is a holding company which operates primarily through its subsidiary, the Bank. The Bank is a community-oriented bank which has traditionally offered a wide variety of savings products to its retail customers while concentrating its lending activities on real estate loans. The primary elements of the Bank's operating strategy include:

Emphasize Residential Mortgage Lending and Residential Construction Lending. The Bank has historically attempted to establish itself as a niche lender in its primary market areas by focusing a part of its lending activities on the origination of loans secured by one- to four-family residential dwellings, including an emphasis on loans for the construction of residential dwellings. In an effort to meet the credit needs of borrowers in its primary areas, the Bank actively originates one- to four-family mortgage loans that do not qualify for sale in the secondary market under FHLMC

guidelines. The Bank has also been an active participant in the secondary market, originating residential loans for sale to the FHLMC on a servicing retained basis. The Bank occasionally retains fixed-rate one- to four-family mortgage loans in its portfolio for yield and asset-liability management purposes.

Diversify Primary Market Area by Expanding Branch Office Network. In an effort to lessen its dependence on the Grays Harbor County market whose economy has historically been tied to the timber and fishing industries, the Bank has opened branch offices in Pierce, King, Thurston and Kitsap Counties. Pierce, King, Thurston and Kitsap Counties contain the Olympia, Bremerton, and Seattle-Tacoma metropolitan areas and their economies are more diversified with the presence of government, aerospace and computer technology industries. In October 2004, the Bank continued its geographic diversification by acquiring two branches in Lewis County as part of a seven-branch acquisition.

Limit Exposure to Interest Rate Risk. In recent years, a majority of the loans that the Bank has retained in its portfolio generally have periodic interest rate adjustment features or have b en relatively short-term in nature. Loans originated for portfolio retention primarily have included ARM loans and short-term construction loans. Longer term fixed-rate mortgage loans have generally been originated for sale in the secondary market. Management believes that the interest rate sensitivity of these adjustable-rate and short-term loans more closely match the interest rate sensitivity of the Bank's funding sources than other longer duration assets with fixed-interest rates.

Emphasize the Origination of Commercial Real Estate and Commercial Business Loans. The Bank established a business banking division in 1998 for the purpose of increasing the Bank's origination of commercial real estate and commercial business loans. Originally, three lenders were hired to staff the division. Currently, a Division Manager and seven lenders are active in the origination of commercial real estate and commercial business loans.

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Increase the Consumer Loan Portfolio. In 2001 the Bank hired a consumer loan specialist to increase the origination of consumer loans. The consumer loans generated since that time have been secured primarily by real estate. The Bank expects to continue expanding its portfolio of consumer loans.

Pursue Low Cost Core Deposits and Deposit Related Fee Income. The Bank has placed an emphasis on attracting commercial and personal checking accounts. These transactional accounts typically provide a lower cost of funding than certificates of deposit accounts and generate non-interest fee income. The Bank implemented a checking account acquisition program in 2000 to increase these transactional accounts. On October 9, 2004, the Bank increased its transaction account base by acquiring seven branches and the related deposits.

Market Risk and Asset and Liability Management

General. Market risk is the risk of loss from adverse changes in market prices and rates. The Company's market risk arises primarily from interest rate risk inherent in its lending, investment, deposit and borrowing activities. The Bank, like other financial institutions, is subject to interest rate risk to the extent that its interest-earning assets reprice differently than its interest-bearing liabilities. Management actively

monitors and manages its interest rate risk exposure. Although the Bank manages other risks, such as credit quality and liquidity risk, in the normal course of business management considers interest rate risk to be its most significant market risk that could potentially have the largest material effect on the Bank's financial condition and results of operations. The Bank does not maintain a trading account for any class of financial instruments nor does it engage in hedging activities or derivative instruments. Furthermore, the Bank is not subject to foreign currency exchange rate risk or commodity price risk.

Qualitative Aspects of Market Risk. The Bank's principal financial objective is to achieve long-term profitability while reducing its exposure to fluctuating market interest rates. The Bank has sought to reduce the exposure of its earnings to changes in market interest rates by attempting to manage the difference between asset and liability maturities and interest rates. The principal element in achieving this objective is to increase the interest-rate sensitivity of the Bank's interest-earning assets by retaining in its portfolio, short-term loans and loans with interest rates subject to periodic adjustments. The Bank relies on retail deposits as its primary source of funds. Management believes retail deposits, compared to brokered deposits, reduce the effects of interest rate fluctuations because they generally represent a more stable source of funds. As part of its interest rate risk management strategy, the Bank promotes transaction accounts and certificates of deposit with terms of up to six years.

The Bank has adopted a strategy that is designed to substantially match the interest rate sensitivity of assets relative to its liabilities. The primary elements of this strategy involve originating ARM loans for its portfolio, maintaining residential construction loans as a portion of total net loans receivable because of their generally shorter terms and higher yields than other one- to four-family residential mortgage loans, matching asset and liability maturities, investing in short-term securities, originating fixed-rate loans for retention or sale in the secondary market, and retaining the related mortgage servicing rights.

Sharp increases or decreases in interest rates may adversely affect the Bank's earnings. Management of the Bank monitors the Bank's interest rate sensitivity through the use of a model provided for the Bank by FIMAC Solutions, LLC ("FIMAC"), a company that specializes in providing the financial services industry interest risk rate risk and balances sheet management services. Based on a rate shock analysis prepared by FIMAC, an immediate increase in interest rates of 200 basis points would increase the Bank's projected net interest income by approximately 0.4%, primarily because a larger portion of the Bank's interest rate sensitive assets than interest rate sensitive liabilities would reprice within a one year period. Similarly, an immediate 200 basis point decrease in interest rates would negatively affect net interest income by approximately 5.4%, as repricing would have the opposite effect. See "Quantitative Aspects of Market Risk" below for additional information. Management has sought to sustain the match between asset and liability maturities and rates, while maintaining an acceptable interest rate spread. Pursuant to this strategy, the Bank actively originates adjustable-rate loans for retention in its loan portfolio. Fixed-rate mortgage loans with maturities greater than seven years generally are originated for the immediate or future resale in the secondary mortgage market. At September 30, 2006, adjustable-rate mortgage loans and adjustable-rate mortgage-backed securities constituted $302.8 million or 67.6%, of the Bank's total combined mortgage loan and mortgage-backed securities portfolio. Although the Bank has sought to

originate ARM loans, the ability to originate such loans depends to a great extent on market interest rates and borrowers' preferences. Particularly in lower interest rate environments, borrowers often prefer fixed-rate loans.

Consumer loans and construction and land development loans typically have shorter terms and higher yields than permanent residential mortgage loans, and accordingly reduce the Bank's exposure to fluctuations in interest rates. At September 30, 2006, the construction and land development, and consumer loan portfolios amounted to $146.9 million and $48.6 million, or 29.9% and 9.9% of total loans receivable (including loans held for sale), respectively.

Quantitative Aspects of Market Risk. The model provided for the Bank by FIMAC estimates the changes in net portfolio value ("NPV") and net interest income in response to a range of assumed changes in market interest rates. The model first estimates the level of the Bank's NPV (market value of assets, less market value of liabilities, plus or minus the market value of any off-balance sheet items) under the current rate environment. In general, market values are estimated by discounting the estimated cash flows of each instrument by appropriate discount rates. The model then recalculates the Bank's NPV under different interest rate scenarios. The change in NPV under the different interest rate scenarios provides a measure of the Bank's exposure to interest rate risk. The following table is provided by FIMAC based on data at September 30, 2006.

Projected Interest Rate Scenario	Net Interest Income			Current Market Value		
	Estimated Value	$ Change from Base	% Change from Base	Estimated Value	$ Change from Base	% Change from Base
	(Dollars in thousands)					
+300	$25,066	$ 126	0.50%	$ 84,428	$ (7,397)	(8.06)%
+200	25,048	108	0.43	86,936	(4,889)	(5.32)
+100	24,997	57	0.23	89,413	(2,412)	(2.63)
BASE	24,940	--	--	91,825	--	--
-100	24,502	(438)	(1.76)	92,811	986	1.07
-200	23,600	(1,340)	(5.37)	91,984	159	0.17
-300	22,395	(2,545)	(10.20)	90,569	(1,256)	(1.37)

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(1) Does not include loan fees, which are included in interest income on the financial statements.
(2) Includes BOLI income, which is included in non-interest income on the financial statements.

Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions, including relative levels of market interest rates, loan repayments and deposit decay, and should not be relied upon as indicative of actual results. Furthermore, the computations do not reflect any actions management may undertake in response to changes in interest rates.

In the event of a 200 basis point decrease in interest rates, the Bank would be expected to experience a 0.2% increase in NPV and a 5.4% decrease in net interest income. In the event of a 200 basis point increase in interest rates, a 5.3% decrease in NPV and a 0.4% increase in net interest income would be expected. Based upon the modeling described above, the Bank's asset and liability structure generally results in decreases in net interest income in a declining interest rate scenario and increases in net interest income in a rising rate scenario. This structure also generally results in decreases in

NPV in a rising rate environment and increases in NVP when rates decrease by 200 basis points or less.

As with any method of measuring interest rate risk, certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets have features which restrict changes in interest rates on a short-term basis and over the life of the asset. Further, in the event of a change in interest rates,

expected rates of prepayments on loans and early withdrawals from certificates could possibly deviate significantly from those assumed in calculating the table.

Comparison of Financial Condition at September 30, 2006 and September 30, 2005

The Company's total assets increased 4.4% to $577.1 million at September 30, 2006 from $552.8 million at September 30, 2005 primarily attributable to a $36.5 million increase in net loans receivable. This increase was partially offset by an $8.2 million decrease in investment and mortgage-backed securities and a $5.8 million decrease in cash and due from financial institutions, interest bearing deposits in banks and federal funds sold. This asset growth was primarily funded by a $19.4 million increase in deposits.

The Company's capital increased by $4.7 million during the year primarily due to retained net income and funds received from stock option exercises. The Company also continued to manage its capital level through stock repurchases and dividends to shareholders. During the year the Company repurchased 108,600 shares of its stock for $3.7 million and paid $2.5 million in dividends to its shareholders.

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

Cash and Due from Financial Institutions, Interest Bearing Deposits in Banks, and Federal Funds Sold: Cash and due from financial institutions, interest bearing deposits in banks and federal funds sold decreased to $22.9 million at September 30, 2006 from $28.7 million at September 30, 2005 as a portion of the funds held in these liquid accounts were used to fund loan growth.

Investments and Mortgage-backed Securities and FHLB Stock: Investments and mortgage-backed securities (including FHLB stock) decreased by $8.2 million to $87.2 million at September 30, 2006 from $95.4 million at September 30, 2005, as a portion of these funds were used to fund loan growth. For additional details on investments and mortgage-backed securities see, "Item 1, Business - Investment Activities" and Note 3 of the Notes to the Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

Loans Receivable and Loans Held for Sale, Net of Allowance for Loan Losses: Net loans receivable, including loans held for sale, increased by $36.5 million to $424.6 million at September 30, 2006 from $388.1 million

at September 30, 2005. The increase in the portfolio was primarily a result of $17.9 million increase in construction loans (net of undisbursed portions), a $12.8 million increase in commercial real estate loans, a $6.9 million increase in consumer loans and a $4.6 million increase in land loans. Partially offsetting these increases were decreases of $3.1 million in one- to four-family mortgage loans and $2.5 million in multi-family loans.

Loan originations totaled $256.3 million for the year ended September 30, 2006 compared to $230.0 million for the year ended September 30, 2005. The Bank sold loans totaling $26.4 million during the year ended September 30, 2006, compared to $26.9 million ($25.4 million in fixed rate one- to four-family mortgage loans and $1.5 million in credit card loans) during the year ended September 30, 2005. For additional information on loans, see "Item 1, Business - Lending Activities" and Note 4 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

Premises and Equipment: Premises and equipment increased $868,000 to $16.7 million at September 30, 2006 from $15.9 million at September 30, 2005. This increase was primarily attributable to remodeling costs associated with several branch and administrative facilities. For additional information on premises and equipment, see "Item 2, Properties" and Note 6 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

Other Real Estate Owned: Other real estate owned ("OREO") and other repossessed items decreased $494,000 to $15,000 at September 30, 2006 from $509,000 at September 30, 2005. The balance decreased as several properties were sold during the year. The OREO balance of $15,000 at September 30, 2006 consisted of one land parcel.

For additional information on OREOs, see "Item 1, Business Lending Activities - Nonperforming Assets" and Note 7 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

Goodwill and Core Deposit Intangible ("CDI"): The amortized value of goodwill and CDI decreased $328,000 to $7.2 million at September 30, 2006 from $7.5 million at September 30, 2005 due to scheduled amortization of CDI. The Bank recorded goodwill and CDI in connection with the October 2004 acquisition of seven branches and related deposits. For additional information on Goodwill and CDI, see Note 1 and Note 8 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

Deposits: Deposits increased by $19.4 million to $431.1 million at September 30, 2006 from $411.7 million at September 30, 2005. The $19.4 million deposit increase is comprised of a $28.2 million increase in certificate of deposit accounts and a $6.1 million increase in non-interest bearing accounts. These increases were partially offset by a $6.9 million decrease in money market accounts, a $4.0 million increase in savings accounts, and a $4.0 million decrease in N.O.W. checking accounts. For additional information on deposits, see "Item 1, Business - Deposit Activities and Other Sources of Funds" and Note 9 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

Federal Home Loan Bank Advances: FHLB advances increased $408,000 to $62.8 million at September 30, 2006 from $62.4 million at September 30, 2005. For additional information on borrowings, see "Item 1, Business - Deposit

Activities and Other Sources of Funds - Borrowings" and Notes 10 and 11 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

Shareholders' Equity: Total shareholders' equity increased by $4.7 million to $79.4 million at September 30, 2006 from $74.6 million at September 30, 2005, primarily as a result of net income of $8.2 million and a $2.5 million increase to additional paid in capital from the exercise of stock options and the vesting associated with the Bank's benefit plans. Also increasing shareholders' equity was a decrease of $535,000 in the equity components related to unearned shares issued to the ESOP and MRDP. Partially offsetting these increases to shareholders' equity were the repurchase of 108,600 shares of the Company's stock for $3.7 million, the payment of $2.5 million in dividends to shareholders, and a $130,000 increase in accumulated other comprehensive loss.

On April 7, 2005, the Company announced a plan to repurchase up to 5% of the Company's outstanding shares, or 187,955 shares. This represents the Company's 13th stock repurchase plan. As of September 30, 2006, the Company had repurchased 136,450 of these shares at an average price of $31.85. Cumulatively, the Company has repurchased 3,475,721 (52.6%) of the 6,612,500 shares that were issued when the Company went public in January 1998 at an average price of $15.97 per share.

Comparison of Operating Results for the Years Ended September 30, 2006 and 2005

The Company's net income increased by 23.3% to $8.16 million for the year ended September 30, 2006 from $6.62 million for the year ended September 30, 2005. Diluted earnings per share increased by 23.1% to $2.24 for the year ended September 30, 2006 from $1.82 for the year ended September 30, 2005. The improved results were primarily a result of increased net interest income and increased non-interest income, which were partially offset by higher non-interest expenses.

The increased net interest income was primarily a result of a larger interest earning asset base, an increased interest rate spread due to the increasing interest rate environment, an increase in prepayment penalties (which are recorded as interest income), and an increase in the level of non-accrual interest collected.

The increased non-interest income was primarily a result of increased fees from the sale of non-deposit investment products, increased service charges on deposits, and increased ATM fees. These increases were partially offset by a decrease in gains from loan sales.

Partially offsetting the increased net interest income and non-interest income was an increase in non-interest expenses. The increased expenses were primarily a result of increased salary and benefit expenses due to a larger employee base, annual salary adjustments, and increased health insurance costs.

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

Net Income: Net income for the year ended September 30, 2006 increased by

$1.54 million to $8.16 million, or $2.24 per diluted share ($2.32 per basic share) from $6.62 million, or $1.82 per diluted share ($1.90 per basic share) for the year ended September 30, 2005. The $0.42 increase in diluted earnings per share for the year ended September 30, 2006 was primarily the result of a $2.45 million ($1.62 million net of income tax - $0.45 per diluted share) increase in net interest income after provision for loan losses and a $171,000 ($113,000 net of income tax - $0.03 per diluted share) increase in non-interest income. These items were partially offset by a $360,000 ($238,000 net of income tax - $0.06 per diluted share) increase in non-interest expense.

Net Interest Income: Net interest income increased by $2.31 million to $24.64 million for the year ended September 30, 2006 from $22.33 million for the year ended September 30, 2005, primarily due to a larger interest earning asset base, an increased interest rate spread, a $327,000 increase in prepayment penalties (which are recorded as interest income), and the collection of $162,000 in non-accrual interest. The collection of the prepayment penalties and the non-accrual interest increased the yearly net interest margin by approximately 10 basis points. Total interest income increased $4.51 million to $35.45 million for the year ended September 30, 2006 from $30.94 million for the year ended September 30, 2005 as average total interest earning assets increased by $16.58 million. The yield on interest earning assets increased to 7.06% for the year ended September 30, 2006 from 6.37% for the year ended September 30, 2005. Total interest expense increased by $2.20 million to $10.81 million for the year ended September 30, 2006 from $8.61 million for the year ended September 30, 2005 as average interest bearing liabilities increased by $4.69 million. The average rate paid on interest bearing liabilities increased to 2.57% for the year ended September 30, 2006 from 2.07% for the year ended September 30, 2005. The net interest margin increased to 4.91% for the year ended September 30, 2006 from 4.60% for the year ended September 30, 2005.

Provision for Loan Losses: The Bank did not make a provision for loan losses during the year ended September 30, 2006 as credit quality factors improved. This compares to a provision for loan losses of $141,000. The provision for loan losses decreased primarily due to a decrease in the level of loans classified as substandard and an increase in the level of net recoveries. The Bank had a net recovery of $23,000 for the year ended September 30, 2006 compared to a net charge-off of $33,000 for the year ended September 30, 2005. The net charge-offs (recoveries) to average outstanding loans ratio was (0.01%) for the year ended September 30, 2006 and 0.01% for the year ended September 30, 2005.

The Bank has established a comprehensive methodology for determining the provision for loan losses. On a quarterly basis the Bank performs an analysis taking into consideration pertinent factors underlying the quality of the loan portfolio. These factors include changes in the amount and composition of the loan portfolio, historical loss experience for various loan segments, changes in economic conditions, delinquency rates, a detailed analysis of individual loans on non-accrual status, and other factors to determine the level of allowance for loan losses needed. The allowance for loan losses increased $23,000 to $4.12 million at September 30, 2006 from $4.10 million at September 30, 2005. Although there was a decrease in loans classified as substandard, the Company decided to maintain the current level of the allowance for loan losses primarily due to a larger loan portfolio, which increased by $36.5 million to $424.6 million at September 30, 2006, from $388.1 million at September 30, 2005.

Based on the comprehensive methodology, management deemed the allowance for loan losses of $4.12 million at September 30, 2006 (0.96% of loans receivable and 5,152.50% 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. While the Bank believes it has established its existing allowance for loan losses in accordance with GAAP, there can be no assurance that regulators, in reviewing the Bank's loan portfolio, will not request the Bank to increase significantly 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. Any material increase in the allowance for loan losses would adversely affect the Bank's financial condition and results of operations. For additional information, see "Item 1, Business - Lending Activities - Allowance for Loan Losses."

Non-interest Income: Total non-interest income increased by $171,000 to $6.24 million for the year ended September 30, 2006 from $6.07 million for the year ended September 30, 2005, primarily due to a $217,000 increase in fees from the sale of non-deposit investment products, a $159,000 increase in service charges on deposits, and a $155,000 increase in ATM transaction fees. These increases were partially offset by a $342,000 decrease in gains from loan sales. Income from loan sales was larger in the period a year ago in part due to the sale of the Bank's credit card portfolio in December 2004, which resulted in a gain of $264,000.

Non-interest Expense: Total non-interest expense increased by $360,000 to $18.90 million for the year ended September 30, 2006 from $18.54 million for the year ended September 30, 2005. Non-interest expense was higher in the current year primarily due to a $548,000 increase in salary and benefit expense and a $196,000 increase in premises and equipment expense. The increased salary and benefit expenses were primarily attributable to a larger employee base, annual salary adjustments, and increased health insurance costs. The increased premises and equipment expenses were primarily due to increased building and equipment maintenance costs. These increases were partially offset by a $182,000 decrease in real estate operation expenses (due to gains from the sale of OREO properties) and a $109,000 decrease in advertising expenses. The Company's efficiency ratio improved to 61.19% for the year ended September 30, 2006 from 65.27% for the year ended September 30, 2005.

Provision for Income Taxes: The provision for income taxes increased $724,000 to $3.83 million for the year ended September 30, 2006 from $3.11 million for the year ended September 30, 2005 primarily as a result of increased income before taxes. The Company's effective tax rate was 31.95% for the year ended September 30, 2006 and 31.93% for the year ended September 30, 2005.

Comparison of Operating Results for the Years Ended September 30, 2005 and September 30, 2004

The Company's net income increased by 18.4% to $6.62 million for the year ended September 30, 2005 from $5.59 million for the year ended September 30, 2004. Diluted earnings per share increased by 24.7% to $1.82 for the year ended September 30, 2005 from $1.46 for the year ended September 30, 2004. The improved results were primarily a result of increased net interest income and increased non-interest income, which were partially offset by higher non-interest expenses.

The increased net interest income was largely a result of an increased loan portfolio and an increased investment securities portfolio. These portfolio increases were primarily funded by the net cash received in connection with the acquisition of seven branch offices and related deposits in October 2004. The acquired deposit base represents a valuable low cost funding source for the Bank as a majority of the deposits consist of checking, savings, and money market accounts. Net interest income was increased as the Bank was successful in deploying a substantial portion of the net cash received from the deposit acquisition into loans and investment securities.

The increase in non-interest income was primarily a result of increased service charges from deposits and increased ATM transaction fees. These increases were largely a result of an increased transaction account base attributable to the branch acquisition. Non-interest income was also increased during the year as a result of a $264,000 gain from the sale of the Bank's credit card portfolio.

Partially offsetting the increased net interest income and non-interest income was increased non-interest expenses as the Bank operated with a larger branch network and employee base as a result of the branch acquisition. The Company also incurred approximately $253,000 in compliance costs attributable to Section 404 of the Sarbanes-Oxley Act of 2002 during the year ended September 30, 2005.

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

Net Income: Net income for the year ended September 30, 2005 increased $1.03 million to $6.62 million, or $1.82 per diluted share ($1.90 per basic share) from $5.59 million, or $1.46 per diluted share ($1.54 per basic share) for the year ended September 30, 2004. The $0.36 increase in diluted earnings per share for the year ended September 30, 2005 was primarily the result of a $3.11 million ($2.05 million net of income tax - $0.53 per diluted share) increase in net interest income after provision for loan losses, a $1.50 million ($988,000 net of income tax - $0.26 per diluted share) increase in non-interest income, and a lower number of weighted average shares outstanding which increased diluted earnings per share by approximately $0.08. These items were partially offset by a $2.96 million ($1.95 million net of income tax - $0.51 per diluted share) increase in non-interest expense.

Net Interest Income: Net interest income increased $3.08 million to $22.33 million for the year ended September 30, 2005 from $19.25 million for the year ended September 30, 2004, primarily as a result of increased interest income from a larger interest earning asset base. Total interest income increased $4.37 million to $30.94 million for the year ended September 30, 2005 from $26.57 million for the year ended September 30, 2004 as average total interest earning assets increased by $73.76 million. The increased interest earning asset balances were primarily a result of investing the funds received in connection with the October 2004 acquisition of deposits into loans and investment securities. The increased interest earning balances were partially offset by a reduction in the yield on assets. The yield on earning assets decreased to 6.37% for the year ended September 30, 2005 from 6.45% for the year ended September 30, 2004. The decrease in yield was partially attributable to a change in the composition of interest earning assets as investment securities comprised a higher percentage of the total interest

earning asset base during 2005. Also partially offsetting the increased interest income was an increase in interest expense as average interest bearing deposits and borrowings increased. Total interest expense increased by $1.28 million to $8.61 million for the year ended September 30, 2005 from $7.33 million for the year ended September 30, 2004 as average interest bearing liabilities increased $75.33 million. As a result of these changes the net interest margin decreased to 4.60% for the year ended September 30, 2005 from 4.67% for the year ended September 30, 2004.

Provision for Loan Losses: The provision for loan losses decreased to $141,000 for the year ended September 30, 2005 from $167,000 for the year ended September 30, 2004. The provision for loan losses was lower primarily as a result of changes in the composition of the portfolio, a decrease in the level of loans classified as substandard, and a decrease in the level of actual charge-offs. For the years ended September 30, 2005 and 2004, net charge-offs were $33,000 and $67,000. The net charge-offs to average outstanding loans ratio was 0.01% for the year ended September 30, 2005 and 0.02% for the year ended September 30, 2004.

The Bank has established a comprehensive methodology for determining the provision for loan losses. On a quarterly basis the Bank performs an analysis taking into consideration pertinent factors underlying the quality of the loan portfolio. These factors include changes in the amount and composition of the loan portfolio, historical loss experience for various loan segments, changes in economic conditions, delinquency rates, a detailed analysis of individual loans on non-accrual status, and other factors to determine the level of allowance for loan losses needed. The allowance for loan losses increased by $108,000 to $4.10 million at September 30, 2005 from $3.99 million at September 30, 2004. The increased level of the allowance for loan losses was primarily attributable to a larger loan portfolio (loans receivable and loans held for sale), which increased by $43.5 million to $388.1 million at September 30, 2005 from $344.6 million at September 30, 2004. Partially offsetting the increased allowance due to loan portfolio growth, were decreases in the level of loans classified as substandard and changes in the category composition of the loan portfolio. The Bank's $1.5 million credit card portfolio, which historically had the highest charge-off rate, was sold in December 2004.

Based on the comprehensive methodology, management deemed the allowance for loan losses of $4.10 million at September 30, 2005 (1.05% of loans receivable and 140.09% 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. While the Bank believes it has established its existing allowance for loan losses in accordance with GAAP, there can be no assurance that regulators, in reviewing the Bank's loan portfolio, will not request the Bank to increase significantly 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. Any material increase in the allowance for loan losses would

adversely affect the Bank's financial condition and results of operations. For additional information, see "Item 1, Business - Lending Activities Allowance for Loan Losses."

Non-interest Income: Total non-interest income increased by $1.49 million

to $6.07 million for the year ended September 30, 2005 from $4.58 million for the year ended September 30, 2004, primarily as a result of an $895,000 increase in service charges on deposits, a $235,000 increase in ATM transaction fees, a $155,000 increase in income from loan sales (gain on sale of loans and servicing income on loans sold) and an $81,000 distribution from one of the Bank's ATM network associations. The increased service charges on deposits and the increased ATM transaction fees were primarily a result of the increased transaction account base acquired through the branch acquisition in October 2004. The increased income from loan sales was primarily attributable to $264,000 gain from the sale of the Bank's credit card portfolio. The increased income from the credit card portfolio is partially offset by a $109,000 decrease in income from the sale and servicing income on fixed rate one- to four-family mortgages. The ATM network association distribution was cash consideration paid to network association members in connection with the association's merger.

Non-interest Expense: Total non-interest expense increased by $2.96 million to $18.54 million for the year ended September 30, 2005 from $15.58 million for the year ended September 30, 2004, as the Company operated with a larger branch network as a result of the acquisition of seven branch offices and the associated employees in October 2004. The increase was primarily a result of a $1.40 million increase in salaries and employee benefits, a $367,000 core deposit intangible amortization expense, a $350,000 increase in premises and equipment expenses, a $186,000 increase in postage and courier expense, a $69,000 increase in ATM operating fees and $142,000 in expenses associated with the branch acquisition in October 2004. The increased employee expenses were primarily attributable to the larger employee base resulting from the branch acquisition, annual salary adjustments, and increased medical insurance costs. The Company also incurred approximately $253,000 in compliance related costs attributable to Section 404 of the Sarbanes-Oxley Act of 2002 during the year ended September 30, 2005. The Company's efficiency ratio decreased slightly to 65.27% for the year ended September 30, 2005 from 65.38% for the year ended September 30, 2004.

Provision for Income Taxes: The provision for income taxes increased $613,000 to $3.11 million for the year ended September 30, 2005 from $2.49 million for the year ended September 30, 2004 primarily as a result of increased income before taxes. The Company's effective tax rate was 31.9% for the year ended September 30, 2005 and 30.8% for the year ended September 30, 2005. The increase in the effective tax rate was primarily a result of a decrease in the percentage of tax exempt income during the current year and tax adjustments relating to the Company's branch acquisition.

Average Balances, Interest and Average Yields/Cost

The earnings of the Company depend largely on the spread between the yield on interest-earning assets and the cost of interest-bearing liabilities, as well as the relative amount of the Company's interest-earning assets and interest- bearing liability portfolios.

The following table sets forth, for the periods indicated, information regarding average balances of assets and liabilities as well as the total dollar amounts of interest income from average interest-earning assets and interest expense on average interest-bearing liabilities and average yields and costs. Such yields and costs for the periods indicated are derived by dividing income or expense by the average daily balance of assets or liabilities, respectively, for the periods presented.

	Year Ended September 30,							
	2006			2005			2004	
	Average Balance	Interest and Dividends	Yield/ Cost	Average Balance	Interest and Dividends	Yield/ Cost	Average Balance	Intere and Divide
	(Dollars in thousands)							
Interest-earning assets:								
Loans receivable (1)(2)..............	$399,811	$31,397	7.85%	$378,113	$ 27,514	7.28%	$338,752	$24,
Mortgage-backed and investment securities (3)......	55,373	2,152	3.89	54,541	1,962	3.60	22,376	
FHLB stock and equity securities (3)......	36,882	1,436	3.89	37,904	1,093	2.88	39,183	1,
Federal funds sold...	8,414	389	4.62	11,653	282	2.42	577	
Interest-bearing deposits............	1,714	78	4.55	3,405	85	2.50	10,970	
Total interest-earning assets..............	502,194	35,452	7.06	485,616	30,936	6.37	411,858	26,
Non-interest-earning assets..............	52,037			52,786			37,845	
Total assets.........	$554,231			$538,402			$449,703	
Interest-bearing liabilities:								
Savings accounts.....	$ 62,255	442	0.71%	$ 61,798	438	0.71%	$ 48,243	
Money market accounts............	43,204	711	1.65	50,337	626	1.24	38,558	
NOW accounts.........	91,507	684	0.75	95,471	657	0.69	70,195	
Certificates of deposit.............	168,578	6,068	3.60	148,483	3,701	2.53	126,521	2,
Short-term borrowings(4).......	4,664	218	4.67	5,875	236	4.02	633	
Long-term borrowings (5)......	51,109	2,691	5.27	54,662	2,951	5.40	57,145	3,
Total interest bearing liabilities.	421,317	10,814	2.57	416,626	8,609	2.07	341,295	7,
Non-interest bearing liabilities.........	55,870			48,916			34,115	
Total liabilities....	477,187			465,542			375,410	
Shareholders' equity.	77,044			72,860			74,293	
Total liabilities and shareholders' equity.............	$554,231			$538,402			$449,703	
Net interest income..		$24,638			$22,327			$19,
Interest rate spread.			4.49%			4.30%		

Net interest margin (6)..........	4.91%	4.60%
Ratio of average interest-earning assets to average interest-bearing liabilities.........	119.20%	116.56%

(1) Does not include interest on loans 90 days or more past due. Includes loans originated for sale. Amortized net deferred loan fees, late fees, extension fees and prepayment penalties (2006, $2,137; 2005, $2,146; and 2004, $1,718) included with interest and dividends.

(2) Average balance includes nonaccrual loans.

(footnotes continued on following page)

(3) For purposes of the computation of average yield on investments available for sale, historical cost balances were utilized, therefore the yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity.
(4) Includes FHLB advances with original maturities of less than one year and other short-term borrowings-repurchase agreements.
(5) Includes FHLB advances with original maturities of one year or greater.
(6) Net interest income divided by total average interest earning assets.

Rate/Volume Analysis

The following table sets forth the effects of changing rates and volumes on net interest income on the Company. Information is provided with respect to the (i) effects on interest income attributable to changes 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.

	Year Ended September 30, 2006 Compared to Year Ended September 30, 2005 Increase (Decrease) Due to			Year Ended September 30, 2005 Compared to Year Ended September 30, 2004 Increase (Decrease) Due to		
	Rate	Volume	Net Change	Rate	Volume	Net Change
	(In thousands)					
Interest-earning assets:						
Loans receivable (1)...	$2,252	$1,631	$3,883	$ 150	$ 2,863	$3,013
Investments and						

mortgage-backed securities............	161	29	190	(145)	1,173	1,028
FHLB stock and equity securities............	373	(30)	343	106	(34)	72
Federal funds sold.....	202	(95)	107	1	273	274
Interest-bearing deposits..............	48	(55)	(7)	87	(109)	(22)
Total net change in income on interest-earning assets........	3,036	1,480	4,516	199	4,166	4,365
Interest-bearing liabilities:						
Savings accounts.......	1	3	4	--	96	96
NOW accounts...........	55	(28)	27	(66)	179	113
Money market accounts..............	182	(97)	85	35	152	187
Certificate accounts...	1,964	403	2,367	219	639	858
Short-term borrowings..	69	(87)	(18)	27	197	224
Long-term borrowings...	(72)	(188)	(260)	(59)	(135)	(194)
Total net change in expense on interest-bearing liabilities...	2,199	6	2,205	156	1,128	1,284
Net change in net interest income.......	$ 837	$1,474	$2,311	$ 43	$ 3,038	$3,081

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

Liquidity and Capital Resources

The Company's primary sources of funds are customer deposits, proceeds from principal and interest payments on loans, the sale of loans, maturing securities and FHLB advances. While the maturity and 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.

The Bank must maintain an adequate level of liquidity to ensure the availability of sufficient funds to fund 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 September 30, 2006, 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 12.43%. At September 30, 2006, the Bank maintained an uncommitted credit facility with the FHLB-Seattle that provided for immediately available advances up to an aggregate amount equal to 30% of total assets, limited by available collateral, under which $62.8 million was outstanding. The Bank also maintained a $10 million overnight borrowing line with Pacific Coast Banker's Bank. At September 30, 2006, the Bank did not have an outstanding balance on this borrowing line.

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 and other short-term government and agency obligations. If the Bank requires funds beyond its ability to generate them internally, it has additional borrowing capacity with the FHLB, Pacific Coast Banker's Bank and collateral for repurchase agreements.

The Bank's primary investing activity is the origination of mortgage loans, which includes construction and land development loans. During the years ended September 30, 2006, 2005, and 2004, the Bank originated $215.8 million, $190.3 million, and $172.4 million of mortgage loans, respectively. At September 30, 2006, the Bank had loan commitments totaling $39.2 million and undisbursed loans in process totaling $59.3 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 September 30, 2006 totaled $153.9 million. Historically, the Bank has been able to retain a significant amount of its deposits as they mature.

The Bank's liquidity is also affected by the volume of loans sold and loan principal payments. During the years ended September 30, 2006, 2005, and 2004, the Bank sold $26.4 million, $25.4 million, and $35.7 million in fixed rate, one- to four-family mortgage loans. The Bank also sold $1.5 million in credit card loans during the year ended September 30, 2005. During the years ended September 30, 2006, 2005 and 2004, the Bank received $177.0 million, $160.8 million, and $133.9 million in principal repayments.

The Bank's liquidity has been impacted by increases in deposit levels. During the years ended September 30, 2006, 2005 and 2004, deposits increased by $19.4 million, $92.1 million, and $11.9 million. On October 9, 2004, the Bank acquired $86.3 million in deposits by acquiring seven branches.

Investment and mortgage-backed securities and interest bearing deposits decreased to $89.5 million at September 30, 2006 from $98.4 million at September 30, 2005.

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 September 30, 2006, the Bank was in compliance with all applicable capital requirements. For additional details see Note 20 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data" and "Item 1, Business - Regulation of the Bank - Capital Requirements."

Contractual obligations. The following table presents, as of September 30, 2006, the Company's significant fixed and determinable contractual obligations, within the categories described below, by payment date or contractual maturity. These contractual obligations, except for the operating lease obligations are included in the Consolidated Balance Sheet. The payment

amounts represent those amounts contractually due at September 30, 2006.

Contractual obligations	Total	Within 1 year	After 1 year through 3 years	After 3 years through 5 years	After 5 years
	Payments due by period				
	(In thousands)				
Short-term debt obligations	$29,947	$29,947	$ --	$ --	$ --
Long-term debt obligations	33,761	9,064	19,697	--	5,000
Operating lease obligations	16	5	11	--	--
Total contractual obligations	$63,724	$39,016	$19,708	$ --	$ 5,000

Effect of Inflation and Changing Prices

The consolidated financial statements and related financial data presented herein have been prepared in accordance with accounting principles generally accepted in the United States of America which require the measurement of financial position and operating results in terms of historical dollars, without considering the change in the relative purchasing power of money over time due to inflation. The primary impact of inflation on the operation of the Company is reflected in increased operating costs. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates generally have a more significant impact on a financial institution's performance than do general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

The information contained under "Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations - Market Risk and Asset and Liability Management" of this Form 10-K is incorporated herein by reference.

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Item 8. Financial Statements and Supplementary Data

Management's Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. The Company's internal control over financial reporting includes

those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management conducted an evaluation of the effectiveness of internal control over financial reporting based on the framework in Internal Control -- Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management concluded that the Company's internal control over financial reporting was effective as of September 30, 2006. Management's assessment of the effectiveness of the Company's internal control over financial reporting has been audited by McGladrey & Pullen, LLP, an independent registered public accounting firm, as stated in their report which is included herein.

Report of Independent Registered Public Accounting Firm on Internal Control Over Financial Reporting

[McGladrey & Pullen Letterhead]

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors
Timberland Bancorp, Inc.
Hoquiam, Washington

We have audited management's assessment, included in the accompanying Internal Control Assessment, that Timberland Bancorp, Inc. and Subsidiary maintained effective internal control over financial reporting as of September 30, 2006, based on criteria established in Internal Control -- Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Timberland Bancorp, Inc. and Subsidiary's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that: (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Timberland Bancorp, Inc. and Subsidiary maintained effective internal control over financial reporting as of September 30, 2006, is fairly stated, in all material respects, based on criteria established in Internal Control -- Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also in our opinion, Timberland Bancorp, Inc. and Subsidiary maintained, in all material respects, effective internal control over financial reporting as of September 30, 2006, based on criteria established in Internal Control -- Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of Timberland Bancorp, Inc. and Subsidiary and our report dated December 5, 2006 expressed an unqualified opinion.

/s/McGladrey & Pullen LLP

Seattle, Washington

December 5, 2006

TIMBERLAND BANCORP, INC. AND SUBSIDIARY

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors
Timberland Bancorp, Inc.
Hoquiam, Washington

We have audited the consolidated balance sheets of Timberland Bancorp, Inc. and Subsidiary as of September 30, 2006 and 2005, and the related consolidated statements of income, shareholders' equity, cash flows and comprehensive income for each of the three years in the period ended September 30, 2006. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Timberland

Bancorp, Inc. and Subsidiary as of September 30, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2006, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Timberland Bancorp, Inc. and Subsidiary's internal control over financial reporting as of September 30, 2006, based on criteria established in Internal Control -- Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated December 5, 2006 expressed an unqualified opinion on management's assessment of the effectiveness of Timberland Bancorp's internal control over financial reporting and an unqualified opinion on the effectiveness of Timberland Bancorp's internal control over financial reporting.

As discussed in Note 1 to the financial statements, the Company adopted the provisions of the Financial Accounting Standards Board's Statement of Financial Standards No. 123 (revised 2004), Share-Based Payment in fiscal year 2006.

/s/ McGladrey & Pullen, LLP

Seattle, Washington
December 5, 2006

Consolidated Balance Sheets

(Dollars in Thousands)

Timberland Bancorp, Inc. and Subsidiaries
September 30, 2006 and 2005

	2006	2005
Assets		
Cash equivalents:		
Cash and due from financial institutions	$ 14,870	$ 20,015
Interest-bearing deposits in other banks	2,519	2,868
Federal funds sold	5,400	5,635
	22,789	28,518
Certificate of deposits ("CDs") held for investment	100	200
Mortgage-backed securities - held to maturity (market value $73 and $101)	75	104
Investments and mortgage-backed securities - available for sale	81,408	89,595
Federal Home Loan Bank ("FHLB") stock (at cost)	5,705	5,705
Loans receivable, net of allowance for loan losses of $4,122 and $4,099	422,196	385,754
Loans held for sale	2,449	2,355
	424,645	388,109
Premises and equipment, net	16,730	15,862
Other real estate owned and other repossessed items	15	509
Accrued interest receivable	2,806	2,294
Bank owned life insurance ("BOLI")	11,951	11,502

Goodwill	5,650	5,650
Core deposit intangible ("CDI")	1,506	1,834
Mortgage servicing rights	932	928
Other assets	2,775	1,955
Total assets	$577,087	$552,765
Liabilities and shareholders' equity		
Liabilities		
Deposits:		
Demand, non-interest-bearing	$ 57,905	$ 51,791
Interest-bearing	373,156	359,874
Total deposits	431,061	411,665
FHLB advances	62,761	62,353
Other borrowings: repurchase agreements	947	781
Other liabilities and accrued expenses	2,953	3,324
Total liabilities	497,722	478,123
Commitments and contingencies (See Note 18)	- -	- -
Shareholders' equity		
Preferred stock, $0.01 par value; 50,000,000 shares authorized; none issued	- -	- -
Common stock, $0.01 par value; 50,000,000 shares authorized; 2006 - 3,757,676 shares issued and outstanding 2005 - 3,759,937 shares issued and outstanding	38	38
Additional paid-in capital	20,888	22,040
Unearned shares issued to Employee Stock Ownership Plan ("ESOP")	(3,305)	(3,833)
Unearned shares issued to Management Recognition and Development Plan ("MRDP")	(188)	- -
Retained earnings	62,933	57,268
Accumulated other comprehensive loss	(1,001)	(871)
Total shareholders' equity	79,365	74,642
Total liabilities and shareholders' equity	$577,087	$552,765

See notes to consolidated financial statements.

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Consolidated Statements of Income

(Dollars in Thousands, Except Per Share Amounts)

Timberland Bancorp, Inc. and Subsidiaries
Years Ended September 30, 2006, 2005 and 2004

	2006	2005	2004
Interest and dividend income			
Loans receivable	$31,397	$27,514	$24,501
Investments and mortgage-backed securities	2,152	1,962	934
Dividends from investments	1,436	1,093	1,021
Interest-bearing deposits in banks	467	367	115
Total interest and dividend income	35,452	30,936	26,571

Interest expense			
Deposits	7,905	5,422	4,168
FHLB advances - short term	2,691	3,096	3,148
FHLB advances - long term	169	60	9
Other borrowings - repurchase agreements	49	31	- -
Total interest expense	10,814	8,609	7,325
Net interest income	24,638	22,327	19,246
Provision for loan losses	- -	141	167
Net interest income after provision for loan losses	24,638	22,186	19,079
Non-interest income			
Service charges on deposits	2,981	2,822	1,927
ATM transaction fees	1,026	871	636
BOLI net earnings	449	430	462
Gain on sale of loans, net	386	728	642
Servicing income on loans sold	425	379	310
Escrow fees	120	141	140
Fee income from non-deposit investment sales	286	69	28
Loss on sale of securities available for sale, net	- -	- -	(6)
Other	571	633	437
Total non-interest income	6,244	6,073	4,576
Non-interest expense			
Salaries and employee benefits	10,744	10,196	8,794
Premises and equipment	2,425	2,229	1,879
Advertising	688	797	729
Other real estate owned expense (income)	(178)	4	(3)
ATM expenses	428	465	396
Postage and courier	486	529	343
Amortization of CDI	328	367	- -
State and local taxes	564	436	343
Professional fees	793	714	541
Other	2,618	2,799	2,553
Total non-interest expense	18,896	18,536	15,575
Income before federal income taxes	11,986	9,723	8,080
Federal income taxes	3,829	3,105	2,492
Net income	$ 8,157	$ 6,618	$ 5,588
Earnings per common share			
Basic	$ 2.32	$ 1.90	$ 1.54
Diluted	2.24	1.82	1.46

See notes to consolidated financial statements.

Consolidated Statements of Shareholders' Equity

(Dollars in Thousands)

Timberland Bancorp, Inc. and Subsidiaries
Years Ended September 30, 2006, 2005 and 2004

	Common Stock Shares	Amount	Additional Paid-in Capital	Unearned Shares Issued to ESOP	Unearned Shares Issued to MRDP	Retained Earnings	Accumu Other Compre hensiv Income (Loss)
Balance, September 30, 2003	4,251,680	$ 43	$ 33,775	($4,891)	($1,182)	$49,699	$ 167
Net income	- -	- -	- -	- -	- -	5,588	- -
Repurchase of common stock	(482,016)	(5)	(11,074)	- -	- -	- -	- -
Exercise of stock options	112,406	1	1,747	- -	- -	- -	- -
Cash dividends ($.57 per share)	- -	- -	- -	- -	- -	(2,320)	- -
Earned ESOP shares		- -	283	529	- -	- -	- -
Earned MRDP shares		- -	136	- -	645	- -	- -
Change in fair value of securities available for sale, net of tax	- -	- -	- -	- -	- -	- -	(324
Balance, September 30, 2004	3,882,070	39	24,867	(4,362)	(537)	52,967	(157
Net income	- -	- -	- -	- -	- -	6,618	- -
Repurchase of common stock	(174,434)	(2)	(4,062)	- -	- -	- -	- -
Exercise of stock options	52,301	1	813	- -	- -	- -	- -
Cash dividends ($.61 per share)	- -	- -	- -	- -	- -	(2,317)	- -
Earned ESOP shares		- -	293	529	- -	- -	- -
Earned MRDP shares		- -	129	- -	537	- -	- -
Change in fair value of securities available for sale, net of tax	- -	- -	- -	- -	- -	- -	(714
Balance, September 30, 2005	3,759,937	$ 38	$22,04	($3,833)	$- -	$57,268	($871
Net income	- -	- -	- -	- -	- -	8,157	- -
Issuance of MRDP shares	6,000	- -	195	- -	(195)	- -	- -
Repurchase of common stock	(108,600)	(1)	(3,700)	- -	- -	- -	- -
Exercise of stock options	100,339	1	1,827	- -	- -	- -	- -
Cash dividends ($.66 per share)	- -	- -	- -	- -	- -	(2,492)	- -
Earned ESOP shares		- -	480	528	- -	- -	- -
Earned MRDP shares		- -	(4)	- -	7	- -	- -
Stock option compensation exp.	- -	- -	50	- -	- -	- -	- -
Change in fair value of securities available for sale, net of tax	- -	- -	- -	- -	- -	- -	(130
Balance, September 30, 2006	3,757,676	$ 38	$20,888	($3,305)	($188)	$62,933	($1,001

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

(Dollars in Thousands)

Timberland Bancorp, Inc. and Subsidiaries
Years Ended September 30, 2006, 2005 and 2004

	2006	2005	2004
Cash flows from operating activities			
Net income	$ 8,157	$ 6,618	$ 5,588
Non-cash revenues, expenses, gains and losses included in net income:			
Depreciation	998	933	812
Deferred federal income taxes	226	64	69
Amortization of core deposit intangible	328	367	- -
Earned ESOP shares	528	529	529
Earned MRDP shares	7	537	645
Stock option compensation expense	50	- -	- -
Stock option tax effect less excess tax benefit	113	186	386
FHLB stock dividends	- -	(23)	(228)
Gain on sale of other real estate owned, net	(158)	(5)	(81)
Loss on sale of securities available for sale	- -	- -	6
Gain on sale of loans	(386)	(728)	(642)
(Gain) loss on sale of premises and equipment	(37)	13	- -
Provision for loan and other real estate owned losses	- -	161	206
Loans originated for sale	(26,153)	(26,528)	(35,350)
Proceeds from loans held for sale	26,445	25,247	36,383
Proceeds from credit card portfolio sale	- -	264	- -
BOLI net earnings	(449)	(430)	(462)
Net change in accrued interest receivable and other assets, and other liabilities and accrued expenses	(1,906)	397	(357)
Net cash provided by operating activities	7,663	7,602	7,504
Cash flows from investing activities			
Net (increase) decrease in CD's held for investment	100	(1)	- -
Activity in securities held to maturity:			
Maturities and prepayments	27	62	105
Activity in securities available for sale:			
Sales	- -	- -	1,600
Maturities and prepayments	7,960	8,140	10,006
Purchases	- -	(38,977)	(17,965)
Increase in loans receivable, net	(36,398)	(42,272)	(23,453)
Additions to premises and equipment	(1,924)	(837)	(1,296)
Purchase of branches, net of cash and cash equivalents	- -	76,630	- -
Proceeds from sale of other real estate owned	680	549	1,138
Proceeds from the disposition of premises and equipment	95	6	- -
Net cash provided (used) by investing activities	(29,460)	3,300	(29,865)

(continued)

See notes to consolidated financial statements.

Consolidated Statements of Cash Flows

(concluded) (Dollars in Thousands)

Timberland Bancorp, Inc. and Subsidiaries
Years Ended September 30, 2006, 2005 and 2004

	2006	2005	2004
Cash flows from financing activities			
Increase in deposits	$ 19,396	$ 5,600	$ 11,898
Net decrease in FHLB advances - long term	(20,592)	(583)	(6,669)
Net increase (decrease) in FHLB advances - short term	21,000	(2,485)	10,485
Net increase in repurchase agreements	166	781	- -
Proceeds from exercise of stock options	1,221	628	1,362
ESOP tax effect	480	293	283
MRDP tax effect	(4)	129	136
Stock option excess tax benefit	494	- -	- -
Repurchase of common stock	(3,701)	(4,064)	(11,079)
Payment of dividends	(2,492)	(2,317)	(2,320)
Net cash provided (used) by financing activities	15,968	(2,018)	4,096
Net increase (decrease) in cash equivalents	(5,729)	8,884	(18,265)
Cash equivalents			
Beginning of year	28,518	19,634	37,899
End of year	$ 22,789	$28,518	$ 19,634
Supplemental disclosures of cash flow information			
Income taxes paid	$ 3,755	$ 2,370	$ 2,095
Interest paid	10,496	8,362	7,107
Supplemental disclosures of non-cash investing and financing activities			
Market value adjustment of securities held for sale, net of tax	($130)	($ 714)	($ 324)
Loans transferred to other real estate owned	28	625	344
Financed sale of other real estate owned	- -	- -	169
Shares issued to MRDP	195	- -	- -
Supplemental disclosures of branch purchase			
Premium paid for deposits	$ - -	($ 7,848)	$ - -
Fair value of assets acquired	- -	(2,064)	- -
Deposits assumed	- -	86,495	- -
Other liabilities assumed	- -	47	- -
Net cash provided by branch purchase	$ - -	$76,630	$ - -

See notes to consolidated financial statements.

Consolidated Statements of Comprehensive Income

(Dollars in Thousands)

Timberland Bancorp, Inc. and Subsidiaries
Years Ended September 30, 2006, 2005 and 2004

	2006	2005	2004
Comprehensive income			
Net income	$8,157	$ 6,618	$5,588
Change in fair value of securities available for sale, net of tax	(130)	(714)	(324)
Total comprehensive income	$8,027	$ 5,904	$5,264

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements

Timberland Bancorp, Inc. and Subsidiaries
September 30, 2006 and 2005

Note 1 - Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the accounts of Timberland Bancorp, Inc. ("Company"); its wholly owned subsidiary, Timberland Bank ("Bank"); and the Bank's wholly owned subsidiary, Timberland Service Corp. All significant intercompany transactions and balances have been eliminated.

Nature of Operations

The Company is a bank holding company which operates primarily through its subsidiary, the Bank. The Bank was established in 1915 and, through its 21 branches located in Grays Harbor, Pierce, Thurston, Kitsap, King and Lewis counties in Washington State, attracts deposits from the general public, and uses those funds, along with other borrowings, to provide residential real estate, construction and land development, commercial real estate, consumer and commercial business loans to borrowers in western Washington, and to invest in investment securities and mortgage-backed securities.

Consolidated Financial Statement Presentation

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

Certain prior year amounts have been reclassified to conform to the 2006 presentation with no change to net income or shareholders' equity previously reported.

Segment Reporting

The Company has one reportable operating segment which is defined as community banking in western Washington under the operating name Timberland Bank.

(continued)

Note 1 - Summary of Significant Accounting Policies (continued)

Investments and Mortgage-Backed Securities - Available for Sale

Debt and equity securities that may be sold in response to changes in market interest rates, prepayment rates, need for liquidity, and changes in the availability of and the yield of alternative investments, are considered securities available for sale, and are reported at fair value. Unrealized gains and losses are excluded from earnings, and are reported as a separate component of shareholders' equity, net of the related deferred tax effect, entitled "Accumulated other comprehensive income (loss)." Realized gains and losses on securities available for sale, determined using the specific identification method, are included in earnings. Amortization of premiums and accretion of discounts are recognized in interest income over the period to maturity.

Investments and Mortgage-Backed Securities - Held to Maturity

Debt securities for which the Company has the positive intent and ability to hold to maturity are reported at cost, adjusted for amortization of premiums and accretion of discounts, which are recognized in interest income using the interest method.

Declines in the fair value of individual securities held to maturity and available for sale below their cost that are other than temporary would result

in write-downs of the individual securities to their fair value. Management evaluates individual securities for other than temporary impairment on a quarterly basis based on the securities' current credit quality, interest rates, term to maturity and management's intent and ability to hold the securities until the net book value is recovered. Any other than temporary declines in fair value are recognized in the statement of income as realized losses.

Federal Home Loan Bank Stock

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

Loans Held for Sale

Mortgage loans originated and intended for sale in the secondary market are stated in the aggregate at the lower of cost or estimated market value. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income. Gains or losses on sales of loans are recognized at the time of sale. The gain or loss is the difference between the net sales proceeds and the recorded value of the loans, including any remaining unamortized deferred loan origination fees.

Loans Receivable

Loans are stated at the amount of unpaid principal, reduced by the undisbursed portion of construction loans in process, deferred loan origination fees and an allowance for loan losses.

(continued)

Note 1 - Summary of Significant Accounting Policies (continued)

Allowance for Loan Losses

The allowance for loan losses is maintained at a level sufficient to provide for estimated loan losses based on evaluating known and inherent risks in the loan portfolio. The allowance is provided 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, delinquency levels, actual loan loss experience, current economic conditions, and detailed analysis of individual loans for which full collectibility may not be assured. The detailed analysis includes methods to estimate the fair value of loan collateral and the existence of potential alternative sources of repayment. The allowance consists of specific, general and unallocated components. The specific component relates to loans that are deemed impaired. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower

than the recorded value of that loan. The general component covers non-classified loans and classified loans that are not evaluated individually for impairment and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio. The appropriateness of the allowance for losses on loans is estimated based upon these factors and trends identified by management at the time financial statements are prepared.

In accordance with Statement of Financial Accounting Standards ("SFAS" or "Statement") No. 114, Accounting by Creditors for Impairment of a Loan, and SFAS No. 118, an amendment of SFAS No. 114, a loan is considered impaired when it is probable that a creditor will be unable to collect all amounts (principal and interest) due according to the contractual terms of the loan agreement. Smaller balance homogenous loans, such as residential mortgage loans and consumer loans, may be collectively evaluated for potential loss. When a loan has been identified as being impaired, the amount of the impairment is measured by using discounted cash flows, except when, as an alternative, the current fair value of the collateral, reduced by costs to sell, is used. When the measurement of the impaired loan is less than the recorded investment in the loan (including accrued interest and net deferred loan origination fees or costs), an impairment is recognized by creating or adjusting an allocation of the allowance for loan losses. Uncollected accrued interest is reversed against interest income. If ultimate collection of principal is in doubt, all cash receipts on impaired loans are applied to reduce the principal balance.

A provision for loan losses is charged against income and is added to the allowance for loan losses based on quarterly comprehensive analyses of the loan portfolio. The allowance for loan losses is allocated to certain loan categories based on the relative risk characteristics, asset classifications and actual loss experience of the loan portfolio. While management has allocated the allowance for loan losses to various loan portfolio segments, the allowance is general in nature and is available for the loan portfolio in its entirety.

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

Interest on Loans and Loan Fees

Interest on loans is accrued daily based on the principal amount outstanding. Allowances are established for uncollected interest on loans for which the interest is determined to be uncollectible. Generally, all loans past due (based on contractual terms) 90 days or more are placed on non-accrual status and internally classified as substandard. Any interest income accrued at that time is reversed. Subsequent collections are applied proportionately to past due principal and interest, unless collectibility of principal is in doubt, in which case all payments are applied to principal. Loans are removed from non-accrual status only when the loan is deemed current, and the collectibility of principal and interest is no longer doubtful, or on one- to four-family loans, when the loan is less than 90 days delinquent.

(continued)

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Notes to Consolidated Financial Statements

Timberland Bancorp, Inc. and Subsidiaries
September 30, 2006 and 2005

Note 1 - Summary of Significant Accounting Policies (continued)

Interest on Loans and Loan Fees (concluded)

The Bank charges fees for originating loans. These fees, net of certain loan origination costs, are deferred and amortized to income, on the level-yield basis, over the loan term. If the loan is repaid prior to maturity, the remaining unamortized deferred loan origination fee is recognized in income at the time of repayment.

Mortgage Servicing Rights

Mortgage servicing rights are capitalized when acquired through the origination of loans that are subsequently sold with the 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 mortgage servicing rights 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 future cash flows from the servicing assets to those estimated at the time servicing assets were originated. Fair values are estimated using discounted cash flows based on current market rates of interest. For purposes of measuring impairment, the rights must be stratified by one or more predominant risk characteristics of the underlying loans. The Company stratifies its capitalized mortgage servicing rights based on product type, interest rate and term of the underlying loans. The amount of impairment recognized is the amount, if any, by which the amortized cost of the rights for each stratum exceed their fair value.

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. Goodwill is presumed to have an indefinite useful life and is analyzed, at least annually, for impairment. An annual review is performed at the end of 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 exceeds the recorded value, goodwill is not considered impaired and no additional analysis is necessary. As of September 30, 2006, there have been no events or changes in the circumstances that would indicate a potential impairment.

Core Deposit Intangible

The core deposit intangible ("CDI") is amortized to non-interest expense using an accelerated method over a ten-year period.

Premises and Equipment

Premises and equipment are recorded at cost. Depreciation is computed on the straight-line method over the following estimated useful lives: buildings and improvements - up to 40 years; furniture and equipment - three to seven years; and automobiles - five years. The cost of maintenance and repairs is charged to expense as incurred. Gains and losses on dispositions are reflected in earnings.

(continued)

Note 1 - Summary of Significant Accounting Policies (continued)

Other Real Estate Owned and Other Repossessed Items

Other real estate owned and other repossessed items consist of properties or assets acquired through or in lieu of foreclosure, and are recorded initially at the lower of cost or fair value of the properties less estimated costs of disposal. Costs relating to development and improvement of the properties or assets are capitalized while costs relating to holding the properties or assets are expensed.

Valuations are periodically performed by management, and an allowance for losses is established by a charge to earnings if the recorded value of a property exceeds its estimated net realizable value.

Transfers of Financial Assets

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

Income Taxes

The Company files a consolidated federal income tax return with its subsidiaries. Prior to fiscal year 1997, the Bank qualified under provisions of the Internal Revenue Code which permitted, as a deduction from taxable income, an allowance for bad debts based on a percentage of taxable income.

In 1996, the percentage-of-income bad debt deduction for federal tax purposes was eliminated. In addition, federal tax bad debt reserves which had been accumulated since October 1, 1988, that exceeded the reserves which would have been accumulated based on actual experience, are subject to recapture over a six-year recapture period. As of September 30, 2005, all federal tax bad debt reserves had been recaptured.

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.

Employee Stock Ownership Plan

The Bank sponsors a leveraged Employee Stock Ownership Plan ("ESOP"). The ESOP is accounted for in accordance with the American Institute of Certified Public Accountants Statement of Position 93-6, Employers' Accounting for Employee Stock Ownership Plan. Accordingly, the debt of the ESOP is recorded as other borrowed funds of the Bank, and the shares pledged as collateral are reported as unearned shares issued to the employee stock ownership trust on the consolidated balance sheets. The debt of the ESOP is with the Company and is thereby eliminated in the consolidated financial statements. As shares are released from collateral, compensation expense is recorded equal to the average market price of the shares for the period, and the shares become available for earnings per share calculations.

(continued)

Note 1 - Summary of Significant Accounting Policies (continued)

Cash Equivalents and Cash Flows

The Company considers amounts included in the balance sheets' captions "Cash and due from financial institutions", "Interest-bearing deposits in other banks" and "Federal funds sold" to be cash equivalents. Cash flows from loans, deposits, FHLB advances - short term, FHLB advances - long term, and other borrowings - repurchase agreements are reported net.

Advertising

Costs for advertising and marketing are expensed as incurred.

Stock-Based Compensation

Prior to October 1, 2005, the Company accounted for stock-based compensation expense using the intrinsic value method as required by Accounting Principals Board ("APB") Opinion No. 25, Accounting for Stock Issued to Employees, and as permitted by SFAS No. 123, Accounting for Stock-Based Compensation. No compensation expense for stock options was reflected in net income for the fiscal years ended September 30, 2005 and 2004, as all stock options granted had an exercise price equal to the market price of the underlying common stock at the date of the grant.

On October 1, 2005, the Company adopted SFAS No. 123(R) 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 Company's valuation methodology previously utilized for options in footnote

disclosure 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.

As a result of adopting SFAS No. 123(R) on October 1, 2005, the Company's income before federal income taxes and net income were reduced by $50,000 and $33,000, respectively, and basic and diluted earnings per share for the fiscal year ended September 30, 2006 were each reduced by $0.01.

(continued)

Note 1 - Summary of Significant Accounting Policies (continued)

As required under SFAS No. 123(R), the reported net income and earnings per share for the fiscal years ended September 30, 2005 and 2004 have been presented below to reflect the impact had the Company been required to recognize compensation cost based on the fair value at the grant date for stock options. The pro forma amounts are as follows (dollars in thousands, except per share amounts)

	2005	2004
Net income, as reported	$6,618	$5,588
Less total stock-based compensation expense determined under fair value method for all qualifying awards, net of tax	256	172
Pro forma net income	$6,362	$5,416
Earnings Per Share		
Basic:		
As reported	$ 1.90	$ 1.54
Pro forma	1.83	1.49
Diluted:		
As reported	1.82	1.46
Pro forma	1.76	1.41

The Company's stock compensation plans are described more fully in Note 16.

Earnings Per Share

Basic earnings per share exclude dilution and are computed by dividing net income by the weighted average number of common shares outstanding. Diluted earnings per share reflect the potential dilution that could occur if common shares were issued under the Company's stock option plans and Management Recognition and Development Plan ("MRDP").

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value under Generally Accepted Accounting Principles ("GAAP"), and expands disclosures about fair value measurements. This Statement applies under other accounting pronouncements that require or permit fair value measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Management is assessing the impact of adoption of SFAS 157 on the Company's consolidated financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108 ("SAB 108"), Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements, providing guidance on quantifying financial statement misstatement and implementation (e.g., restatement or cumulative effect to assets, liabilities and retained earnings) when first applying this guidance. SAB 108 is effective for the Company for all financial statements issued after November 15, 2006 and is not expected to have a material effect on the Company's consolidated financial statements.

(continued)

Note 1 - Summary of Significant Accounting Policies (concluded)

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 new interpretation is effective for fiscal years beginning after December 15, 2006. The Company will adopt the provisions of FIN 48 on October 1, 2007 and is currently evaluating the guidance contained in FIN 48 to determine the effect adoption of the guidance will have on the Company's consolidated financial statements.

In March 2006, FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets. SFAS No. 156 amends Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, to require all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. SFAS No. 156 also permits servicers to subsequently measure each separate class of servicing assets and servicing liabilities at fair value rather than at the lower of cost or market. For those companies that elect to measure their servicing assets and liabilities at fair value, SFAS No. 156 requires the difference between the recorded value and fair value at the date of adoption to be recognized as a cumulative effect adjustment to retained earnings as of the beginning of the fiscal year in which the election is made. The Company will adopt SFAS No. 156 beginning in the first quarter of 2007. The Company is currently assessing the impact of adopting SFAS No. 156 but does not expect the standard to have a material impact on the Company's consolidated financial statements.

In May 2005, FASB issued SFAS No. 154, Accounting Changes for Error Corrections. SFAS No. 154 provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transaction requirements specific to the newly adopted accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in the fiscal years ending after December 15, 2005. The Company adopted SFAS No. 154 in 2006 and it did not have a material effect on the Company's consolidated financial statements.

Note 2 - Restricted Assets

Federal Reserve Board regulations require that the Bank maintain certain minimum reserve balances on hand or on deposit with the Federal Reserve Bank, based on a percentage of transaction account deposits. During the year ended September 30, 2006, the Bank obtained approval from the Federal Reserve Board to internally reclassify a portion of certain transaction accounts as savings accounts which allowed the Bank to reduce its reserve requirement. The amount of the reserve requirement balance for the years ended September 30, 2006 and 2005 was approximately $517,000 and $10.2 million, respectively.

Note 3 - Investments and Mortgage-Backed Securities

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2006				
Held to Maturity				
Mortgage-backed securities	$ 75	$- -	($2)	$ 73
Available for Sale				
Mortgage-backed securities	$17,989	$ 14	($400)	$17,603
Mutual funds	32,938	- -	(851)	32,087
U.S. agency securities	31,997	- -	(279)	31,718
Total	$82,924	$ 14	($1,530)	$81,408
September 30, 2005				
Held to Maturity				
Mortgage-backed securities	$ 104	$- -	($3)	$ 101

Available for Sale				
Mortgage-backed securities	$23,990	$ 78	($333)	$23,735
Mutual funds	32,939	- -	(774)	32,165
U.S. agency securities	33,986	- -	(291)	33,695
Total	$90,915	$ 78	($1,398)	$89,595

(continued)

Notes to Consolidated Financial Statements

Timberland Bancorp, Inc. and Subsidiaries
September 30, 2006 and 2005

Note 3 - Investments and Mortgage-Backed Securities (concluded)

The fair value of temporarily impaired securities, the amount of unrealized losses and the length of time these unrealized losses existed as of September 30, 2006 are as follows (in thousands):

	Less Than 12 Months		12 Months or Longer		Total	
Description of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unr Los
Mutual funds	$ - -	$ - -	$32,087	($851)	$32,087	(
Mortgage-backed securities	181	(1)	16,107	(399)	16,288	
U.S. agency securities	- -	- -	31,718	(279)	31,718	
Total	$181	($1)	$79,912	($1,529)	$80,093	($1

The Company has evaluated these securities and has determined that the decline in their value is temporary and is not related to any company or industry specific event. The unrealized losses are generally due to increases in the market interest rate environment. The fair value the mortgage-backed securities and the U.S. agency securities is expected to recover at the securities approach their maturity date and/or as market interest rates change. The fair value of the mutual funds is expected to recover when interest rates stabilize or begin to decline and the yield curve regains a steeper slope. The Company has the ability and intent to hold the investments until the market value recovers.

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 $49,513,000 and $56,516,000 at September 30, 2006 and 2005, respectively.

The contractual maturities of debt securities at September 30, 2006 are as follows (in thousands). Expected maturities may differ from scheduled

maturities due to the prepayment of principal or call provisions.

	Held to Maturity		Available for Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due within one year	$- -	$- -	$ 5,998	$ 5,964
Due after one year to five years	- -	- -	24,519	24,307
Due after five to ten years	- -	- -	2,127	2,096
Due after ten years	75	73	17,342	16,954
Mutual funds	- -	- -	32,938	32,087
Total	$ 75	$ 73	$82,924	$81,408

There were no gross realized gains or gross realized losses on sales of securities available for sale for the years ended September 30, 2006 and 2005. For the year ended September 30, 2004 gross realized losses totaled $6,000 and there were no gross realized gains on sales of securities available for sale.

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Notes to Consolidated Financial Statements

Timberland Bancorp, Inc. and Subsidiaries
September 30, 2006 and 2005

Note 4 - Loans Receivable and Loans Held for Sale

Loans receivable and loans held for sale consisted of the following at September 30 (in thousands):

	2006	2005
Mortgage loans:		
One- to four-family	$ 96,260	$ 99,408
Multi-family	17,689	20,170
Commercial	137,609	124,849
Construction and land development	146,855	112,470
Land	29,598	24,981
Total mortgage loans	428,011	381,878
Consumer loans:		
Home equity and second mortgage	37,435	32,298
Other	11,127	9,330
Total consumer loans	48,562	41,628
Commercial business loans	11,803	12,013
Total loans receivable	488,376	435,519
Less:		
Undisbursed portion of construction loans in process	59,260	42,771
Deferred loan origination fees	2,798	2,895
Allowance for loan losses	4,122	4,099
	66,180	49,765

Loans receivable, net	422,196	385,754
Loans held for sale (one- to four-family)	2,449	2,355
Total loans receivable and loans held for sale	$424,645	$388,109

Certain related parties of the Bank, principally Bank directors and officers, were loan customers of the Bank in the ordinary course of business during the years ended September 30, 2006 and 2005. Activity in related party loans during the years ended September 30 is as follows (in thousands):

	2006	2005
Balance, beginning of year	$1,395	$1,467
New loans	1,495	1
Repayments	(268)	(73)
Balance, end of year	$2,622	$1,395

(continued)

Note 4 - Loans Receivable and Loans Held for Sale (concluded)

At September 30, 2006 and 2005, the Bank had non-accruing loans totaling approximately $80,000 and $2,926,000, respectively. At September 30, 2006 and 2005, no loans were 90 days or more past due and still accruing interest. Interest income recognized on a cash basis on non-accrual loans for the years ended September 30, 2006, 2005 and 2004 was $384,000 $189,000 and $43,000, respectively. The average investment in non-accrual loans for the years ended September 30, 2006 and 2005 was $1,938,000 and $2,681,000, respectively.

An analysis of the allowance for loan losses for the years ended September 30 follows (in thousands):

	2006	2005	2004
Balance, beginning of year	$4,099	$3,991	$3,891
Provision for loan losses	- -	141	167
Loans charged off	(2)	(50)	(86)
Recoveries	25	17	19
Net charge-offs	(23)	(33)	(67)
Balance, end of year	$4,122	$4,099	$3,991

Following is a summary of information related to impaired loans at September 30 (in thousands):

	2006	2005

Impaired loans without a valuation allowance	$ 80	$2,601
Impaired loans with a valuation allowance	- -	325
	$ 80	$2,926
Valuation allowance related to impaired loans	$- -	$ 49

Note 5 - Loan Servicing

Loans serviced for the Federal Home Loan Mortgage Corporation and others are not included on the consolidated balance sheets. The principal amounts of those loans at September 30, 2006, 2005 and 2004 were $156,187,000, $155,864,000 and $165,206,000, respectively.

Following is an analysis of the changes in mortgage servicing rights for the years ended September 30 (in thousands):

	2006	2005	2004
Balance, at beginning of year	$ 928	$ 930	$1,017
Additions	241	200	273
Amortization	(237)	(202)	(360)
Balance, end of year	$ 932	$ 928	$ 930

(continued)

Note 5 - Loan Servicing (concluded)

At September 30, 2006, 2005 and 2004 the fair value of mortgage servicing rights totaled $1,891,000, $1,433,000 and $1,718,000, respectively. The fair values for 2006, 2005, and 2004 were estimated using premium rates of 9.59%, 9.62% and 9.34% and prepayment speed factors of 204, 313 and 250, respectively. There was no valuation allowance at September 30, 2006, 2005 or 2004.

Note 6 - Premises and Equipment

Premises and equipment consisted of the following at September 30 (in thousands):

	2006	2005
Land	$ 3,760	$ 3,760
Buildings and improvements	13,169	12,508
Furniture and equipment	5,506	5,175
Property held for future expansion	299	293
Construction and purchases in progress	890	426
	23,624	22,162

Less accumulated depreciation	6,894	6,300
Total premises and equipment	$16,730	$15,862

The Bank leases premises under operating leases. Rental expense of leased premises was $207,000, $199,000, and $171,000 for September 30, 2006, 2005 and 2004, respectively, which is included in premises and equipment expense.

Minimum net rental commitments under noncancellable leases having an original or remaining term of more than one year for future years ending September 30 are as follows (in thousands):

2007	$223
2008	218
2009	159
2010	150
2011	- -
Total minimum payments required	$750

Certain leases contain renewal options from five to ten years and escalation clauses based on increases in property taxes and other costs.

Note 7 - Real Estate Owned and Other Repossessed Items

Real estate owned and other repossessed items consisted of the following at September 30 (in thousands):

	2006	2005
Real estate acquired through foreclosure	$15	$509
Items acquired through repossession	- -	- -
Total real estate owned and other repossessed items	$15	$509

Note 8 - Core Deposit Intangibles ("CDI")

During the year ended September 30, 2005, the Company recorded a core deposit intangible of $2,201,000 in connection with the October 2004 acquisition of seven branches and related deposits. Net unamortized core deposit intangible totaled $1,506,000 and $1,834,000 at September 30, 2006 and 2005, respectively. Amortization expense related to the core deposit intangible for the years ended September 30, 2006 and 2005 was $328,000 and $367,000, respectively.

Amortization expense for the core deposit intangible for future years ending September 30 is estimated to be as follows (in thousands):

2007	$ 285
2008	249
2009	217
2010	190
2011	167
After 2012	398
Total	$1,506

Timberland Bancorp, Inc. and Subsidiaries
September 30, 2006 and 2005

Note 9 - Deposits

Deposits consisted of the following at September 30 (in thousands):

	2006	2005
Non-interest-bearing	$ 57,905	$ 51,791
NOW checking	89,509	93,478
Savings	60,235	64,274
Money market accounts	42,378	49,295
Certificates of deposit	181,034	152,827
Total deposits	$431,061	$411,665

Certificates of deposit of $100,000 or greater totaled $52,851,000 and $35,209,000 at September 30, 2006 and 2005, respectively.

Scheduled maturities of certificates of deposit for future years ending September 30 are as follows (in thousands):

2007	$153,939
2008	20,037
2009	3,978
2010	2,303
2011	729
Thereafter	48
Total	$181,034

Interest expense by account type is as follows for the years ended September 30 (in thousands):

	2006	2005	2004
NOW checking	$ 684	$ 657	$ 544
Savings	442	438	342
Money market accounts	711	625	439
Certificates of deposit	6,068	3,702	2,843
Total	$7,905	$5,422	$4,168

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Notes to Consolidated Financial Statements

Timberland Bancorp, Inc. and Subsidiaries
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Note 10 - Other Borrowings - Repurchase Agreements

Other borrowings at September 30, 2006 and 2005 consisted of overnight repurchase agreements with customers totaling $947,000 and $781,000, respectively.

Information concerning repurchase agreements is summarized as follows at September 30, (dollars in thousands):

	2006	2005
Average daily balance during the period	$ 1,148	$ 1,345
Average daily interest rate during the period	4.27%	2.30%
Maximum month-end balance during the period	$ 1,895	$ 2,102
Weighted average rate at end of period	5.01%	3.14%
Securities underlying the agreements at the end of period:		
Carrying value	$ 2,606	$ 1,803
Fair value	2,606	1,803

The securities underlying the agreements at September 30, 2006 were under the Company's control in safekeeping at third-party financial institutions.

Note 11 - Federal Home Loan Bank ("FHLB") Advances and Other Borrowing Lines

The Bank has long- and short-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 September 30 (in thousands):

	2006	2005
Short-term	$ 29,000	$ 8,000
Long-term	33,761	54,353
Total	$ 62,761	$ 62,353

Information concerning short-term FHLB advances is summarized as follows at September 30 (dollars in thousands):

	2006	2005
Average daily balance during the period	$ 3,516	$ 4,529
Average daily interest rate during the period	4.18%	4.53%

Maximum month-end balance during the period	$ 29,000	$ 98,000
Weighted average rate at end of the period	5.49%	3.79%

(continued)

Notes to Consolidated Financial Statements

Timberland Bancorp, Inc. and Subsidiaries
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Note 11 - Federal Home Loan Bank ("FHLB") Advances and Other Borrowing Lines (concluded)

The short-term borrowings as of September 30, 2006 mature at various dates through January 2007 and bear interest at rates ranging from 5.35% to 5.69%. The long-term borrowings mature at various dates through January 2016 and bear interest at rates ranging from 4.16% to 6.18%. Advances totaling $4,761,000 have monthly payments aggregating $5,000 plus interest. Under the Advances, Security and Deposit Agreement, virtually all of the Bank's assets, not otherwise encumbered, are pledged as collateral for advances. Principal reductions due for future years ending September 30 are as follows (in thousands):

2007	$ 38,064
2008	15,069
2009	4,628
2010	- -
2011	- -
Thereafter	5,000
	$ 62,761

In addition, the Bank has a $10,000,000 overnight borrowing line with Pacific Coast Banker's Bank. The borrowing line may be reduced or withdrawn at any time. As of September 30, 2006 and 2005 the Bank did not have any outstanding advances on this borrowing line.

Note 12 - Other Liabilities and Accrued Expenses

Other liabilities and accrued expenses were comprised of the following at September 30 (in thousands):

	2006	2005
Accrued deferred compensation and profit sharing plans payable	$ 541	$ 1,077
Accrued interest payable on deposits, FHLB advances and other borrowings	1,026	708
Accounts payable and accrued expenses - other	1,386	1,539
Total other liabilities and accrued expenses	$ 2,953	$ 3,324

Note 13 - Federal Income Taxes

The Bank previously qualified under provisions of the Internal Revenue Code that permitted federal income taxes to be computed after a deduction for additions to bad debt reserves. Accordingly, retained earnings include approximately $2,200,000 for which no provision for federal income taxes has been made. If in the future this portion of retained earnings is used for any purpose other than to absorb bad debt losses, federal income taxes at the current applicable rates would be imposed.

(continued)

Timberland Bancorp, Inc. and Subsidiaries
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Note 13 - Federal Income Taxes (continued)

The components of the provision for income taxes at September 30 are as follows (in thousands):

	2006	2005	2004
Current	$3,603	$3,041	$2,423
Deferred	226	64	69
Total federal income taxes	$3,829	$3,105	$2,492

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

	2006	2005
Prepaid federal income taxes	$ 777	$ 259
Net deferred tax assets	877	1,054
Total	$ 1,654	$ 1,313

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

	2006	2005
Deferred Tax Assets		
Accrued interest on loans	$ 1	$ 53
Accrued vacation	145	127
Deferred compensation	79	89
Unearned ESOP shares	420	420
Allowance for loan losses	1,454	1,466
CDI	141	77
Unearned MRDP shares	2	- -
Net unrealized securities losses	498	449
Stock option compensation expense	12	- -

Total deferred tax assets	2,752	2,681
Deferred Tax Liabilities		
FHLB stock dividends	906	906
Depreciation	243	281
Goodwill	264	132
Certificate of deposit valuation	25	19
Mortgage servicing rights	326	289
Prepaid expenses	111	- -
Total deferred tax liabilities	1,875	1,627
Net deferred tax assets	$ 877	$1,054

(continued)

Notes to Consolidated Financial Statements

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Note 13 - Federal Income Taxes (concluded)

The provision for federal income taxes for the years ended September 30 differs from that computed at the statutory corporate tax rate as follows (dollars in thousands):

	2006		2005		2004	
	Amount	Percent	Amount	Percent	Amount	Percent
Taxes at statutory rate	$4,195	35.0%	$3,403	35.0%	$2,828	35.0%
BOLI income	(157)	(1.3)	(151)	(1.6)	(162)	(2.0)
Other - net	(209)	(1.8)	(147)	(1.5)	(174)	(2.2)
Federal income taxes	$3,829	31.9%	$3,105	31.9%	$2,492	30.8%

Note 14 - Profit Sharing Plans

The Bank has established a 401(k) profit sharing plan for employees who meet the eligibility requirements set forth in the plan. Eligible employees may contribute up to the maximum established by the Internal Revenue Service. Contributions by the Bank are at the discretion of the board of directors. Bank contributions totaled $558,000, $641,000 and $524,000 for the years ended September 30, 2006, 2005 and 2004, respectively.

In addition, the Bank has an employee bonus plan based primarily on net income. Bonuses accrued for the years ended September 30, 2006, 2005 and 2004 totaled $354,000, $215,000 and $175,000, respectively.

Note 15 - Employee Stock Ownership Plan ("ESOP")

In 1998, the Bank established an ESOP that benefits employees with at least

one year of service who are 21 years of age or older. The ESOP may be funded by Bank contributions in cash or stock. Employee vesting occurs over six years. The amount of the annual contribution is discretionary, except that it must be sufficient to enable the ESOP to service its debt. All dividends received by the ESOP are used to pay debt service. As of September 30, 2006, 37,477 ESOP shares had been distributed to participants.

In January 1998, the ESOP borrowed $7,930,000 from the Company to purchase 529,000 shares of common stock of the Company. The loan is being repaid primarily from the Company's contributions to the ESOP over 15 years. The interest rate on the loan is 8.5%. The balance of the loan at September 30, 2006 was $4,506,000.

Shares held by the ESOP as of September 30 were classified as follows:

	2006	2005	2004
Unallocated shares	220,415	255,682	290,949
Shares released for allocation	271,108	240,836	217,159
Total ESOP shares	491,523	496,518	508,108

(continued)

Note 15 - Employee Stock Ownership Plan (concluded)

The approximate fair market value of the Bank's unallocated shares at September 30, 2006, 2005 and 2004, was $7,737,000, $5,932,000 and $6,829,000, respectively. Compensation expense recognized under the ESOP was $683,000, $516,000 and $524,000 for the years ended September 30, 2006, 2005 and 2004, respectively.

Note 16 - Stock Compensation Plans

Stock Options Plans

Under the Company's stock option plans (1999 Stock Option Plan and 2003 Stock Option Plan), the Company may grant options for up to 811,250 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 stock on the date of grant. The options vest over a ten-year period, which may be accelerated if the Company meets certain performance criteria. Generally, options vest in annual installments of 10% on each of the ten anniversaries from the date of grant and 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 (iv) increasing the Company's earnings per share over the prior fiscal year. The Company performs the accelerated vesting analysis in February of each year based on the results of the most recently completed fiscal year. At September 30, 2006, options for 139,208 shares are available for future grant under these plans.

The Company uses the Black-Scholes option pricing model to estimate the fair value of stock-based awards with the weighted average assumptions noted in the following table. The risk-free interest rate is based on the U.S. Treasury rate of a similar term as the stock option at the particular grant date. The expected life is based on historical data, vesting terms, and estimated exercise dates. The expected dividend yield is based on the most recent quarterly dividend on an annualized basis. The expected volatility is based on historical volatility of the Company's stock price.

	Risk-Free Interest Rate	Expected Life (Years)	Expected Dividend Yield	Expected Volatility
Fiscal 2006	NA	NA	NA	NA
Fiscal 2005	NA	NA	NA	NA
Fiscal 2004	3.6%	8	2.4%	21.5%

There were no options granted during the fiscal years ended September 30, 2006 or 2005. The weighted average fair value of options granted during the fiscal year ended September 30, 2004 was $5.25.

(continued)

Note 16 - Stock Compensation Plans (continued)

Stock option activity is summarized in the following table:

	Number of Shares	Weighted Average Exercise Price
Outstanding September 30, 2003	500,119	$12.75
Grants	28,338	23.06
Options exercised	(112,406)	12.11
Forfeited	(1,339)	12.00
Outstanding September 30, 2004	414,712	13.63
Options exercised	(52,301)	12.01
Outstanding September 30, 2005	362,411	13.86

Options exercised	(100,339)	12.18
Outstanding September 30, 2006	262,072	14.51

The weighted average grant date fair value of shares granted during the year ended September 30, 2006 was $5.25 per share. The total fair value of shares that vested during the years ended September 30, 2006, 2005 and 2004 was $65,000, $192,000 and $605,000, respectively.

A summary of unvested options as of September 30, 2006 and changes during the year ended September 30, 2006 were as follows:

	Total Unvested Options	
	Shares	Weighted Average Fair Value
Unvested options, beginning of period	38,840	$4.17
Vested	16,336	4.00
Unvested options, end of period	22,504	$4.29

Proceeds, related tax benefits realized from options exercised and intrinsic value of options exercised for the years ended September 30 were as follows (in thousands):

	2006	2005	2004
Proceeds from options exercised	$1,221	$628	$1,362
Related tax benefit recognized	607	186	386
Intrinsic value of options exercised	1,785	613	1,202

(continued)

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Note 16 - Stock Compensation Plans (continued)

Additional information regarding options outstanding at September 30, 2006 is as follows:

	Options Outstanding			Options Exercisable		
Range of Exercise Prices	Number	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Number	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)

$12.00 - 12.38	162,555	$12.01	2.4	162,055	$12.01	2.4
13.59 - 14.90	33,339	14.70	4.7	30,005	14.70	4.7
15.20 - 15.96	7,000	15.61	5.5	2,500	15.60	5.5
19.05	28,340	19.05	6.4	14,170	19.05	6.4
22.92- 23.25	30,838	23.06	7.3	30,838	23.06	7.3
	262,072	$14.51	3.8	239,568	$14.22	3.6

The aggregate intrinsic value of all options outstanding at September 30, 2006 was $5.40 million. The aggregate intrinsic value of all options that were exercisable at September 30, 2006 was $5.00 million.

Management Recognition and Development Plan ("MRDP")

In November 1998, the Board of Directors adopted the MRDP. In January 1999, shareholders approved the adoption of the MRDP for the benefit of employees, officers and directors of the Company. The objective of the MRDP is to retain 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 264,500 shares of the Company's common stock. Shares issued may be purchased in the open market or may be issued from authorized and unissued shares. During the year ended September 30, 2001 the Company awarded 204,927 shares under the MRDP to employees, officers and directors. These 204,927 shares were all vested by September 30, 2005. During the year ended September 30, 2006 the Company awarded 6,000 shares to employees. These 6,000 shares had a weighted-average grant date fair value of $32.44 per share and were unvested at September 30, 2006. No shares were awarded during the years ended September 30, 2005 and 2004. Awards under the MRDP were 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. Compensation expense related to the MRDP was $8,000, $556,000 and $691,000 for the years ended September 30, 2006, 2005 and 2004, respectively. At September 30, 2006, there were 53,573 shares available for future grant under the MRDP.

(continued)

Note 16 - Stock Compensation Plans (concluded)

Expense for Stock Compensation Plans

Compensation expense recorded in the financial statements for all stock-based

plans were as follows for the years ended September 30 follows (in thousands):

	2006	2005	2004
Stock options	$ 50	$ - -	$ - -
MRDP stock grants	8	556	691
Less: related tax benefit recognized	(20)	(189)	(235)
	$ 38	$ 367	$ 456

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

	Stock Options	Stock Grants (MRDP)	Total Awards
2007	$ 27	$ 39	$ 66
2008	5	39	44
2009	2	39	41
2010	1	39	40
2011	--	33	33

Note 17 - Deferred Compensation/Non-Competition Agreement and Employee Severance Compensation Agreement

The Bank has a deferred compensation/non-competition arrangement with its former chief executive officer, which provides monthly payments of $2,000 per month upon retirement. Payments under this agreement began in March 2004 and will continue until his death, at which time payments will continue to his surviving spouse until the earlier of her death or for 60 months. The present value of the payments as of September 30, 2006 and 2005, $177,000 and $201,000, respectively, has been accrued under the agreement and is included in other liabilities on the consolidated balance sheets.

In connection with the January 1998 mutual to stock conversion, the Bank adopted an Employee Severance Compensation Plan, which expires in ten years, to provide benefits to eligible employees in the event of a change in control of the Company or the Bank (as defined in the plan). In general, all employees with two or more years of service will be eligible to participate in the plan. Under the plan, in the event of a change in control of the Company or the Bank, eligible employees who are terminated or who terminate employment (but only upon the occurrence of events specified in the plan) within 12 months of the effective date of a change in control would be entitled to a payment based on years of service with the Bank. The maximum payment for any eligible employee would be equal to 24 months of their current compensation.

Note 18 - Commitments and Contingencies

The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit. These instruments involve, to varying degrees, elements of credit risk not recognized on the consolidated balance sheets.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments as it does for on-balance-sheet instruments. A summary of the Bank's commitments at September 30 is as follows (in thousands):

	2006	2005
Undisbursed portion of construction loans in process (see Note 4)	$59,260	$42,771
Undisbursed lines of credit	18,479	14,876
Commitments to extend credit	20,695	18,374

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

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

Note 19 Significant Concentrations of Credit Risk

Most of the Bank's lending activity is with customers located in the state of Washington and involves real estate. At September 30, 2006, the Bank had $467,895,000 (including $59,260,000 of undisbursed construction loan proceeds) in loans secured by real estate, which represents 95.3% of the total loan portfolio. The real estate loan portfolio is primarily secured by one- to four-family properties, multi-family properties, undeveloped land, and a variety of commercial real estate property types. At September 30, 2006, there were no concentrations of real estate loans to a specific industry or secured by a specific collateral type that equaled or exceeded 20% of the Bank's total loan portfolio, other than loans secured by one-to four-family properties. The ultimate collectibility of a substantial portion of the loan portfolio is susceptible to changes in economic and market conditions in the region and the impact of those changes on the real estate market. The Bank typically maintains loan-to-value ratios of no greater than 90% on real estate loans.

The Bank believes its lending policies and procedures adequately minimize the potential exposure to such risks and that adequate provisions for loan losses are provided for all known and inherent risks. Collateral and / or guarantees are required for all loans.

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Note 20 - Regulatory Matters

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

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

At September 30, 2006, the most recent notification from the Bank's regulator categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category.

The Company's and the Bank's actual capital amounts (dollars in thousands) and ratios are also presented in the table.

	Actual		Capital Adequacy Purposes		To be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
September 30, 2006						
Tier 1 capital (to average assets):						
Consolidated	$72,360	13.1%	$22,151	4.0%	N/A	N/A
Timberland Bank	63,222	11.5	22,017	4.0	$27,521	5.0%
Tier 1 capital (to risk-weighted assets):						
Consolidated	72,360	16.6	17,446	4.0	N/A	N/A
Timberland Bank	63,222	14.6	17,314	4.0	25,970	6.0
Total capital						

(to risk-weighted assets):						
Consolidated	76,482	17.5	34,892	8.0	N/A	N/A
Timberland Bank	67,344	15.6	34,627	8.0	43,284	10.0
September 30, 2005						
Tier 1 capital (to average assets):						
Consolidated	$67,074	12.3%	$21,833	4.0%	N/A	N/A
Timberland Bank	58,224	10.7	21,783	4.0	$27,229	5.0%
Tier 1 capital (to risk-weighted assets):						
Consolidated	67,074	16.8	15,936	4.0	N/A	N/A
Timberland Bank	58,224	14.7	15,838	4.0	23,757	6.0
Total capital (to risk-weighted assets):						
Consolidated	71,173	17.9	31,873	8.0	N/A	N/A
Timberland Bank	62,323	15.7	31,677	8.0	39,596	10.0

(continued)

Note 20 - Regulatory Matters (concluded)

Restrictions on Retained Earnings

The Bank is subject to certain restrictions on the amount of dividends that it may declare without prior regulatory approval.

At the time of conversion of the Bank from a Washington-chartered mutual savings bank to a Washington-chartered stock savings bank, the Bank established a liquidation account in an amount equal to its retained earnings of $23,866,000 as of June 30, 1997, the date of the latest statement of financial condition used in the final conversion prospectus. The liquidation account will be maintained for the benefit of eligible withdrawable account holders who have maintained their deposit accounts in the Bank after conversion. The liquidation account reduces annually to the extent that eligible account holders have reduced their qualifying deposits as of each anniversary date. Subsequent increases will not restore an eligible account holder's interest in the liquidation account. In the event of a complete liquidation of the Bank (and only in such an event), eligible depositors who have continued to maintain accounts will be entitled to receive a distribution from the liquidation account before any liquidation may be made with respect to common stock. The Bank may not declare or pay cash dividends if the effect thereof would reduce its regulatory capital below the amount required for the liquidation account.

Note 21 - Condensed Financial Information - Parent Company Only

Condensed Balance Sheets - September 30
(In Thousands)

	2006	2005
Assets		
Cash and due from financial institutions	$ 368	$ 229
Interest-bearing deposits in banks	630	414
Investments and mortgage-backed securities (available for sale)	2,079	2,084
Loan receivable from Bank	4,507	5,032
Investment in Bank	70,211	65,777
Other assets	1,648	1,223
Total assets	$79,443	$74,759
Liabilities and shareholders' equity		
Accrued expenses	$ 78	$ 117
Shareholders' equity	79,365	74,642
Total liabilities and shareholders' equity	$79,443	$74,759

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Note 21 - Condensed Financial Information - Parent Company Only (continued)

Condensed Statements of Income - Years Ended September 30
(In Thousands)

	2006	2005	2004
Operating income			
Interest-bearing deposits in banks	$ 27	$ 11	$ 9
Interest on loan receivable from Bank	411	454	494
Dividends on investments	91	66	63
Loss on sale of investment securities available for sale	- -	- -	(6)
Dividends from Bank	4,500	5,029	9,169
Total operating income	5,029	5,560	9,729
Non-Operating Income	3	- -	- -
Operating expenses	465	507	507
Income before income taxes and equity in undistributed income of Bank	4,567	5,053	9,222
Income taxes (benefit)	(91)	(96)	(77)

Income before equity in undistributed income of Bank	4,658	5,149	9,299
Equity in undistributed income of bank (dividends in excess of income of bank)	3,499	1,469	(3,711)
Net income	$8,157	$6,618	$5,588

(continued)

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Note 21 - Condensed Financial Information - Parent Company Only (concluded)

Condensed Statements of Cash Flows - Years Ended September 30
(In Thousands)

	2006	2005	2004
Cash flows from operating activities			
Net income	$ 8,157	$ 6,618	$ 5,588
Adjustments to reconcile net income to net cash provided:			
(Equity in undistributed income of Bank) dividends in excess of income of Bank	(3,499)	(1,469)	3,711
ESOP shares earned	528	529	529
MRDP shares earned	7	537	645
Stock option compensation expense	50	- -	- -
Loss on sale of securities available for sale	- -	- -	6
Other, net	(462)	(340)	(480)
Net cash provided by operating activities	4,781	5,875	9,999
Cash flows from investing activities			
Investment in Bank	(1,062)	(1,377)	(1,499)
Proceeds from sales of securities available for sale	- -	- -	1,600
Principal repayments on loan receivable from Bank	525	483	444
Net cash provided by (used in) investing activities	(537)	(894)	545
Cash flows from financing activities			
Proceeds from exercise of stock options	1,221	628	1,362
Repurchase of common stock	(3,701)	(4,064)	(11,079)
Payment of dividends	(2,492)	(2,317)	(2,320)
ESOP tax effect	480	293	283
MRDP tax effect	(4)	129	136
Stock option tax effect	607	186	386
Net cash used in financing activities	(3,889)	(5,145)	(11,232)

Net increase (decrease) in cash	355	(164)	(688)
Cash equivalents			
Beginning of year	643	807	1,495
End of year	$ 998	$ 643	$ 807

Notes to Consolidated Financial Statements

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Note 22 - Earnings Per Share Disclosures

Basic earnings per share are computed by dividing net income applicable to common stock by the weighted average number of common shares outstanding during the period, without considering any dilutive items. Diluted earnings per share are computed by dividing net income applicable to 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 and from assumed vesting of shares awarded but not released under the Company's MRDP. In accordance with Statement of Position 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. Information regarding the calculation of basic and diluted earnings per share for the years ended September 30 is as follows (dollars in thousands, except per share amounts):

	2006	2005	2004
Basic EPS Computation			
Numerator - net income	$8,157	$6,618	$5,588
Denominator - weighted average common shares outstanding	3,516,331	3,475,400	3,637,510
Basic EPS	$2.32	$1.90	$1.54
Diluted EPS Computation			
Numerator - net income	$8,157	$6,618	$5,588
Denominator - weighted average common shares outstanding	3,516,331	3,475,400	3,637,510
Effect of dilutive stock options	124,545	132,732	161,808
Effect of dilutive MRDP shares	72	19,857	28,679
Weighted average common shares outstanding- assuming dilution	3,640,948	3,627,989	3,827,997
Diluted EPS	$2.24	$1.82	$1.46

Notes to Consolidated Financial Statements

Timberland Bancorp, Inc. and Subsidiaries
September 30, 2006 and 2005

Note 23 - Comprehensive Income

Net unrealized gains and losses included in comprehensive income were computed as follows for the years ended September 30 (in thousands):

	Before-Tax Amount	Tax (Benefit) Expense	Net-of-Tax Amount
2006			
Unrealized holding losses arising during the year	($196)	($66)	($130)
Net unrealized losses	($196)	($66)	($130)
2005			
Unrealized holding losses arising during the year	($1,083)	($369)	($714)
Net unrealized losses	($1,083)	($369)	($714)
2004			
Unrealized holding losses arising during the year	($497)	($169)	($328)
Reclassification adjustment for losses included in net income	6	2	4
Net unrealized losses	($491)	($167)	($324)

Notes to Consolidated Financial Statements

Timberland Bancorp, Inc. and Subsidiaries
September 30, 2006 and 2005

Note 24 - Fair Value of Financial Instruments

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 or dealer quotes.

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 is estimated for portfolios of loans with similar financial characteristics. Fair value is 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. Loans held for sale has been based on quoted market prices.

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.

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 Bank's off-balance-sheet instruments consist of non-fee producing, variable-rate commitments, the Bank has determined they do not have a distinguishable fair value.

(continued)

Timberland Bancorp, Inc. and Subsidiaries
September 30, 2006 and 2005

Note 24 - Fair Value of Financial Instruments (concluded)

The estimated fair value of financial instruments at September 30 were as follows (in thousands):

	2006 Recorded Amount	2006 Fair Value	2005 Recorded Amount	2005 Fair Value
Financial Assets				
Cash and due from financial institutions and interest-bearing deposits in banks	$17,489	$17,489	$23,083	$23,083
Federal funds sold	5,400	5,400	5,635	5,635
Investments and mortgage-backed securities	81,483	81,481	89,699	89,696
FHLB stock	5,705	5,705	5,705	5,705
Loans receivable	424,645	416,518	388,109	387,086
Accrued interest receivable	2,806	2,806	2,294	2,294
Financial Liabilities				
Deposits	$431,061	$431,581	$411,665	$412,115
FHLB advances - short term	29,000	29,000	8,000	8,000
FHLB advances - long term	33,761	33,685	54,353	55,421
Other borrowings: repurchase agreements	947	947	781	781
Accrued interest payable	1,026	1,026	708	708

The Bank assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair value of the Bank's financial instruments will change when interest rate levels change and that change may either be favorable or unfavorable to the Bank. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed interest rate obligations are less likely to prepay in a rising interest rate environment and more likely to prepay in a falling interest rate environment. Conversely, depositors who are receiving fixed interest rates are more likely to withdraw funds before maturity in a rising interest rate environment and less likely to do so in a falling interest rate environment. Management monitors interest rates and maturities of assets and liabilities, and attempts to minimize interest rate risk by adjusting terms of new loans, and deposits and by investing in securities with terms that mitigate the Bank's overall interest rate risk.

Note 25 - Stock Repurchase Plan

In April 2005, the Company initiated a stock repurchase plan for the purchase of 187,955 shares of stock. As of September 30, 2006, 136,450 shares have been repurchased.

Timberland Bancorp, Inc. and Subsidiaries
September 30, 2006 and 2005

Note 26 - Subsequent Events

On October 24, 2006, the board of directors approved a dividend in the amount of $0.18 per share to be paid on November 27, 2006 to shareholders of record as of November 13, 2006.

On October 24, 2006, the Company awarded a total of 1,540 shares under the MRDP to non-employee directors. The shares have a five-year vesting period.

On November 16, 2006, the Company announced that it had completed the stock repurchase program referenced in Note 25.

On November 20, 2006, the Company announced that its board of directors had authorized a stock repurchase plan for the purchase of 186,266 shares of stock.

Note 27 - Selected Quarterly Financial Data (Unaudited)

The following selected financial data are presented for the quarters ended (in thousands, except per share amounts):

	September 30, 2006	June 30, 2006	March 31, 2006	December 31 2005
Interest and dividend income	$9,283	$9,074	$8,649	$8,446
Interest expense	(3,023)	(2,786)	(2,587)	(2,418)
Net interest income	6,260	6,288	6,062	6,028
Provision for loan losses	- -	- -	- -	- -
Non-interest income	1,653	1,528	1,508	1,555
Non-interest expense	(4,750)	(4,791)	(4,718)	(4,637)
Income before income taxes	3,163	3,025	2,852	2,946
Federal income taxes	1,019	964	906	940
Net income	$2,144	$2,061	$1,946	$2,006
Basic earnings per share	$0.610	$0.584	$0.554	$0.572
Diluted earnings per share	0.589	0.564	0.534	0.553

(continued)

Timberland Bancorp, Inc. and Subsidiaries
September 30, 2006 and 2005

Note 27 - Selected Quarterly Financial Data (Unaudited) (concluded)

	September 30, 2005	June 30, 2005	March 31, 2005	December 31 2004
Interest and dividend income	$8,166	$8,037	$7,430	$7,303
Interest expense	(2,443)	(2,228)	(2,004)	(1,934)
Net interest income	5,723	5,809	5,426	5,369
Provision for loan losses	(25)	(96)	(20)	- -
Non-interest income	1,647	1,548	1,340	1,538
Non-interest expense	(4,640)	(4,465)	(4,671)	(4,760)
Income before income taxes	2,705	2,796	2,075	2,147
Federal income taxes	867	961	624	653
Net income	$1,838	$1,835	$1,451	$1,494
Basic earnings per share	$0.533	$0.537	$0.415	$0.420
Diluted earnings per share	0.513	0.513	0.398	0.401

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure
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Not applicable.

Item 9A. Controls and Procedures

(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 annual report. The Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures as currently in effect are effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the 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 Act) that occurred during the quarter ended September 30, 2006, 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 on ways to

strengthen existing controls. The Company does not expect that its disclosure controls and procedures and internal controls over financial reporting will prevent all error 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 judgements 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; over time, controls 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 de detected.

Management's Report on Internal Control Over Financial Reporting is included in this Form 10-K under Part II, Item 8, "Financial Statements and Supplementary Data."

Item 9B. Other Information

None.

PART III

Item 10. Directors and Executive Officers of the Registrant

The information contained under the section captioned "Proposal I - Election of Directors" is included in the Company's Definitive Proxy Statement for the 2007 Annual Meeting of Stockholders ("Proxy Statement") and is incorporated herein by reference.

For information regarding the executive officers of the Company and the Bank, see "Item 1. Business - Executive Officers."

Compliance with Section 16(a) of the Exchange Act

The information contained under the section captioned "Section 16(a) Beneficial Ownership Reporting Compliance" is included in the Company's Proxy Statement and is incorporated herein by reference.

Audit Committee Financial Expert

The Company has a separately designated standing Audit Committee, composed of Directors Warren, Robbel and Smith. Each member of the Audit Committee is "independent" as defined in the Nasdaq Stock Market listing standards. The Company's Board of Directors has designated Directors Warren and Robbel as the Audit Committee financial experts, as defined in the SEC's Regulation S-K.

Directors Warren, Robbel and Smith are independent as that term is used in Item 7(d)(3)(iv) of Schedule 14A promulgated under the Exchange Act.

Code of Ethics

The Board of Directors ratified its Code of Ethics for the Company's officers (including its senior financial officers), directors and employees during the year ended September 30, 2006. The Code of Ethics requires the Company's officers, directors and employees to maintain the highest standards of professional conduct. The Company's Code of Ethics was filed as an exhibit to its Annual Report on Form 10-K for the year ended September 30, 2003.

Item 11. Executive Compensation

The information contained under the sections captioned "Executive Compensation," "Directors' Compensation" and "Compensation Committee Interlocks and Insider Participation" is included in the Company's Proxy Statement and is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

(a) Security Ownership of Certain Beneficial Owners.

The information contained under the section captioned "Security Ownership of Certain Beneficial Owners and Management" is included in the Company's Proxy Statement and is incorporated herein by reference.

(b) Security Ownership of Management.

The information contained under the sections captioned "Security Ownership of Certain Beneficial Owners and Management" and "Proposal I - Election of Directors" is included in the Company's Proxy Statement and are incorporated herein by reference.

(c) Changes In Control.

The Company is not aware of any arrangements, including any pledge by any person of securities of the Company, the operation of which may at a subsequent date result in a change in control of the Company.

(d) Equity Compensation Plan Information. The following table summarizes share and exercise price information about the Company's equity compensation plans as of September 30, 2006.

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants, and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))

	(a)	(b)	(c)
Equity compensation plans approved by security holders:			
Management Recognition and Development Plan...	--	$ --	53,573
1999 Stock Option Plan...............	249,941	14.09	1,339
2003 Stock Option Plan..............	12,131	23.25	137,869
Equity compensation plans not approved by security holders.............	-	--	--
Total...............	262,072	$ 14.51	192,781

Item 13. Certain Relationships and Related Transactions

The information contained under the section captioned "Certain Relationships and Related Transactions" is included in the Company's Proxy Statement and is incorporated herein by reference.

Item 14. Principal Accounting Fees and Services

The information contained under the section captioned "Independent Auditors" is included in the Company's Proxy Statement and is incorporated herein by reference.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) Exhibits

- 3.1 Articles of Incorporation of the Registrant (1)
- 3.2 Bylaws of the Registrant (1)
- 3.3 Amendment to Bylaws(2)
- 10.1 Employee Severance Compensation Plan (3)
- 10.2 Employee Stock Ownership Plan (3)
- 10.3 1999 Stock Option Plan (4)
- 10.4 2003 Stock Option Plan (5)
- 10.5 Form of Incentive Stock Option Agreement (6)
- 10.6 Form of Non-qualified Stock Option Agreement (6)
- 10.7 Management Recognition and Development Plan (4)
- 10.8 Form of Management Recognition and Development Award Agreement (6)
- 14 Code of Ethics (7)
- 21 Subsidiaries of the Registrant
- 23 Consent of Accountants

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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(1) Filed as an exhibit to the Registrant's Registration Statement on Form S-1 (333-35817).

(2) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended September 30, 2002.

(3) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 1997.

(4) Incorporated by reference to Exhibit 99 included in the Registrant's Registration Statement on Form S-8 (333-32386)

(5) Incorporated by reference to Exhibit 99.2 included in the Registrant's Registration Statement on Form S-8 (333-1161163)

(6) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended September 30, 2005.

(7) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended September 30, 2003.

SIGNATURES

Pursuant to the requirements of section 13 or 15(d) 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: December 5, 2006

By:/s/Michael R. Sand

Michael R. Sand
President and Chief Executive Officer

Pursuant to the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

SIGNATURES	TITLE	DATE
/s/Michael R. Sand ---------------------- Michael R. Sand	President, Chief Executive Officer and Director (Principal Executive Officer)	December 5, 2006
/s/Clarence E. Hamre ---------------------- Clarence E. Hamre	Chairman of the Board	December 5, 2006

/s/Dean J. Brydon Dean J. Brydon	Chief Financial Officer (Principal Financial and Accounting Officer)	December 5, 2006
/s/Andrea M. Clinton Andrea M. Clinton	Director	December 5, 2006
/s/David A. Smith David A. Smith	Director	December 5, 2006
/s/Harold L. Warren Harold L. Warren	Director	December 5, 2006
/s/Jon C. Parker Jon C. Parker	Director	December 5, 2006
/s/James C. Mason James C. Mason	Director	December 5, 2006
/s/Ronald A. Robbel Ronald A. Robbel	Director	December 5, 2006

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EXHIBIT INDEX

Exhibit No.	Description of Exhibit
21	Subsidiaries of the Registrant
23	Consent of Accountants
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

Exhibit 21

Subsidiaries of the Registrant

Parent
Timberland Bancorp, Inc.

Subsidiaries	Percentage of Ownership	Jurisdiction or State of Incorporation
Timberland Bank	100%	Washington
Timberland Service Corporation (1)	100%	Washington

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(1) This corporation is a wholly-owned subsidiary of Timberland Bank.

Exhibit 23

Consent of Accountants

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in Registration Statements No. 333-32386 and No. 333-116163 on Form S-8 of Timberland Bancorp, Inc. of our reports dated December 5, 2006, relating to the consolidated financial statements and the effectiveness of internal control over financial reporting of Timberland Bancorp, Inc. which appear in this Form 10-K for the year ended September 30, 2006.

/s/McGladrey & Pullen, LLP

MCGLADREY & PULLEN, LLP
Seattle, Washington
December 13, 2006

Exhibit 31.1

Certification Required
by Rules 13a-15 and 15d-15 under the Securities Exchange Act of 1934

I, Michael R. Sand, certify that:

1. I have reviewed this Annual Report on Form 10-K of Timberland Bancorp, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: December 5, 2006

/s/Michael R. Sand

Michael R. Sand
Chief Executive Officer

Exhibit 31.2

Certification Required
by Rules 13a-15 and 15d-15 under the Securities Exchange Act of 1934

I, Dean J. Brydon, certify that:

1. I have reviewed this Annual Report on Form 10-K of Timberland Bancorp, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of

the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: December 5, 2006

/s/Dean J. Brydon

Dean J. Brydon
Chief Financial Officer

Exhibit 32

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
OF TIMBERLAND BANCORP, INC.
PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

The undersigned hereby certify, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and in connection with this Annual Report on Form 10-K, that:

1. the report fully complies with the requirements of Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, and

2. the information contained in the report fairly presents, in all material respects, the Company's financial condition and results of operations, as of the dates and for the periods presented in the financial statements included in such report.

/s/Michael R. Sand

Michael R. Sand
Chief Executive Officer

/s/Dean J. Brydon

Dean J. Brydon
Chief Financial Officer

Dated: December 5, 2006