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TIMBERLAND BANCORP INC  
Form 10-Q  
August 09, 2011

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended June 30, 2011

OR

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

Commission file number 0-23333

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

Washington  
(State or other jurisdiction of incorporation or organization)

91-1863696  
(IRS Employer Identification No.)

624 Simpson Avenue, Hoquiam, Washington  
(Address of principal executive offices)

98550  
(Zip Code)

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

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

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

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

Large accelerated filer ----- Accelerated Filer -----  
Non-accelerated filer ----- Smaller reporting company X -----

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

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Yes            No X  
 ----        ----

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

| CLASS<br>-----                | SHARES OUTSTANDING AT July 31, 2011<br>----- |
|-------------------------------|--|
| Common stock, \$.01 par value | 7,045,036                                    |

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PART I. FINANCIAL INFORMATION  
 Item 1. Financial Statements

TIMBERLAND BANCORP, INC. AND SUBSIDIARY  
 CONDENSED CONSOLIDATED BALANCE SHEETS  
 June 30, 2011 and September 30, 2010  
 (Dollars in thousands, except share data)  
 (Unaudited)

|   | June 30,<br>2011 | September 30,<br>2010 |
|---|------------------|-----------------------|
| <hr/>   |                  |                       |
| Assets  |                  |                       |
| Cash and cash equivalents:  |                  |                       |
| Cash and due from financial institutions  | \$ 10,997        | \$ 9,466              |
| Interest-bearing deposits in banks  | 103,306          | 102,320               |
|   | <hr/>            |                       |
| Total cash and cash equivalents   | 114,303          | 111,786               |
|   | <hr/>            |                       |
| Certificates of deposit ("CDs") held for investment (at cost)   | 18,087           | 18,047                |
| Mortgage-backed securities ("MBS") and other investments - held to maturity, at amortized cost (estimated fair value \$4,352 and \$4,842) | 4,283            | 5,066                 |
| MBS and other investments - available for sale  | 7,679            | 11,119                |
| Federal Home Loan Bank of Seattle ("FHLB") stock  | 5,705            | 5,705                 |
| Loans receivable  | 532,322          | 535,885               |
| Loans held for sale   | 766              | 2,970                 |
| Less: Allowance for loan losses   | (11,790)         | (11,264)              |
|   | <hr/>            |                       |
| Net loans receivable  | 521,298          | 527,591               |
|   | <hr/>            |                       |
| Premises and equipment, net   | 16,981           | 17,383                |
| Other real estate owned ("OREO") and other repossessed assets, net  | 10,996           | 11,519                |
| Accrued interest receivable   | 2,527            | 2,630                 |
| Bank owned life insurance ("BOLI")  | 13,762           | 13,400                |
| Goodwill  | 5,650            | 5,650                 |
| Core deposit intangible ("CDI")   | 439              | 564                   |
| Mortgage servicing rights ("MSRs"), net   | 2,463            | 1,929                 |
| Prepaid Federal Deposit Insurance Corporation ("FDIC") insurance assessment   | 2,335            | 3,268                 |
| Other assets  | 8,510            | 7,030                 |
|   | <hr/>            |                       |
| Total assets  | \$735,018        | \$742,687             |
|   | <hr/>            |                       |
| Liabilities and shareholders' equity  |                  |                       |
| Deposits: Non-interest-bearing demand   | \$ 57,735        | \$ 58,755             |
| Deposits: Interest-bearing  | 531,763          | 520,114               |
|   | <hr/>            |                       |

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|   |           |           |
|---|-----------|-----------|
| Total deposits  | 589,498   | 578,869   |
| -----   |           |           |
| FHLB advances   | 55,000    | 75,000    |
| Repurchase agreements   | 598       | 622       |
| Other liabilities and accrued expenses  | 3,588     | 2,788     |
| -----   |           |           |
| Total liabilities   | 648,684   | 657,279   |
|   |           |           |
| Shareholders' equity  |           |           |
| Preferred stock, \$.01 par value; 1,000,000 shares authorized; 16,641 shares, Series A, issued and outstanding; \$1,000 per share liquidation value | 15,932    | 15,764    |
| Common stock, \$.01 par value; 50,000,000 shares authorized; 7,045,036 shares issued and outstanding  | 10,464    | 10,377    |
| Unearned shares - Employee Stock Ownership Plan ("ESOP")  | (2,049)   | (2,247)   |
| Retained earnings   | 62,608    | 62,238    |
| Accumulated other comprehensive loss  | (621)     | (724)     |
| -----   |           |           |
| Total shareholders' equity  | 86,334    | 85,408    |
| -----   |           |           |
| Total liabilities and shareholders' equity  | \$735,018 | \$742,687 |
| =====   |           |           |

See notes to unaudited condensed consolidated financial statements

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TIMBERLAND BANCORP, INC. AND SUBSIDIARY  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
For the three and nine months ended June 30, 2011 and 2010  
(Dollars in thousands, except share amounts)  
(Unaudited)

|  | Three Months Ended<br>June 30, |          | Nine Months Ended<br>June 30, |          |
|--|--------------------------------|----------|-------------------------------|----------|
|  | 2011                           | 2010     | 2011                          | 2010     |
|  | -----                          |          | -----                         |          |
| Interest and dividend income                                       |                                |          |                               |          |
| Loans receivable   | \$ 8,192                       | \$ 8,764 | \$24,966                      | \$26,661 |
| MBS and other investments  | 141                            | 239      | 486                           | 695      |
| Dividends from mutual funds  | 8                              | 9        | 23                            | 27       |
| Interest-bearing deposits in banks                                 | 90                             | 90       | 260                           | 218      |
| -----  |                                |          |                               |          |
| Total interest and dividend income                                 | 8,431                          | 9,102    | 25,735                        | 27,601   |
| -----  |                                |          |                               |          |
| Interest expense   |                                |          |                               |          |
| Deposits   | 1,463                          | 1,950    | 4,805                         | 5,986    |
| FHLB advances - long term  | 556                            | 760      | 1,835                         | 2,384    |
| Federal Reserve Bank of San Francisco ("FRB") and other borrowings | - -                            | 1        | - -                           | 3        |

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|  |       |       |        |         |
|--|-------|-------|--------|---------|
| Total interest expense   | 2,019 | 2,711 | 6,640  | 8,373   |
| Net interest income  | 6,412 | 6,391 | 19,095 | 19,228  |
| Provision for loan losses  | 3,400 | 750   | 5,000  | 8,545   |
| Net interest income after provision for loan losses                          | 3,012 | 5,641 | 14,095 | 10,683  |
| Non-interest income  |       |       |        |         |
| Total other than temporary impairment ("OTTI")                               | (70)  | (81)  | (224)  | (688)   |
| Portion of OTTI recognized in other comprehensive loss (before income taxes) | (95)  | (71)  | (112)  | (1,340) |
| Net OTTI recognized in earnings  | (165) | (152) | (336)  | (2,028) |
| Realized loss on MBS and other investments                                   | --    | --    | (2)    | (17)    |
| Gains on sales of MBS and other investments                                  | --    | --    | 79     | --      |
| Service charges on deposits  | 993   | 1,066 | 2,875  | 3,218   |
| ATM transaction fees   | 515   | 439   | 1,384  | 1,187   |
| BOLI net earnings  | 121   | 120   | 361    | 369     |
| Gains on sales of loans, net   | 247   | 238   | 1,214  | 987     |
| Servicing income (expense) on loans sold, net                                | 7     | 32    | (13)   | 86      |
| Valuation recovery (allowance) on MSRs                                       | (137) | 22    | 703    | --      |
| Fee income from non-deposit investment sales                                 | 25    | 17    | 73     | 52      |
| Other  | 155   | 159   | 482    | 486     |
| Total non-interest income, net   | 1,761 | 1,941 | 6,820  | 4,340   |

See notes to unaudited condensed consolidated financial statements

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TIMBERLAND BANCORP, INC. AND SUBSIDIARY  
CONDENSED CONSOLIDATED STATEMENTS OPERATIONS (continued)  
For the three and nine months ended June 30, 2011 and 2010  
(Dollars in thousands, except share amounts)  
(Unaudited)

|                                | Three Months Ended<br>June 30, |          | Nine Months Ended<br>June 30, |          |
|--------------------------------|--------------------------------|----------|-------------------------------|----------|
|                                | 2011                           | 2010     | 2011                          | 2010     |
| Non-interest expense           |                                |          |                               |          |
| Salaries and employee benefits | \$ 3,150                       | \$ 3,117 | \$ 9,393                      | \$ 9,019 |
| Premises and equipment         | 667                            | 717      | 2,036                         | 2,120    |

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|   |            |           |           |            |
|---|------------|-----------|-----------|------------|
| Advertising   | 235        | 235       | 604       | 626        |
| OREO and other repossessed assets<br>expense, net         | 496        | 373       | 930       | 767        |
| ATM expenses  | 203        | 164       | 583       | 490        |
| Postage and courier                                       | 139        | 130       | 400       | 400        |
| Amortization of CDI                                       | 42         | 48        | 125       | 143        |
| State and local taxes                                     | 155        | 159       | 475       | 453        |
| Professional fees   | 190        | 193       | 567       | 561        |
| FDIC insurance  | 248        | 317       | 919       | 1,323      |
| Insurance   | 56         | 154       | 299       | 283        |
| Other   | 1,201      | 815       | 3,005     | 2,427      |
|   | -----      | -----     | -----     | -----      |
| Total non-interest expense                                | 6,782      | 6,422     | 19,336    | 18,612     |
|   | -----      | -----     | -----     | -----      |
| Income (loss) before federal and<br>state income taxes    | (2,009)    | 1,160     | 1,579     | (3,589)    |
| Provision (benefit) for federal<br>and state income taxes | (729)      | 356       | 417       | (1,439)    |
|   | -----      | -----     | -----     | -----      |
| Net income (loss)   | (1,280)    | 804       | 1,162     | (2,150)    |
| Preferred stock dividends                                 | (208)      | (208)     | (624)     | (624)      |
| Preferred stock discount accretion                        | (57)       | (53)      | (168)     | (156)      |
|   | -----      | -----     | -----     | -----      |
| Net income (loss) to common<br>shareholders               | \$ (1,545) | \$ 543    | \$ 370    | \$ (2,930) |
|   | =====      | =====     | =====     | =====      |
| Net income (loss) per common share:                       |            |           |           |            |
| Basic   | \$ (0.23)  | \$ 0.08   | \$ 0.05   | \$ (0.44)  |
| Diluted   | \$ (0.23)  | \$ 0.08   | \$ 0.05   | \$ (0.44)  |
| Weighted average shares<br>outstanding:                   |            |           |           |            |
| Basic   | 6,745,250  | 6,715,410 | 6,745,250 | 6,713,103  |
| Diluted   | 6,745,250  | 6,715,410 | 6,745,487 | 6,711,103  |
| Dividends paid per common<br>share:                       | \$ - -     | \$ 0.01   | \$ - -    | \$ 0.04    |

See notes to unaudited condensed consolidated financial statements

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TIMBERLAND BANCORP, INC. AND SUBSIDIARY  
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
For the nine months ended June 30, 2011 and the year ended September 30, 2010  
(Dollars in thousands, except per share amounts)  
(Unaudited)

Number of Shares                      Amount

Accumu  
late  
Othe

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|  | Preferred<br>Stock | Common<br>Stock | Preferred<br>Stock | Common<br>Stock | Unearned<br>Shares -<br>ESOP | Retained<br>Earnings | Compre<br>hensiv<br>Los |
|--|--------------------|-----------------|--------------------|-----------------|------------------------------|----------------------|-------------------------|
| Balance, September 30, 2009  | 16,641             | 7,045,036       | \$15,554           | \$10,315        | \$(2,512)                    | \$65,854             | \$(2,012)               |
| Net loss   | --                 | --              | --                 | --              | --                           | (2,291)              | --                      |
| Accretion of preferred stock<br>discount                                   | --                 | --              | 210                | --              | --                           | (210)                | --                      |
| Cash dividends<br>(\$0.04 per common share)<br>(5% preferred stock)        | --                 | --              | --                 | --              | --                           | (283)<br>(832)       | --                      |
| Earned ESOP shares   | --                 | --              | --                 | (78)            | 265                          | --                   | --                      |
| MRDP (1) compensation expense  | --                 | --              | --                 | 134             | --                           | --                   | --                      |
| Stock option compensation<br>expense                                       | --                 | --              | --                 | 6               | --                           | --                   | --                      |
| Unrealized holding gain on<br>securities available for<br>sale, net of tax | --                 | --              | --                 | --              | --                           | --                   | 491                     |
| Change in OTTI on securities<br>held to maturity, net of tax               | --                 | --              | --                 | --              | --                           | --                   | 766                     |
| Accretion of OTTI on securities<br>held to maturity, net of tax            | --                 | --              | --                 | --              | --                           | --                   | 31                      |
| Balance, September 30, 2010  | 16,641             | 7,045,036       | 15,764             | 10,377          | (2,247)                      | 62,238               | (724)                   |
| Net income   | --                 | --              | --                 | --              | --                           | 1,162                | --                      |
| Accretion of preferred stock<br>discount                                   | --                 | --              | 168                | --              | --                           | (168)                | --                      |
| 5% preferred stock dividend  | --                 | --              | --                 | --              | --                           | (624)                | --                      |
| Earned ESOP shares   | --                 | --              | --                 | (47)            | 198                          | --                   | --                      |
| MRDP (1) compensation expense  | --                 | --              | --                 | 129             | --                           | --                   | --                      |
| Stock option compensation<br>expense                                       | --                 | --              | --                 | 5               | --                           | --                   | --                      |
| Unrealized holding gain on<br>securities available for<br>sale, net of tax | --                 | --              | --                 | --              | --                           | --                   | 2                       |
| Change in OTTI on securities<br>held to maturity, net of tax               | --                 | --              | --                 | --              | --                           | --                   | 74                      |
| Accretion of OTTI on securities<br>held to maturity, net of tax            | --                 | --              | --                 | --              | --                           | --                   | 27                      |
| Balance, June 30, 2011   | 16,641             | 7,045,036       | \$15,932           | \$10,464        | \$(2,049)                    | \$62,608             | \$(621)                 |

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

See notes to unaudited condensed consolidated financial statements

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(Unaudited)

|  | Nine Months Ended June 30, |            |
|--|----------------------------|------------|
|  | 2011                       | 2010       |
| Cash flow from operating activities  |                            |            |
| Net income (loss)  | \$ 1,162                   | \$ (2,150) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                            |            |
| Provision for loan losses  | 5,000                      | 8,545      |
| Depreciation   | 743                        | 881        |
| Deferred federal income taxes  | (412)                      | 1,466      |
| Amortization of CDI  | 125                        | 143        |
| Earned ESOP shares   | 198                        | 199        |
| MRDP compensation expense  | 129                        | 128        |
| Stock option compensation expense  | 5                          | 4          |
| Gains on sales of OREO and other repossessed assets, net                                 | (527)                      | (270)      |
| Provision for OREO losses  | 973                        | 505        |
| Loss on disposition of premises and equipment  | 3                          | 14         |
| BOLI net earnings  | (361)                      | (360)      |
| Gains on sales of loans, net   | (1,214)                    | (987)      |
| Decrease in deferred loan origination fees   | (241)                      | (207)      |
| OTTI losses on MBS and other investments   | 336                        | 2,028      |
| Gains on sales of available for sale securities  | (79)                       | --         |
| Realized losses on held to maturity securities   | 2                          | 17         |
| Loans originated for sale  | (44,266)                   | (44,213)   |
| Proceeds from sale of loans  | 47,684                     | 44,376     |
| Increase in other assets, net  | (718)                      | (5,235)    |
| Increase (decrease) in other liabilities and accrued expenses, net                       | 177                        | (206)      |
|  | 8,719                      | 4,678      |
| Net cash provided by operating activities  |                            |            |
| Cash flow from investing activities  |                            |            |
| Net increase in CDs held for investment  | (40)                       | (11,937)   |
| Proceeds from maturities and prepayments of securities available for sale                | 1,248                      | 2,432      |
| Proceeds from maturities and prepayments of securities held to maturity                  | 697                        | 955        |
| Proceeds from sales of available for sale securities                                     | 2,272                      | --         |
| Increase in loans receivable, net  | (3,476)                    | (1,095)    |
| Additions to premises and equipment  | (344)                      | (378)      |
| Proceeds from sales of OREO and other repossessed assets                                 | 2,883                      | 2,651      |
|  | 3,240                      | (7,372)    |
| Net cash provided by (used in) investing activities                                      |                            |            |
| Cash flow from financing activities  |                            |            |
| Increase in deposits, net  | 10,629                     | 62,324     |
| Repayment of FHLB advances   | (20,000)                   | (20,000)   |
| Repayment of FRB advances  | --                         | (10,000)   |
| Decrease in repurchase agreements  | (24)                       | (64)       |
| ESOP tax effect  | (47)                       | (76)       |
| MRDP compensation tax effect   | --                         | 2          |
| Payment of dividends   | --                         | (699)      |
|  | (9,442)                    | 31,487     |
| Net cash provided by (used in) financing activities                                      |                            |            |

See notes to unaudited condensed consolidated financial statements



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TIMBERLAND BANCORP, INC. AND SUBSIDIARY  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)  
 For the nine months ended June 30, 2011 and 2010  
 (Dollars in thousands)  
 (Unaudited)

|  | Nine Months Ended June 30, |           |
|--|----------------------------|-----------|
|  | 2011                       | 2010      |
|  | -----                      |           |
| Net increase in cash and cash equivalents                | \$ 2,517                   | \$ 28,793 |
| Cash and cash equivalents                                |                            |           |
| Beginning of period                                      | 111,786                    | 66,462    |
|  | -----                      |           |
| End of period  | \$114,303                  | \$ 95,255 |
|  | =====                      |           |
| Supplemental disclosure of cash flow information         |                            |           |
| Income taxes paid  | \$ 2,097                   | \$ 791    |
| Interest paid  | 6,786                      | 8,555     |
| Supplemental disclosure of non-cash investing activities |                            |           |
| Loans transferred to OREO and other repossessed assets   | \$ 4,344                   | \$ 9,009  |
| Loan originated to facilitate the sale of OREO           | 1,538                      | 1,351     |

See notes to unaudited condensed consolidated financial statements

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TIMBERLAND BANCORP, INC. AND SUBSIDIARY  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)  
 For the three and nine months ended June 30, 2011 and 2010  
 (Dollars in thousands)  
 (Unaudited)

|   | Three Months Ended |        | Nine Months Ended |           |
|---|--------------------|--------|-------------------|-----------|
|   | June 30,           |        | June 30,          |           |
|   | 2011               | 2010   | 2011              | 2010      |
|   | -----              |        | -----             |           |
| Comprehensive income (loss):                        |                    |        |                   |           |
| Net income (loss)                                   | \$(1,280)          | \$ 804 | \$1,162           | \$(2,150) |
| Unrealized holding gain on securities available for |                    |        |                   |           |

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|  |            |        |          |          |
|--|------------|--------|----------|----------|
| sale, net of tax   | 50         | 79     | 2        | 84       |
| Change in OTTI on securities held to maturity, net of tax:                                   |            |        |          |          |
| Additions  | (9)        | 23     | (65)     | 83       |
| Additional amount recognized related to credit loss for which OTTI was previously recognized | 5          | 10     | 15       | 706      |
| Amount reclassified to credit loss for previously recorded market loss                       | 67         | 13     | 124      | 82       |
| Accretion of OTTI securities held to maturity, net of tax                                    | 8          | 7      | 27       | 25       |
|  | -----      |        | -----    |          |
| Total comprehensive income (loss)  | \$ (1,159) | \$ 936 | \$ 1,265 | \$ (870) |
|  | =====      |        | =====    |          |

See notes to unaudited condensed consolidated financial statements

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Timberland Bancorp, Inc. and Subsidiary  
Notes to Unaudited Condensed Consolidated Financial Statements

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation: The accompanying unaudited condensed consolidated financial statements for Timberland Bancorp, Inc. ("Company") were prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and with instructions for Form 10-Q and, therefore, do not include all disclosures necessary for a complete presentation of financial condition, results of operations, and cash flows in conformity with GAAP. However, all adjustments which are in the opinion of management necessary for a fair presentation of the interim condensed consolidated financial statements have been included. All such adjustments are of a normal recurring nature. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended September 30, 2010 ("2010 Form 10-K"). The results of operations for the three and nine months ended June 30, 2011 are not necessarily indicative of the results that may be expected for the entire fiscal year.

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

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

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operating name, "Timberland Bank."

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

(e) Certain prior period amounts have been reclassified to conform to the June 30, 2011 presentation with no change to net income (loss) or total shareholders' equity previously reported.

### (2) REGULATORY MATTERS

In December 2009, the FDIC and the Washington State Department of Financial Institutions, Division of Banks ("Division") determined that the Bank required supervisory attention and, on December 29, 2009, entered into an agreement on a Memorandum of Understanding with the Bank ("Bank MOU"). Under the Bank MOU, the Bank must among other things, maintain Tier 1 Capital of not less than 10.0% of the Bank's adjusted total assets and maintain capital ratios above the "well capitalized" thresholds as defined under FDIC Rules and Regulations; obtain the prior consent from the FDIC and the Division prior to the Bank declaring a dividend to its holding company; and not engage in any transactions that would materially change the Bank's balance sheet composition including growth in total assets of five percent or more or significant changes in funding sources without the prior non-objection of the FDIC.

In addition, on February 1, 2010, the Federal Reserve Bank of San Francisco ("FRB") determined that the Company required additional supervisory attention and entered into a Memorandum of Understanding with the Company ("Company MOU"). Under the Company MOU, the Company must, among other things, obtain prior written approval or non-objection from the FRB to declare or pay any dividends, or make any other capital distributions; issue any trust preferred securities; or purchase or redeem any of its stock. The FRB has denied

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the Company's requests to pay dividends on its Series A Preferred Stock issued under the U.S. Treasury Department's Capital Purchase Program ("CPP") for quarterly payments due for the last five quarters commencing with the payments due May 15, 2010. For additional information on the CPP, see Note 3 below entitled "U.S Treasury Department's Capital Purchase Program."

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

On December 23, 2008, the Company received \$16.64 million from the U.S. Treasury Department ("Treasury") as a part of the Treasury's CPP. The CPP was established as part of the Troubled Asset Relief Program ("TARP"). The Company sold 16,641 shares of senior preferred stock with a related warrant to purchase 370,899 shares of the Company's common stock at a price of \$6.73 per share at any time through December 23, 2018. The preferred stock pays a 5.0% dividend for the first five years, after which the rate increases to 9.0% if the preferred shares are not redeemed by the Company.

Preferred stock is initially recorded at the amount of proceeds received. Any discount from the liquidation value is accreted to the expected call date and charged to retained earnings. This accretion is recorded using the

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level-yield method. Preferred dividends paid (or accrued) and any accretion is deducted from (added to) net income (loss) for computing income available (loss) to common shareholders and net income (loss) per share computations.

Under the Company MOU, the Company must, among other things, obtain prior written approval, or non-objection from the FRB to declare or pay any dividends. The FRB has denied the Company's requests to pay dividends on its Series A Preferred Stock issued under the CPP for quarterly payments due for the last five quarters commencing with the payment due May 15, 2010. There can be no assurances that the FRB will approve such payments or dividends in the future. The Company may not declare or pay dividends on its common stock or, with certain exceptions, repurchase common stock without first having paid all cumulative preferred dividends that are due. If dividends on the Series A Preferred Stock are not paid for six quarters, whether or not consecutive, the Treasury has the right to appoint two members to the Company's Board of Directors.

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#### (4) MBS AND OTHER INVESTMENTS

MBS and other investments have been classified according to management's intent and are as follows as of June 30, 2011 and September 30, 2010 (dollars in thousands):

|                           | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---------------------------|-------------------|------------------------------|-------------------------------|---------------|
|                           | -----             | -----                        | -----                         | -----         |
| June 30, 2011             |                   |                              |                               |               |
| -----                     |                   |                              |                               |               |
| Held to Maturity          |                   |                              |                               |               |
| MBS:                      |                   |                              |                               |               |
| U.S. government agencies  | \$ 1,889          | \$ 35                        | \$ (4)                        | \$ 1,920      |
| Private label residential | 2,366             | 107                          | (71)                          | 2,402         |
| U.S. agency securities    | 28                | 2                            | - -                           | 30            |
|                           | -----             | -----                        | -----                         | -----         |
| Total                     | \$ 4,283          | \$ 144                       | \$ (75)                       | \$ 4,352      |
|                           | =====             | =====                        | =====                         | =====         |
| Available for Sale        |                   |                              |                               |               |
| MBS:                      |                   |                              |                               |               |
| U.S. government agencies  | \$ 4,800          | \$ 176                       | \$ - -                        | \$ 4,976      |
| Private label residential | 1,804             | 69                           | (145)                         | 1,728         |
| Mutual funds              | 1,000             | - -                          | (25)                          | 975           |
|                           | -----             | -----                        | -----                         | -----         |
| Total                     | \$ 7,604          | \$ 245                       | \$ (170)                      | \$ 7,679      |
|                           | =====             | =====                        | =====                         | =====         |
| September 30, 2010        |                   |                              |                               |               |
| -----                     |                   |                              |                               |               |
| Held to Maturity          |                   |                              |                               |               |
| MBS:                      |                   |                              |                               |               |
| U.S. government agencies  | \$ 2,107          | \$ 29                        | \$ (5)                        | \$ 2,131      |
| Private label residential | 2,931             | 161                          | (411)                         | 2,681         |
| U.S. agency securities    | 28                | 2                            | - -                           | 30            |
|                           | -----             | -----                        | -----                         | -----         |

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|                           |          |        |          |          |
|---------------------------|----------|--------|----------|----------|
| Total                     | \$ 5,066 | \$ 192 | \$ (416) | \$ 4,842 |
|                           | =====    | =====  | =====    | =====    |
| Available for Sale        |          |        |          |          |
| MBS:                      |          |        |          |          |
| U.S. government agencies  | \$ 7,846 | \$ 262 | \$ - -   | \$ 8,108 |
| Private label residential | 2,198    | 73     | (248)    | 2,023    |
| Mutual funds              | 1,000    | - -    | (12)     | 988      |
|                           | -----    | -----  | -----    | -----    |
| Total                     | \$11,044 | \$ 335 | \$ (260) | \$11,119 |
|                           | =====    | =====  | =====    | =====    |

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The estimated fair value of temporarily impaired securities, the amount of unrealized losses and the length of time these unrealized losses existed as of June 30, 2011 are as follows (dollars in thousands):

|                           | Less Than 12 Months             |                               | 12 Months or Longer             |                               | Total                           |                               |
|---------------------------|---------------------------------|-------------------------------|---------------------------------|-------------------------------|---------------------------------|-------------------------------|
|                           | Esti-<br>mated<br>Fair<br>Value | Gross<br>Unrealized<br>Losses | Esti-<br>mated<br>Fair<br>Value | Gross<br>Unrealized<br>Losses | Esti-<br>mated<br>Fair<br>Value | Gross<br>Unrealized<br>Losses |
|                           | -----                           | -----                         | -----                           | -----                         | -----                           | -----                         |
| Held to Maturity          |                                 |                               |                                 |                               |                                 |                               |
| MBS:                      |                                 |                               |                                 |                               |                                 |                               |
| U.S. government agencies  | \$ 77                           | \$ (1)                        | \$ 365                          | \$ (3)                        | \$ 442                          | \$ (4)                        |
| Private label residential | - -                             | - -                           | 549                             | (71)                          | 549                             | (71)                          |
|                           | -----                           | -----                         | -----                           | -----                         | -----                           | -----                         |
| Total                     | \$ 77                           | \$ (1)                        | \$ 914                          | \$ (74)                       | \$ 991                          | \$ (75)                       |
|                           | =====                           | =====                         | =====                           | =====                         | =====                           | =====                         |

|                           |        |        |         |          |         |          |
|---------------------------|--------|--------|---------|----------|---------|----------|
| Available for Sale        |        |        |         |          |         |          |
| MBS:                      |        |        |         |          |         |          |
| U.S. government agencies  | \$ - - | \$ - - | \$ - -  | \$ - -   | \$ - -  | \$ - -   |
| Private label residential | - -    | - -    | 1,033   | (145)    | 1,033   | (145)    |
| Mutual funds              | - -    | - -    | 975     | (25)     | 975     | (25)     |
|                           | -----  | -----  | -----   | -----    | -----   | -----    |
| Total                     | \$ - - | \$ - - | \$2,008 | \$ (170) | \$2,008 | \$ (170) |
|                           | =====  | =====  | =====   | =====    | =====   | =====    |

During the three months ended June 30, 2011 and 2010, the Company recorded net OTTI charges through earnings on residential MBS of \$165,000 and \$152,000, respectively. During the nine months ended June 30, 2011 and 2010, the Company recorded net OTTI charges through earnings on residential MBS of \$336,000 and \$2.03 million, respectively. The Company provides for the bifurcation of OTTI into (i) amounts related to credit losses which are recognized through earnings, and (ii) amounts related to all other factors which are recognized as a component of other comprehensive income (loss).

To determine the component of the gross OTTI related to credit losses, the Company compared the amortized cost basis of each OTTI security to the present

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value of its revised expected cash flows, discounted using its pre-impairment yield. The revised expected cash flow estimates for individual securities are based primarily on an analysis of default rates, prepayment speeds and third-party analytic reports. Significant judgment by management is required in this analysis that includes, but is not limited to, assumptions regarding the collectability of principal and interest, net of related expenses, on the underlying loans. The following table presents a summary of the significant inputs utilized to measure management's estimate of the credit loss component on OTTI securities as of June 30, 2011 and September 30, 2010:

|                          | Range   |         | Weighted<br>Average |
|--------------------------|---------|---------|---------------------|
|                          | Minimum | Maximum |                     |
| At June 30, 2011         |         |         |                     |
| -----                    |         |         |                     |
| Constant prepayment rate | 6.00%   | 15.00%  | 10.16%              |
| Collateral default rate  | 0.51%   | 40.48%  | 10.52%              |
| Loss severity rate       | 28.13%  | 66.10%  | 45.74%              |
| At September 30, 2010    |         |         |                     |
| -----                    |         |         |                     |
| Constant prepayment rate | 6.00%   | 15.00%  | 8.28%               |
| Collateral default rate  | 3.69%   | 68.09%  | 34.75%              |
| Loss severity rate       | 30.02%  | 60.43%  | 45.35%              |

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The following tables present the OTTI for the three and nine months ended June 30, 2011 and 2010 (dollars in thousands):

|  | Three months ended<br>June 30, 2011 |                       | Three months ended<br>June 30, 2011 |                       |
|--|-------------------------------------|-----------------------|-------------------------------------|-----------------------|
|  | Held To<br>Maturity                 | Available<br>For Sale | Held To<br>Maturity                 | Available<br>For Sale |
| Total OTTI   | \$ 41                               | \$ 29                 | \$ 81                               | \$ - -                |
| Portion of OTTI recognized in<br>other comprehensive loss<br>(before income taxes) (1) | 95                                  | - -                   | 71                                  | - -                   |
| Net OTTI recognized in<br>earnings (2)   | \$ 136                              | \$ 29                 | \$ 152                              | \$ - -                |
|  |                                     |                       |                                     |                       |
|  | Nine months ended<br>June 30, 2011  |                       | Nine months ended<br>June 30, 2011  |                       |
|  | Held To<br>Maturity                 | Available<br>For Sale | Held To<br>Maturity                 | Available<br>For Sale |
| Total OTTI   | \$ 194                              | \$ 30                 | \$ 595                              | \$ 93                 |
| Portion of OTTI recognized in<br>other comprehensive loss<br>(before income taxes) (1) | 112                                 | - -                   | 1,340                               | - -                   |

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|                                     |                          |                         |                            |                         |
|-------------------------------------|--------------------------|-------------------------|----------------------------|-------------------------|
| Net OTTI recognized in earnings (2) | -----<br>\$ 306<br>===== | -----<br>\$ 30<br>===== | -----<br>\$ 1,935<br>===== | -----<br>\$ 93<br>===== |
|-------------------------------------|--------------------------|-------------------------|----------------------------|-------------------------|

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

The following table presents a roll-forward of the credit loss component of held to maturity debt securities that have been written down for OTTI with the credit loss component recognized in earnings and the remaining impairment loss related to all other factors recognized in other comprehensive income (loss) for the nine months ended June 30, 2011 and 2010 (in thousands):

|  | Nine months ended June 30, |                   |
|--|----------------------------|-------------------|
|  | 2011                       | 2010              |
|  | -----                      | -----             |
| Beginning balance of credit loss   | \$ 4,725                   | \$ 3,551          |
| Additions:   |                            |                   |
| Credit losses for which OTTI was not previously recognized   | 53                         | 374               |
| Additional increases to the amount related to credit loss for which OTTI was previously recognized | 283                        | 1,623             |
| Subtractions:  |                            |                   |
| Realized losses recorded previously as credit losses   | (1,390)                    | (499)             |
| Ending balance of credit loss  | \$ 3,671<br>=====          | \$ 5,049<br>===== |

There were no gross realized gains on sale of securities for the three months ended June 30, 2011. There was a gross realized gain on sale of securities for the nine months ended June 30, 2011 of \$79,000. There were no gross realized gains on sale of securities for the three or nine months ended June 30, 2010. During the three

months ended June 30, 2011, the Company recorded a \$509,000 realized loss (as a result of the securities being deemed worthless) on 22 held to maturity residential MBS and one available for sale residential MBS of which the entire amount had been recognized previously as a credit loss. During the nine months ended June 30, 2011, the Company recorded a \$1.392 million realized loss on 23 held to maturity residential MBS and one available for sale residential MBS of which \$1.390 million had been recognized previously as a credit loss. During the three months ended June 30, 2010, the Company recorded a \$247,000 realized loss on nine held to maturity residential MBS which had previously been recognized as a credit loss. During the nine months ended June 30, 2010, the Company recorded a \$499,000 realized loss on thirteen held to maturity residential MBS of which \$482,000 had been recognized previously as a credit loss.

The amortized cost of residential mortgage-backed and agency securities pledged as collateral for public fund deposits, federal treasury tax and loan deposits, FHLB collateral, retail repurchase agreements and other non-profit organization deposits totaled \$8.68 million and \$12.80 million at June 30, 2011 and September 30, 2010, respectively.

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The contractual maturities of debt securities at June 30, 2011 are as follows (dollars in thousands). Expected maturities may differ from scheduled maturities as a result of the prepayment of principal or call provisions.

|                                     | Held to Maturity  |                            | Available for Sale |                            |
|-------------------------------------|-------------------|----------------------------|--------------------|----------------------------|
|                                     | Amortized<br>Cost | Estimated<br>Fair<br>Value | Amortized<br>Cost  | Estimated<br>Fair<br>Value |
| Due within one year                 | \$ - -            | \$ - -                     | \$ 218             | \$ 216                     |
| Due after one year to five<br>years | 25                | 26                         | - -                | - -                        |
| Due after five to ten years         | 39                | 41                         | 115                | 123                        |
| Due after ten years                 | 4,219             | 4,285                      | 6,271              | 6,365                      |
|                                     | -----             | -----                      | -----              | -----                      |
| Total                               | \$4,283           | \$4,352                    | \$6,604            | \$6,704                    |

### (5) FHLB STOCK

The Company views its investment in the FHLB stock as a long-term investment. Accordingly, when evaluating for impairment, the value is determined based on the ultimate recovery of the par value rather than recognizing temporary declines in value. The determination of whether a decline affects the ultimate recovery is influenced by criteria such as: 1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount and length of time a decline has persisted; 2) the impact of legislative and regulatory changes on the FHLB and 3) the liquidity position of the FHLB. On October 25, 2010, the FHLB announced that it had entered into a Consent Agreement with the Federal Housing Finance Agency ("FHFA"), which requires the FHLB to take certain specific actions related to its business and operations. The FHLB will not pay a dividend or repurchase capital stock while it is classified as undercapitalized. As of June 30, 2011, the FHLB reported that it had met all of its regulatory capital requirements pursuant to the Consent Agreement issued by the FHFA. The Company does not believe that its investment in the FHLB is impaired and did not recognize an OTTI loss on its FHLB stock during the three and nine months ended June 30, 2011. However, this estimate could change in the near term if: 1) significant other-than-temporary losses are incurred on the FHLB's MBS causing a significant decline in its regulatory capital status; 2) the economic losses resulting from credit deterioration on the FHLB's MBS increases significantly or 3) capital preservation strategies being utilized by the FHLB become ineffective.

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### (6) LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

Loans receivable and loans held for sale consisted of the following at June 30, 2011 and September 30, 2010 (dollars in thousands):

| June 30,<br>2011 |         | September 30,<br>2010 |         |
|------------------|---------|-----------------------|---------|
| Amount           | Percent | Amount                | Percent |
| -----            | -----   | -----                 | -----   |



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|  |           |        |           |        |
|--|-----------|--------|-----------|--------|
| Mortgage loans:                                      |           |        |           |        |
| One- to four-family (1)                              | \$112,838 | 20.2%  | \$121,014 | 21.6%  |
| Multi-family   | 31,058    | 5.6    | 32,267    | 5.8    |
| Commercial   | 229,800   | 41.2   | 208,002   | 37.2   |
| Construction and land development                    | 68,017    | 12.2   | 69,271    | 12.4   |
| Land   | 50,238    | 9.0    | 62,999    | 11.3   |
|  | -----     |        | -----     | -----  |
| Total mortgage loans                                 | 491,951   | 88.2   | 493,553   | 88.3   |
| Consumer loans:                                      |           |        |           |        |
| Home equity and second mortgage                      | 36,991    | 6.6    | 38,418    | 6.9    |
| Other  | 8,226     | 1.5    | 9,086     | 1.6    |
|  | -----     |        | -----     | -----  |
| Total consumer loans                                 | 45,217    | 8.1    | 47,504    | 8.5    |
| Commercial business loans                            | 20,621    | 3.7    | 17,979    | 3.2    |
|  | -----     |        | -----     | -----  |
| Total loans receivable                               | 557,789   | 100.0% | 559,036   | 100.0% |
|  | -----     | =====  | -----     | =====  |
| Less:  |           |        |           |        |
| Undisbursed portion of construction loans in process | (22,713)  |        | (17,952)  |        |
| Deferred loan origination fees                       | (1,988)   |        | (2,229)   |        |
| Allowance for loan losses                            | (11,790)  |        | (11,264)  |        |
|  | -----     |        | -----     |        |
| Total loans receivable, net                          | \$521,298 |        | \$527,591 |        |
|  | =====     |        | =====     |        |

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(1) Includes loans held for sale.

Construction and Land Development Loan Portfolio Composition

The following table sets forth the composition of the Company's construction and land development loan portfolio at June 30, 2011 and September 30, 2010 (dollars in thousands):

|  | June 30,<br>2011 |         | September 30,<br>2010 |         |
|--|------------------|---------|-----------------------|---------|
|  | Amount           | Percent | Amount                | Percent |
|  | -----            | -----   | -----                 | -----   |
| Custom and owner/builder                         | \$ 28,128        | 41.4%   | \$ 30,945             | 44.7%   |
| Speculative one- to four-family                  | 3,028            | 4.5     | 4,777                 | 6.9     |
| Commercial real estate                           | 26,081           | 38.3    | 23,528                | 33.9    |
| Multi-family<br>(including condominiums)         | 8,254            | 12.1    | 3,587                 | 5.2     |
| Land development                                 | 2,526            | 3.7     | 6,434                 | 9.3     |
|  | -----            | -----   | -----                 | -----   |
| Total construction and<br>land development loans | \$ 68,017        | 100.0%  | \$ 69,271             | 100.0%  |
|  | =====            | =====   | =====                 | =====   |

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**One- To Four-Family Residential Lending:** The Company originates both fixed rate and adjustable rate loans secured by one- to four-family residences. A portion of the fixed-rate one- to four-family loans are sold in the secondary market for asset/liability management purposes and to generate non-interest income. The Company's lending policies generally limit the maximum loan-to-value on one- to four-family loans to 95% of the lesser of the appraised value or the purchase price. However, the Company usually obtains private mortgage insurance on the portion of the principal amount that exceeds 80% of the appraised value of the property.

**Multi-Family Lending:** The Company originates loans secured by multi-family dwelling units (more than four units). Multi-family lending generally affords the Company 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 the 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 economy. The Company seeks to minimize these risks by scrutinizing the financial condition of the borrower, the quality of the collateral and the management of the property securing the loan.

**Commercial Real Estate Lending:** The Company originates commercial real estate loans secured by properties such as office buildings, retail/wholesale facilities, motels, restaurants, mini-storage facilities and other commercial properties. Commercial real estate lending generally affords the Company an opportunity to receive interest at higher rates than those 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 economy. The Company seeks to mitigate these risks by generally limiting the maximum loan-to-value ratio to 80% and scrutinizing the financial condition of the borrower, the quality of the collateral and the management of the property securing the loan.

**Construction and Land Development Lending:** The Company currently originates the following types of construction loans: custom construction loans, owner/builder construction loans, speculative construction loans (on a very limited basis), commercial real estate construction loans, and multi-family construction loans. The Company is no longer originating land development 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 to purchase the finished home. Owner/builder construction loans are originated to home owners rather than home builders and are typically refinanced into permanent loans at the completion of construction.

Speculative one-to four-family construction loans are made to home builders and are termed "speculative" because the home builder does not have, at the time of the loan origination, a signed contract with a home buyer who has a commitment for permanent financing with 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 provide the debt service for the speculative construction loan and finance real estate

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taxes and other carrying costs of the completed home for a significant time after the completion of construction until the home

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buyer is identified and a sale is consummated. The Company is currently originating speculative one-to four-family construction loans on a very limited basis.

Commercial construction loans are originated to construct properties such as office buildings, hotels, retail rental space and mini-storage facilities. Multi-family construction loans are originated to construct apartment buildings and condominium projects.

The Company historically originated loans to real estate developers for the purpose of developing residential subdivisions. The Company is not currently originating any new land development loans.

Construction lending affords the Company 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 one-to four family residential 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 estimated cost of construction proves to be inaccurate, the Company may be required to advance funds beyond the amount originally committed to complete the project. If the estimate of value upon completion proves to be inaccurate, the Company may be confronted with a project whose value is insufficient to assure full repayment and it may incur a loss. Projects may also be jeopardized by disagreements between borrowers and builders and by the failure of builders to pay subcontractors. Loans 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 Company has sought to address these risks by adhering to strict underwriting policies, disbursement procedures, and monitoring practices.

Land Lending: The Company has historically originated 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. Currently, the Company is not offering land loans to new customers and is attempting to decrease its land loan portfolio. 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 or foreclosure, the Company may be confronted with a property value which is insufficient to assure full repayment. The Company attempts to minimize this risk by generally limiting the maximum loan-to-value ratio on land loans to 75%.

Consumer Lending: Consumer loans generally have shorter terms to maturity 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. Home equity lines of credit and second mortgage loans have a 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 Company. Other consumer loans generally entail greater risk than do residential mortgage loans, particularly in the case of

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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.

**Commercial Business Lending:** Commercial business loans are generally secured by business equipment, accounts receivable, inventory or other property. The Company also generally obtains personal guarantees from the principals based on a review of personal financial statements. Commercial business lending generally 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

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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. Accordingly, the repayment of a commercial business loan depends primarily on the creditworthiness of the borrower (and any guarantors), while the liquidation of collateral is a secondary and potentially insufficient source of repayment.

### Allowance for Loan Losses

The following table sets forth information for the three and nine months ended June 30, 2011, regarding activity in the allowance for loan losses (dollars in thousands):

|  | For the Three Months Ended June 30, 2011 |           |             |            |                     |
|--|--|-----------|-------------|------------|---------------------|
|  | Beginning<br>Allowance                   | Provision | Charge-offs | Recoveries | Ending<br>Allowance |
|  | -----                                    | -----     | -----       | -----      | -----               |
| <b>Mortgage loans:</b>                               |  |           |             |            |                     |
| One-to four-family                                   | \$ 738                                   | \$ 250    | \$ 172      | \$ 1       | \$ 817              |
| Multi-family   | 1,016                                    | 88        | -           | 11         | 1,115               |
| Commercial real estate                               | 4,179                                    | (343)     | -           | 4          | 3,840               |
| Construction - custom<br>and owner / builder         | 346                                      | (92)      | -           | -          | 254                 |
| Construction -<br>speculative one- to<br>four-family | 260                                      | (63)      | -           | -          | 197                 |
| Construction -<br>commercial                         | 179                                      | 2,282     | 1,444       | -          | 1,017               |
| Construction -<br>multi-family                       | 263                                      | (125)     | -           | -          | 138                 |
| Construction - land<br>development                   | 28                                       | 667       | 667         | -          | 28                  |
| Land   | 3,254                                    | 790       | 1,147       | 6          | 2,903               |
| <b>Consumer loans:</b>                               |  |           |             |            |                     |
| Home equity and<br>second mortgage                   | 505                                      | (52)      | -           | -          | 453                 |

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|                           |          |         |         |       |          |
|---------------------------|----------|---------|---------|-------|----------|
| Other                     | 436      | (8)     | - -     | - -   | 428      |
| Commercial business loans | 594      | 6       | - -     | - -   | 600      |
| Total                     | \$11,798 | \$3,400 | \$3,430 | \$ 22 | \$11,790 |

For the Nine Months Ended June 30, 2011

|  | Beginning Allowance | Provision | Charge-offs | Recoveries | Ending Allowance |
|--|---------------------|-----------|-------------|------------|------------------|
| Mortgage loans:                                |                     |           |             |            |                  |
| One-to four-family                             | \$ 530              | \$ 543    | \$ 405      | \$149      | \$ 817           |
| Multi-family                                   | 393                 | 692       | - -         | 30         | 1,115            |
| Commercial real estate                         | 3,173               | 609       | 47          | 105        | 3,840            |
| Construction - custom and owner / builder      | 481                 | (227)     | - -         | - -        | 254              |
| Construction - speculative one- to four-family | 414                 | (177)     | 40          | - -        | 197              |
| Construction - commercial                      | 245                 | 2,216     | 1,444       | - -        | 1,017            |
| Construction - multi-family                    | 245                 | (107)     | - -         | - -        | 138              |
| Construction - land development                | 240                 | 938       | 1,150       | - -        | 28               |
| Land   | 3,709               | 709       | 1,560       | 45         | 2,903            |
| Consumer loans:                                |                     |           |             |            |                  |
| Home equity and second mortgage                | 922                 | (362)     | 114         | 7          | 453              |
| Other  | 451                 | 5         | 30          | 2          | 428              |
| Commercial business loans                      | 461                 | 161       | 22          | - -        | 600              |
| Total  | \$11,264            | \$5,000   | \$4,812     | \$338      | \$11,790         |

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The following table presents information on the loans evaluated individually for impairment and collectively evaluated for impairment in the allowance for loan losses at June 30, 2011 (dollars in thousands):

|                     | Allowance for Loan Losses             |                                       |        | Recorded Investment in Loans          |                                       |
|---------------------|---------------------------------------|---------------------------------------|--------|---------------------------------------|---------------------------------------|
|                     | Individually Evaluated for Impairment | Collectively Evaluated for Impairment | Total  | Individually Evaluated for Impairment | Collectively Evaluated for Impairment |
| Mortgage loans:     |                                       |                                       |        |                                       |                                       |
| One- to four-family | \$ 56                                 | \$ 761                                | \$ 817 | \$ 3,180                              | \$109,658                             |

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|  |         |         |          |          |           |
|--|---------|---------|----------|----------|-----------|
| Multi-family                                   | 632     | 483     | 1,115    | 5,482    | 25,576    |
| Commercial real estate                         | 245     | 3,595   | 3,840    | 19,054   | 210,746   |
| Construction - custom and owner / builder      | 13      | 241     | 254      | 591      | 19,056    |
| Construction - speculative one- to four-family | 39      | 158     | 197      | 1,500    | 1,008     |
| Construction - commercial real estate          | 772     | 245     | 1,017    | 5,451    | 10,785    |
| Construction - multi-family                    | - -     | 138     | 138      | 1,911    | 2,485     |
| Construction - land development                | - -     | 28      | 28       | 2,374    | 143       |
| Land   | 461     | 2,442   | 2,903    | 10,498   | 39,740    |
| Consumer loans:                                |         |         |          |          |           |
| Home equity and second mortgage                | 13      | 440     | 453      | 993      | 35,998    |
| Other  | 1       | 427     | 428      | 1        | 8,225     |
| Commercial business loans                      | - -     | 600     | 600      | 47       | 20,574    |
|  | -----   | -----   | -----    | -----    | -----     |
|  | \$2,232 | \$9,558 | \$11,790 | \$51,082 | \$483,994 |
|  | =====   | =====   | =====    | =====    | =====     |

Credit Quality Indicators

The Company uses credit risk grades which reflect the Company's assessment of a loan's risk or loss potential. The Company categorizes loans into risk grade categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors such as the estimated fair value of the collateral. The Company uses the following definitions for credit risk ratings:

**Pass:** Pass loans are defined as those loans that meet acceptable quality underwriting standards.

**Watch:** Watch loans are defined as those loans that still exhibit marginal acceptable quality, but have some concerns that justify greater attention. If these concerns are not corrected, a potential for further adverse categorization exists. These concerns could relate to a specific condition peculiar to the borrower or their industry segment or the general economic environment.

**Special Mention:** Special mention loans are defined as those loans 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 do not expose the Company to sufficient risk to warrant a substandard classification.

**Substandard:** Substandard loans are defined as those loans that are inadequately protected by the current net worth and paying capacity of the obligor, or of the collateral pledged. Loans 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

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possibility that some loss will be sustained.

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The following table lists the loan credit risk grades utilized by the Company that serve as credit quality indicators. Each of the credit risk loan grades include high and low factors associated with their classification that are utilized to calculate the aggregate ranges of the allowance for loan losses at June 30, 2011 (dollars in thousands):

Credit Risk Profile by Internally Assigned Grades

|   | Loan Grades |          |                    |             |           |
|---|-------------|----------|--------------------|-------------|-----------|
|   | Pass        | Watch    | Special<br>Mention | Substandard | Total     |
| Mortgage loans:                                   |             |          |                    |             |           |
| One- to four-family                               | \$ 97,338   | \$ 7,754 | \$ 1,708           | \$ 6,038    | \$112,838 |
| Multi-family                                      | 18,948      | 264      | 10,397             | 1,449       | 31,058    |
| Commercial  | 188,985     | 10,104   | 5,271              | 25,440      | 229,800   |
| Construction - custom and<br>owner / builder      | 18,822      | 234      | - -                | 591         | 19,647    |
| Construction - speculative<br>one- to four-family | 286         | - -      | 1,500              | 722         | 2,508     |
| Construction - commercial<br>real estate          | 10,785      | - -      | - -                | 5,451       | 16,236    |
| Construction - multi-family                       | 1,733       | - -      | 752                | 1,911       | 4,396     |
| Construction - land<br>development                | 143         | - -      | - -                | 2,374       | 2,517     |
| Land  | 26,171      | 7,568    | 5,095              | 11,404      | 50,238    |
| Consumer loans:                                   |             |          |                    |             |           |
| Home equity and second<br>mortgage                | 33,612      | 745      | 1,524              | 1,110       | 36,991    |
| Other   | 8,163       | 51       | - -                | 12          | 8,226     |
| Commercial business loans                         | 17,147      | 85       | 2,124              | 1,265       | 20,621    |
| Total   | \$422,133   | \$26,805 | \$28,371           | \$57,767    | \$535,076 |

The following table presents an age analysis of past due status of loans by category at June 30, 2011 (dollars in thousands):

|                           | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days<br>or More<br>Past Due (1) | Total<br>Past Due | Current   | Total<br>Loans | Total<br>or<br>Sti |
|---------------------------|------------------------|------------------------|------------------------------------|-------------------|-----------|----------------|--------------------|
| Mortgage loans:           |                        |                        |                                    |                   |           |                |                    |
| One- to four-family       | \$ 218                 | \$ 1,547               | \$ 2,634                           | \$ 4,399          | \$108,439 | \$112,838      |                    |
| Multi-family              | 1,449                  | - -                    | - -                                | 1,449             | 29,609    | 31,058         |                    |
| Commercial                | - -                    | 12,454                 | 9,483                              | 21,937            | 207,863   | 229,800        |                    |
| Construction - custom and |                        |                        |                                    |                   |           |                |                    |

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|                             |         |          |          |          |           |           |
|-----------------------------|---------|----------|----------|----------|-----------|-----------|
| owner / builder             | - -     | - -      | 591      | 591      | 19,056    | 19,647    |
| Construction - speculative  |         |          |          |          |           |           |
| one- to four-family         | - -     | - -      | - -      | - -      | 2,508     | 2,508     |
| Construction - commercial   | - -     | - -      | 704      | 704      | 15,532    | 16,236    |
| Construction - multi-family | - -     | - -      | 1,910    | 1,910    | 2,486     | 4,396     |
| Construction - land         |         |          |          |          |           |           |
| development                 | - -     | - -      | 2,374    | 2,374    | 143       | 2,517     |
| Land                        | 606     | 1,870    | 7,775    | 10,251   | 39,987    | 50,238    |
| Consumer loans:             |         |          |          |          |           |           |
| Home equity and second      |         |          |          |          |           |           |
| mortgage                    | 257     | 43       | 643      | 943      | 36,048    | 36,991    |
| Other                       | 33      | - -      | 1        | 34       | 8,192     | 8,226     |
| Commercial business loans   | 49      | 15       | 323      | 387      | 20,234    | 20,621    |
|                             | -----   | -----    | -----    | -----    | -----     | -----     |
| Total                       | \$2,612 | \$15,929 | \$26,438 | \$44,979 | \$490,097 | \$535,076 |
|                             | =====   | =====    | =====    | =====    | =====     | =====     |

-----  
 (1) Includes loans past due 90 days or more and still accruing.

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Impaired Loans

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

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

At June 30, 2011 and September 30, 2010, the Company had impaired loans totaling \$51.08 million and \$42.25 million, respectively. At June 30, 2011, the Company had loans totaling \$4.89 million that were 90 days or more past due and still accruing interest. At September 30, 2010, the Company had loans totaling \$1.33 million that were 90 days or more past due and still accruing interest. Interest income recognized on impaired loans for the nine months ended June 30, 2011 and June 30, 2010 was \$1.43 million and \$861,000, respectively. Interest income recognized on a cash basis on impaired loans for the nine months ended June 30, 2011 and June 30, 2010, was \$843,000 and \$517,000, respectively. The average investment in impaired loans for the nine months ended June 30, 2011 and June 30, 2010 was \$46.15 million and \$42.87 million, respectively.

Troubled debt restructured loans are loans for which the Company, for economic or legal reasons related to the borrower's financial condition, has granted a significant concession to the borrower that it would otherwise not consider. Troubled debt restructured loans are considered impaired loans and can be



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classified as either accrual or non-accrual. The Company had \$25.80 million in troubled debt restructured loans included in impaired loans at June 30, 2011 and had \$144,000 in commitments to lend additional funds on these loans. At June 30, 2011, \$4.96 million of the \$25.80 million in troubled debt restructured loans were on non-accrual status and included in non-performing loans. The Company had \$16.40 million in troubled debt restructured loans included in impaired loans at September 30, 2010 and had \$1.06 million in commitments to lend additional funds on these loans. At September 30, 2010, \$7.41 million of the \$16.40 million in troubled debt restructured loans were on non-accrual status and included in non-performing loans.

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The following table is a summary of information related to impaired loans as of June 30, 2011 (dollars in thousands):

|   | Recorded<br>Investment | Unpaid Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | In<br>I<br>Rec |
|---|------------------------|-----------------------------|----------------------|-----------------------------------|----------------|
|   | -----                  | -----                       | -----                | -----                             | -----          |
| With no related allowance recorded:               |                        |                             |                      |                                   |                |
| Mortgage loans:                                   |                        |                             |                      |                                   |                |
| One- to four-family                               | \$ 2,212               | \$ 2,436                    | \$ - -               | \$ 2,437                          |                |
| Commercial  | 16,315                 | 16,737                      | - -                  | 14,727                            |                |
| Construction - custom and<br>owner / builder      | 478                    | 478                         | - -                  | 513                               |                |
| Construction - speculative one-<br>to four-family | - -                    | 20                          | - -                  | 132                               |                |
| Construction - commercial                         | - -                    | - -                         | - -                  | - -                               |                |
| Construction - multi-family                       | 1,911                  | 1,915                       | - -                  | 1,505                             |                |
| Construction - land development                   | 2,374                  | 7,663                       | - -                  | 2,704                             |                |
| Land  | 6,113                  | 10,106                      | - -                  | 6,475                             |                |
| Consumer loans:                                   |                        |                             |                      |                                   |                |
| Home equity and second mortgage                   | 647                    | 698                         | - -                  | 528                               |                |
| Other   | - -                    | - -                         | - -                  | 6                                 |                |
| Commercial business loans                         | 47                     | 68                          | - -                  | 44                                |                |
|   | -----                  | -----                       | -----                | -----                             |                |
| Subtotal  | 30,097                 | 40,121                      | - -                  | 29,071                            |                |
| With an allowance recorded:                       |                        |                             |                      |                                   |                |
| Mortgage loans:                                   |                        |                             |                      |                                   |                |
| One- to four-family                               | 968                    | 968                         | 56                   | 957                               |                |
| Multi-family                                      | 5,482                  | 5,482                       | 632                  | 5,482                             |                |
| Commercial  | 2,739                  | 3,459                       | 245                  | 2,931                             |                |
| Construction - custom and owner /<br>builder      | 113                    | 113                         | 13                   | 57                                |                |
| Construction - speculative one-<br>to four-family | 1,500                  | 1,500                       | 39                   | 1,500                             |                |
| Construction - commercial                         | 5,451                  | 6,895                       | 772                  | 6,126                             |                |
| Land  | 4,385                  | 4,408                       | 461                  | 4,403                             |                |
| Consumer loans:                                   |                        |                             |                      |                                   |                |
| Home equity and second mortgage                   | 346                    | 346                         | 13                   | 343                               |                |
| Other   | 1                      | 1                           | 1                    | 1                                 |                |
|   | -----                  | -----                       | -----                | -----                             |                |

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|  |          |          |         |          |
|--|----------|----------|---------|----------|
| Subtotal                                       | 20,985   | 23,172   | 2,232   | 21,800   |
| Total  |          |          |         |          |
| Mortgage loans:                                |          |          |         |          |
| One- to four-family                            | 3,180    | 3,404    | 56      | 3,394    |
| Multi-family                                   | 5,482    | 5,482    | 632     | 5,482    |
| Commercial                                     | 19,054   | 20,196   | 245     | 17,658   |
| Construction - custom and owner / builder      | 591      | 591      | 13      | 570      |
| Construction - speculative one- to four-family | 1,500    | 1,520    | 39      | 1,632    |
| Construction - commercial                      | 5,451    | 6,895    | 772     | 6,126    |
| Construction - multi-family                    | 1,911    | 1,915    | - -     | 1,505    |
| Construction - land development                | 2,374    | 7,663    | - -     | 2,704    |
| Land   | 10,498   | 14,514   | 461     | 10,878   |
| Consumer loans:                                |          |          |         |          |
| Home equity and second mortgage                | 993      | 1,044    | 13      | 871      |
| Other  | 1        | 1        | 1       | 7        |
| Commercial business loans                      | 47       | 68       | - -     | 44       |
|  | -----    | -----    | -----   | -----    |
| Total  | \$51,082 | \$63,293 | \$2,232 | \$50,871 |
|  | =====    | =====    | =====   | =====    |

(1) For the three months ended June 30, 2011

The following is a summary of information related to impaired loans at September 30, 2010 (dollars in thousands):

|   |           |
|---|-----------|
| Impaired loans without a valuation allowance  | \$ 36,475 |
| Impaired loans with a valuation allowance     | 5,770     |
|   | -----     |
| Total impaired loans                          | \$ 42,245 |
|   | =====     |
| Valuation allowance related to impaired loans | \$ 862    |

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The following table sets forth information with respect to the Company's non-performing assets at June 30, 2011 and September 30, 2010 (dollars in thousands):

|  |          |               |
|--|----------|---------------|
| Loans accounted for on a non-accrual basis:    | June 30, | September 30, |
|  | 2011     | 2010          |
|  | -----    | -----         |
| Mortgage loans:                                |          |               |
| One- to four family                            | \$ 2,332 | \$ 3,691      |
| Commercial                                     | 5,706    | 7,252         |
| Construction - custom and owner / builder      | 382      | - -           |
| Construction - speculative one- to four-family | - -      | 2,050         |
| Construction - commercial real estate          | 704      | - -           |
| Construction - multi-family                    | 1,910    | 1,771         |
| Construction - land development                | 2,374    | 3,788         |

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|   |           |           |
|---|-----------|-----------|
| Land  | 7,745     | 5,460     |
| Consumer loans:   |           |           |
| Home equity and second mortgage   | 344       | 781       |
| Other   | 1         | 25        |
| Commercial business   | 47        | 46        |
|   | -----     | -----     |
| Total   | 21,545    | 24,864    |
| Accruing loans which are contractually<br>past due 90 days or more                    | 4,893     | 1,325     |
|   | -----     | -----     |
| Total of non-accrual and 90 days past due loans                                       | 26,438    | 26,189    |
| Non-accrual investment securities   | 3,184     | 3,390     |
| OREO and other repossessed assets   | 10,996    | 11,519    |
|   | -----     | -----     |
| Total non-performing assets (1)   | \$ 40,618 | \$ 41,098 |
|   | =====     | =====     |
| Troubled debt restructured loans on accrual<br>status (2)                             | \$ 20,783 | \$ 8,995  |
| Non-accrual and 90 days or more past<br>due loans as a percentage of loans receivable | 4.96%     | 4.86%     |
| Non-accrual and 90 days or more past<br>due loans as a percentage of total assets     | 3.60%     | 3.53%     |
| Non-performing assets as a percentage of total<br>assets                              | 5.53%     | 5.53%     |
| Loans receivable (3)  | \$533,088 | \$538,855 |
|   | =====     | =====     |
| Total assets  | \$735,018 | \$742,687 |
|   | =====     | =====     |

- (1) Does not include troubled debt restructured loans on accrual status.  
(2) Does not include troubled debt restructured loans totaling \$4,956 and \$7,405 reported as non-accrual loans at June 30, 2011 and September 30, 2010, respectively.  
(3) Includes loans held-for-sale and is before the allowance for loan losses.

(7) NET INCOME (LOSS) PER COMMON SHARE

Basic net income (loss) per common share is computed by dividing net income (loss) to common shareholders by the weighted average number of common shares outstanding during the period, without considering any dilutive items. Diluted net income (loss) per common share is computed by dividing net income (loss) to common shareholders 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. Diluted net loss per common share is the same as basic net loss per common share due to the

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anti-dilutive effect of common stock equivalents. Common stock equivalents arise from the assumed conversion of outstanding stock options and the outstanding warrant to purchase common stock. In accordance with the Financial Accounting Standards Board ("FASB") guidance for stock compensation, shares owned by the Bank's ESOP that have not been allocated are not considered to be outstanding for the purpose of computing net income (loss) per common share. At June 30, 2011 and 2010, there were 299,810 and 329,626 shares, respectively, that had not been allocated under the Bank's ESOP.

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

|   | Three Months Ended<br>June 30, |           | Nine Months Ended<br>June 30, |           |
|---|--------------------------------|-----------|-------------------------------|-----------|
|   | 2011                           | 2010      | 2011                          | 2010      |
| Basic net income (loss)                                     |                                |           |                               |           |
| -----   |                                |           |                               |           |
| per common share computation:                               |                                |           |                               |           |
| -----   |                                |           |                               |           |
| Numerator - net income (loss)                               | \$(1,280)                      | \$ 804    | \$ 1,162                      | \$(2,150) |
| Preferred stock dividend                                    | (208)                          | (208)     | (624)                         | (624)     |
| Preferred stock discount accretion                          | (57)                           | (53)      | (168)                         | (156)     |
|   | -----                          | -----     | -----                         | -----     |
| Net income (loss) to common shareholders                    | \$(1,545)                      | \$ 543    | \$ 370                        | \$(2,930) |
|   | =====                          | =====     | =====                         | =====     |
| Denominator - weighted average common shares outstanding    | 6,745,250                      | 6,715,410 | 6,745,250                     | 6,713,103 |
|   | -----                          | -----     | -----                         | -----     |
| Basic net income (loss) per common share                    | \$ (0.23)                      | \$0.08    | \$ 0.05                       | \$ (0.44) |
|   | =====                          | =====     | =====                         | =====     |
| Diluted net income (loss)                                   |                                |           |                               |           |
| -----   |                                |           |                               |           |
| per common share computation:                               |                                |           |                               |           |
| -----   |                                |           |                               |           |
| Numerator - net income (net loss)                           | \$(1,280)                      | \$ 804    | \$ 1,162                      | \$(2,150) |
| Preferred stock dividend                                    | (208)                          | (208)     | (624)                         | (624)     |
| Preferred stock discount accretion                          | (57)                           | (53)      | (168)                         | (156)     |
|   | -----                          | -----     | -----                         | -----     |
| Net income (loss) to common shareholders                    | \$(1,545)                      | \$ 543    | \$ 370                        | \$(2,930) |
|   | =====                          | =====     | =====                         | =====     |
| Denominator - weighted average common shares outstanding    | 6,745,250                      | 6,715,410 | 6,745,250                     | 6,713,103 |
| Effect of dilutive stock options (1) (2)                    | - -                            | - -       | 237                           | - -       |
| Effect of dilutive stock warrants (3)                       | - -                            | - -       | - -                           | - -       |
|   | -----                          | -----     | -----                         | -----     |
| Weighted average common shares and common stock equivalents | 6,745,250                      | 6,715,410 | 6,745,487                     | 6,713,103 |
|   | -----                          | -----     | -----                         | -----     |
| Diluted net income (loss)                                   |                                |           |                               |           |

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|                  |           |        |         |           |
|------------------|-----------|--------|---------|-----------|
| per common share | \$ (0.23) | \$0.08 | \$ 0.05 | \$ (0.44) |
|                  | =====     | =====  | =====   | =====     |

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(1) For the three months and nine months ended June 30, 2011, options to purchase 140,545 and 168,186 shares of common stock, respectively, were outstanding but not included in the computation of diluted net income (loss) per common share because the options' exercise prices were greater than the average market price of the common stock, and, therefore, their effect would have been anti-dilutive. For the three months and nine months ended June 30, 2010, options to purchase 194,864 and 192,483 shares of common stock, respectively, were outstanding but not included in the computation of diluted net income (loss) per common share because the options' exercise prices were greater than the average market price of the common stock, and, therefore, their effect would have been anti-dilutive.

(2) For the three months ended June 30, 2011, the dilutive effect of dilutive stock options was computed to be 710 shares. However, the dilutive effect of these stock options has been excluded from the diluted net income (loss) per common share for the three months ended June 30, 2011 because the Company reported a net loss for the period, and, therefore, their effect would have been anti-dilutive.

(3) For the three and nine months ended June 30, 2011 and June 30, 2010, a warrant to purchase 370,899 shares of common stock was outstanding but not included in the computation of diluted net income (loss) per common share because the warrant's exercise price was greater than the average market price of the common stock, and, therefore, its effect would have been anti-dilutive.

(8) STOCK PLANS AND STOCK BASED COMPENSATION

Stock Option Plans

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Under the Company's stock option plans (the 1999 Stock Option Plan and the 2003 Stock Option Plan), the Company was able to grant options for up to a combined total of 1,622,500 shares of common stock to employees, officers and directors. Shares issued may be purchased in the open market or may be issued from authorized and unissued shares. The exercise price of each option equals the fair market value of the Company's common stock on the date of grant. Generally, options vest in 20% annual installments on each of the five anniversaries from the date of the grant. At June 30, 2011, options for 250,238 shares are available for future grant under the 2003 Stock Option Plan and no shares are available for future grant under the 1999 Stock Option Plan.

Activity under the plans for the nine months ended June 30, 2011 is as follows:

|  | Total Options Outstanding |                                 |
|--|---------------------------|---------------------------------|
|  | Shares                    | Weighted Average Exercise Price |
|  | -----                     | -----                           |
| Options outstanding, beginning of period | 194,864                   | \$ 8.71                         |
| Forfeited                                | 57,138                    | 7.42                            |
|  | -----                     |                                 |
| Options outstanding, end of period       | 137,726                   | \$ 9.25                         |

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|                                    |         |          |
|------------------------------------|---------|----------|
|                                    | =====   |          |
| Options exercisable, end of period | 117,326 | \$ 10.06 |
|                                    | =====   |          |

The aggregate intrinsic value of options outstanding at June 30, 2011 was \$35,000.

At June 30, 2011, there were 20,400 unvested options with an aggregate grant date fair value of \$26,000, all of which the Company assumes will vest. The aggregate intrinsic value of unvested options at June 30, 2011 was \$28,000. There were 5,200 options with an aggregate grant date fair value of \$7,000 that vested during the nine months ended June 30, 2011.

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At June 30, 2010, there were 26,000 unvested options with an aggregate grant date fair value of \$34,000, all of which the Company assumes will vest. There were no options that vested during the nine months ended June 30, 2010.

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 in effect at the time the options were granted. The expected volatility is based on historical volatility of the Company's stock price. There were no options granted during the nine months ended June 30, 2011, and there were 26,000 options granted during the nine months ended June 30, 2010. The weighted average assumptions for options granted during the nine months ended June 30, 2010 were:

|                                 |        |
|---------------------------------|--------|
| Expected volatility             | 38%    |
| Expected term (in years)        | 5      |
| Expected dividend yield         | 2.64%  |
| Risk free interest rate         | 2.47%  |
| Grant date fair value per share | \$1.29 |

Stock Grant Plan

-----

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

The MRDP allowed for the issuance to participants of up to 529,000 shares of the Company's common stock. Awards under the MRDP are made in the form of shares of common stock that are subject to restrictions on the transfer of ownership and are subject to a five-year vesting period. Compensation expense is the amount of the fair value of the common stock at the date of the grant to the plan participants and is recognized over a five-year vesting period, with 20% vesting on each of the five anniversaries from the date of the grant.

There were no MRDP shares granted to officers and directors during the nine months ended June 30, 2011 and 2010.

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At June 30, 2011, there were a total of 24,892 unvested MRDP shares with an aggregated grant date fair value of \$273,000. There were 11,033 MRDP shares that vested during the nine months ended June 30, 2011 with an aggregated grant date fair value of \$132,000. There were 500 MRDP shares forfeited during the nine months ended June 30, 2011 with a grant date fair value of \$5,000. At June 30, 2011, there were no shares available for future awards under the MRDP.

### Expenses for Stock Compensation Plans

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

|   | Nine Months Ended June 30, |                 |                  |                 |
|---|----------------------------|-----------------|------------------|-----------------|
|   | 2011                       |                 | 2010             |                 |
|   | -----                      |                 |                  |                 |
|   | (Dollars in thousands)     |                 |                  |                 |
|   | Stock<br>Options           | Stock<br>Grants | Stock<br>Options | Stock<br>Grants |
|   | -----                      | -----           | -----            | -----           |
| Compensation expense recognized in income | \$ 5                       | \$ 129          | \$ 4             | \$ 130          |
| Related tax benefit recognized            | 2                          | 44              | 1                | 45              |

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

|                   | Stock<br>Options | Stock<br>Grants | Total<br>Awards |
|-------------------|------------------|-----------------|-----------------|
|                   | -----            | -----           | -----           |
| Remainder of 2011 | \$ 2             | \$ 36           | \$ 38           |
| 2012              | 7                | 112             | 119             |
| 2013              | 6                | 38              | 44              |
| 2014              | 6                | 2               | 8               |
| 2015              | 1                | -               | 1               |
|                   | -----            | -----           | -----           |
| Total             | \$ 22            | \$ 188          | \$ 210          |
|                   | =====            | =====           | =====           |

### (9) FAIR VALUE MEASUREMENTS

GAAP 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. In addition, as the Company normally intends to hold the majority of its financial instruments until maturity, it does not expect to realize many of the estimated amounts disclosed. The disclosures also do not include estimated fair value amounts for certain items which are not defined as financial instruments but which may have significant value. The Company does not believe that it would be practicable to estimate a representational fair value for these types of items as of June 30, 2011 and September 30, 2010. Because GAAP excludes certain items from fair value disclosure requirements, any aggregation of the fair value amounts presented would not represent the underlying value of the Company. Major assumptions, methods and fair value estimates for the

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Company's significant financial instruments are set forth below:

### Cash and Cash Equivalents

-----  
The estimated fair value of financial instruments that are short-term or re-price frequently and that have little or no risk are considered to have an estimated fair value equal to the recorded value.

### CDs Held for Investment

-----  
The estimated fair value of financial instruments that are short-term or re-price frequently and that have little or no risk are considered to have an estimated fair value equal to the recorded value.

### MBS and Other Investments

-----  
The estimated fair value of MBS and other investments are based upon the assumptions market participants would use in pricing the security. Such assumptions include observable and unobservable inputs such as quoted market prices, dealer quotes, or discounted cash flows.

### FHLB Stock

-----  
FHLB stock is not publicly traded; however, the recorded value of the stock holdings approximates the estimated fair value, as the FHLB is required to pay par value upon re-acquiring this stock.

### Loans Receivable, Net

-----  
At June 30, 2011 and September 30, 2010, because of the illiquid market for loan sales, loans were priced using comparable market statistics. The loan portfolio was segregated into various categories and a weighted average valuation discount that approximated similar loan sales was applied to each category.

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### Loans Held for Sale

-----  
The estimated fair value is based on quoted market prices obtained from the Federal Home Loan Mortgage Corporation.

### Accrued Interest

-----  
The recorded amount of accrued interest approximates the estimated fair value.

### Deposits

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

### FHLB Advances

-----  
The estimated fair value of FHLB advances is computed 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.



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### Repurchase Agreements

The recorded value of repurchase agreements approximates the estimated fair value due to the short-term nature of the borrowings.

### Off-Balance-Sheet Instruments

Since the majority of the Company's off-balance-sheet instruments consist of variable-rate commitments, the Company has determined that they do not have a distinguishable estimated fair value.

The estimated fair values of financial instruments were as follows as of June 30, 2011 and September 30, 2010 (dollars in thousands):

|                              | June 30, 2011      |                            | September 30, 2010 |                            |
|------------------------------|--------------------|----------------------------|--------------------|----------------------------|
|                              | Recorded<br>Amount | Estimated<br>Fair<br>Value | Recorded<br>Amount | Estimated<br>Fair<br>Value |
| <b>Financial Assets</b>      |                    |                            |                    |                            |
| Cash and cash equivalents    | \$114,303          | \$114,303                  | \$111,786          | \$111,786                  |
| CDs held for investment      | 18,087             | 18,087                     | 18,047             | 18,047                     |
| MBS and other investments    | 11,962             | 12,031                     | 16,185             | 15,961                     |
| FHLB stock                   | 5,705              | 5,705                      | 5,705              | 5,705                      |
| Loans receivable, net        | 520,532            | 474,021                    | 524,621            | 473,986                    |
| Loans held for sale          | 766                | 786                        | 2,970              | 3,059                      |
| Accrued interest receivable  | 2,527              | 2,527                      | 2,630              | 2,630                      |
| <b>Financial Liabilities</b> |                    |                            |                    |                            |
| Deposits                     | \$589,498          | \$592,058                  | \$578,869          | \$581,046                  |
| FHLB advances                | 55,000             | 59,268                     | 75,000             | 81,579                     |
| Repurchase agreements        | 598                | 598                        | 622                | 622                        |
| Accrued interest payable     | 591                | 591                        | 737                | 737                        |

The Company assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the estimated fair value of the Company's financial instruments will change

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when interest rate levels change, and that change may either be favorable or unfavorable to the Company. 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 Company's overall interest rate risk.

Accounting guidance regarding fair value measurements defines fair value and establishes a framework for measuring fair value in accordance with GAAP. Fair value is the exchange price that would be received for an asset or paid

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to transfer a liability in an orderly transaction between market participants on the measurement date. The following definitions describe the levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2: Significant observable inputs other than quoted prices included within Level 1, such as quoted prices in markets that are not active, and inputs other than quoted prices that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a company's own assumptions about the assumptions market participants would use in pricing an asset or liability based on the best information available in the circumstances.

The following table summarizes the balances of assets and liabilities measured at estimated fair value on a recurring basis at June 30, 2011, and the total losses resulting from these estimated fair value adjustments for the nine months ended June 30, 2011 (dollars in thousands):

|                                      | Estimated Fair Value |                |               | Total Losses |
|--------------------------------------|----------------------|----------------|---------------|--------------|
|                                      | Level 1              | Level 2        | Level 3       |              |
| <b>Available for Sale Securities</b> |                      |                |               |              |
| Mutual funds                         | \$ 975               | \$ - -         | \$ - -        | \$ - -       |
| MBS                                  | - -                  | 6,704          | - -           | 29           |
| <b>Total</b>                         | <b>\$ 975</b>        | <b>\$6,704</b> | <b>\$ - -</b> | <b>\$ 29</b> |

The following table summarizes the balances of assets and liabilities measured at estimated fair value on a nonrecurring basis at June 30, 2011, and the total losses resulting from these estimated fair value adjustments for the nine months ended June 30, 2011 (dollars in thousands):

|                                      | Estimated Fair Value |               |                 | Total Losses    |
|--------------------------------------|----------------------|---------------|-----------------|-----------------|
|                                      | Level 1              | Level 2       | Level 3         |                 |
| Impaired loans (1)                   | \$ - -               | \$ - -        | \$20,716        | \$ 4,811        |
| MBS - held to maturity (2)           | - -                  | 673           | - -             | 306             |
| OREO and other repossessed items (3) | - -                  | - -           | 10,996          | 973             |
| <b>Total</b>                         | <b>\$ - -</b>        | <b>\$ 673</b> | <b>\$31,712</b> | <b>\$ 6,090</b> |

(1) The loss represents charge offs on collateral dependent loans for estimated fair value adjustments based on the estimated fair value of the collateral. A loan is considered to be impaired when, based on current

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information and events, it is probable the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. The specific reserve for collateral dependent impaired loans was based on the estimated fair value of the collateral less estimated costs to sell. The estimated fair value of collateral was determined based primarily on appraisals. In some cases, adjustments were made to the appraised values due to various factors including age of the appraisal, age of comparables included in the appraisal, and known changes in the market and in the collateral.

(2) The loss represents OTTI credit-related charges on held-to-maturity MBS.

(3) The Company's OREO and other repossessed assets are initially recorded at estimated fair value less estimated costs to sell. This amount becomes the property's new basis. Estimated fair value was generally determined by management based on a number of factors, including third-party appraisals of estimated fair value in an orderly sale. Estimated costs to sell were based on standard market factors. The valuation of OREO and other repossessed items is subject to significant external and internal judgment. Management periodically reviews the recorded value to determine whether the property continues to be recorded at the lower of its recorded book value or estimated fair value, net of estimated costs to sell.

### (10) RECENT ACCOUNTING PRONOUNCEMENTS

In December 2010, the FASB issued updated guidance on goodwill and other intangibles regarding when to perform step two of the goodwill impairment test for reporting units with zero or negative carrying amounts. The guidance modifies step one of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform step two of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that an impairment may exist such as if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its recorded amount. This guidance becomes effective for the Company on October 1, 2011. The Company does not expect it to have an impact on its condensed consolidated financial statements.

In April 2011, the FASB issued updated guidance on receivables and the determination of whether a restructuring is a troubled debt restructuring. The new guidance clarifies which loan modifications constitute troubled debt restructurings and is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring, both for purposes of recording an impairment loss and for disclosure of troubled debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude under the guidance that both of the following exist: (a) the restructuring constitutes a concession; and (b) the debtor is experiencing financial difficulties. This guidance is effective for the Company's condensed consolidated financial statements as of July 1, 2011, and applies retrospectively to restructurings occurring on or after January 1, 2011. The Company does not expect it to have an impact on its condensed consolidated financial statements.

In May 2011, the FASB issued amended guidance regarding the application of existing fair value measurement guidance. The provisions of the amended guidance clarify the application of existing fair value measurement guidance and revise certain measurement and disclosure requirements to achieve convergence of GAAP and International Financial Reporting Standards. The amendments clarify the FASB's intent about the application of the highest-and-best-use and valuation premise and with respect to the measurement

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of fair value of an instrument classified as equity. The amendment also expands the information required to be disclosed with respect to fair value measurements categorized in Level 3 fair value measurements and the items not measured at fair value but for which fair value must be disclosed. The provisions of this amended guidance are effective for the Company's first reporting period beginning January 1, 2012, with early adoption not permitted. The

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Company is in the process of evaluating the impact of adoption of this guidance and does not expect it to have a material impact its condensed consolidated financial statements.

In June 2011, the FASB issued amended guidance on the presentation of comprehensive income. The new guidance eliminates the current option to present the components of other comprehensive income in the statement of changes in equity and requires the presentation of net income and other comprehensive income (and their respective components) either in a single continuous statement or in two separate but consecutive statements. The amendments do not alter any current recognition or measurement requirements with respect to the items of other comprehensive income. The provision of this guidance are effective for the Company's first reporting period beginning on January 1, 2012, with early adoption permitted. The Company does not expect it to have a material impact on its condensed consolidated financial statements.

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

The following analysis discusses the material changes in the consolidated financial condition and results of operations of the Company at and for the three and nine months ended June 30, 2011. This analysis as well as other sections of this report contains certain "forward-looking statements."

Certain matters discussed in this Form 10-Q may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not statements of historical fact and often include the words "believes," "expects," "anticipates," "estimates," "forecasts," "intends," "plans," "targets," "potentially," "probably," "projects," "outlook" or similar expressions or future or conditional verbs such as "may," "will," "should," "would" and "could." Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, assumptions and statements about future performance. These forward-looking statements are subject to known and unknown risks, uncertainties and other factors that could cause our actual results to differ materially from the results anticipated, including, but not limited to: the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets and may lead to increased losses and non-performing assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses, and require us to materially increase our loan loss reserves; changes in general economic conditions, either nationally or in our market areas; changes in the

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levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes, land and other properties and fluctuations in real estate values in our market areas; secondary market conditions for loans and our ability to sell loans in the secondary market; results of examinations of us by the Federal Reserve and our bank subsidiary by the Federal Deposit Insurance Corporation, the Washington State Department of Financial Institutions, Division of Banks or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our allowance for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings; our compliance with regulatory enforcement actions, including regulatory memoranda of understandings ("MOUs") to which we are subject; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules; the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the implementation regulations; our ability to attract and retain deposits; further increases in premiums for deposit insurance; our ability to control operating costs and expenses; the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our consolidated balance sheet; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges; computer systems on which we depend could fail or

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experience a security breach; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; our ability to manage loan delinquency rates; increased competitive pressures among financial services companies; changes in consumer spending, borrowing and savings habits; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, the interpretation of regulatory capital or other rules and any changes in the rules applicable to institutions participating in the TARP Capital Purchase Program; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; our ability to pay dividends on our common and preferred stock; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; the economic impact of war or any terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations; pricing, products and services; and other risks detailed in our reports filed with the Securities and Exchange Commission, including our Annual Report on Form 10-K for the year ended September 30, 2010.

Any of the forward-looking statements that we make in this Form 10-Q and in the other public statements we make are based upon management's beliefs and

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assumptions at the time they are made. We undertake no obligation to publicly update or revise any forward-looking statements included in this report or to update the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise. We caution readers not to place undue reliance on any forward-looking statements. We do not undertake and specifically disclaim any obligation to revise any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements. These risks could cause our actual results for 2011 and beyond to differ materially from those expressed in any forward-looking statements by, or on behalf of us, and could negatively affect the Company's operations and stock price performance.

### Overview

Timberland Bancorp, Inc., a Washington corporation, is the holding company for Timberland Bank. The Bank opened for business in 1915 and serves consumers and businesses across Grays Harbor, Thurston, Pierce, King, Kitsap and Lewis counties, Washington with a full range of lending and deposit services through its 22 branches (including its main office in Hoquiam). At June 30, 2011, the Company had total assets of \$735.02 million and total shareholders' equity of \$86.33 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 relates primarily to the Bank's operations.

The profitability of the Company's operations depends primarily on its net interest income after provision for loan losses. Net interest income is the difference between interest income, which is the income that the Company earns on interest-earning assets, comprised of primarily loans and investments, and interest expense, the amount the Company pays on its interest-bearing liabilities, which are primarily deposits and borrowings. Net interest income is affected by changes in the volume and mix of interest earning assets, interest earned on those assets, the volume and mix of interest bearing liabilities and interest paid on those interest bearing liabilities. Management strives to match the re-pricing characteristics of the interest earning assets and interest bearing liabilities to protect net interest income from changes in market interest rates and changes in the shape of the yield curve.

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The provision for loan losses is dependent on changes in the loan portfolio and management's assessment of the collectability of the loan portfolio as well as prevailing economic and market conditions. The provision for loan losses reflects the amount that the Company believes is adequate to cover potential credit losses in its loan portfolio.

Net income (loss) is also affected by non-interest income and non-interest expenses. For the three and nine month periods ended June 30, 2011, non-interest income consisted primarily of service charges and fees on deposit accounts, gain on sale of loans, ATM transaction fees, increase in the cash surrender value of life insurance, gain on sale of MBS, other operating income and a valuation allowance recovery on MSRs. Non-interest income is reduced by net OTTI losses on investment securities and by a valuation allowance on MSRs. Non-interest expenses consisted primarily of salaries and employee benefits, premises and equipment, advertising, ATM expenses, OREO expenses, postage and

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courier, professional fees, insurance premiums, state and local taxes and deposit insurance premiums. Non-interest income and non-interest expenses are affected by the growth of our operations and growth in the number of loan and deposit accounts.

Results of operations may be affected significantly by general and local economic and competitive conditions, changes in market interest rates, governmental policies and actions of regulatory authorities.

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 real estate, including residential construction loans, one- to four-family residential loans, multi-family loans, commercial real estate loans and land loans. The Bank originates adjustable-rate residential mortgage loans that do not qualify for sale in the secondary market. The Bank also originates commercial business loans.

### Critical Accounting Policies and Estimates

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

#### Allowance for Loan Losses

The allowance for loan losses is maintained at a level believed to be 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 loss experience, current economic conditions, and detailed analysis of individual loans for which the full collectability 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 and general components. The specific component relates to loans that are deemed impaired. For such loans that are 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 loans that are not evaluated individually for impairment and is based on historical loss experience adjusted for qualitative factors. The appropriateness of the allowance for loan losses is estimated based upon these factors and trends identified by management at the time consolidated financial statements are prepared.

In accordance with the FASB guidance for receivables, 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. Troubled debt restructured loans are considered impaired loans. Smaller balance homogenous loans, such as residential mortgage loans and consumer loans, may be collectively evaluated for

impairment. When a loan has been identified as being impaired, the amount of

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the impairment is measured by using discounted cash flows, except when, as an alternative, the current estimated fair value of the collateral, reduced by estimated costs to sell, is used. The valuation of real estate collateral is subjective in nature and may be adjusted in future periods because of changes in economic conditions. Management considers third-party appraisals, as well as independent fair market value assessments from realtors or persons involved in selling real estate in determining the estimated fair value of particular properties. In addition, as certain of these third-party appraisals and independent fair market value assessments are only updated periodically, changes in the values of specific properties may have occurred subsequent to the most recent appraisals. Accordingly, the amounts of any such potential changes and any related adjustments are generally recorded at the time such information is received. 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), impairment is recognized by creating or adjusting an allocation of the allowance for loan losses and 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 operations 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 Company's control. These factors may result in losses or recoveries differing significantly from those provided in the consolidated financial statements. The Company has experienced a significant decline in valuations for some real estate collateral since October 2008. If real estate values continue to decline and as updated appraisals are received on collateral for impaired loans, the Company may need to increase the allowance for loan losses appropriately. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses, and may require the Company to make additions to the allowance based on their judgment about information available to them at the time of their examinations.

### MSRs (Mortgage Servicing Rights)

MSRs are capitalized when acquired through the origination of loans that are subsequently sold with servicing rights retained and are amortized to servicing income on loans sold in proportion to and over the period of estimated net servicing income. The value of MSRs at the date of the sale of loans is determined based on the discounted present value of expected future cash flows using key assumptions for servicing income and costs and prepayment rates on the underlying loans.

The estimated fair value is evaluated at least annually by a third party firm 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



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assumptions may not be appropriate if they are applied at different times.

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 MSRs 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. Impairment, if deemed temporary, is recognized through a valuation allowance to the extent that fair value is less than the recorded

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amount.

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

### Goodwill

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

One of the circumstances evaluated when determining if an impairment test of goodwill is needed more frequently than annually is the extent and duration that the Company's market capitalization (total common shares outstanding multiplied by current stock price) is less than the total equity applicable to common shareholders. During the quarter ended June 30, 2011, the Company engaged a third party firm to perform the annual test for goodwill impairment. The test concluded that recorded goodwill was not impaired. No assurance can

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be given, however, that the Company will not record an impairment loss on goodwill in the future.

### OREO (Other Real Estate Owned) and Other Repossessed Assets

OREO and other repossessed assets consist of properties or assets acquired through or by deed in lieu of foreclosure, and are recorded initially at the estimated fair value of the properties less estimated costs of disposal. Costs relating to the 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 a charge to earnings is recorded if the recorded value of a property exceeds its estimated net realizable value.

### Comparison of Financial Condition at June 30, 2011 and September 30, 2010

The Company's total assets decreased by \$7.67 million, or 1.0%, to \$735.02 million at June 30, 2011 from \$742.69 million at September 30, 2010. The decrease was primarily attributable to a decrease in net loans receivable and MBS and other investments.

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Net loans receivable decreased by \$6.29 million, or 1.2%, to \$521.30 million at June 30, 2011 from \$527.59 million at September 30, 2010. The decrease was primarily due to a decrease in all loan categories other than commercial real estate and commercial business loans which increased \$21.80 million and \$2.64 million, respectively.

Total deposits increased by \$10.63 million, or 1.8%, to \$589.50 million at June 30, 2011 from \$578.87 million at September 30, 2010, primarily as a result of increases in savings account balances and N.O.W. account balances.

Shareholders' equity increased by \$926,000, or 1.1%, to \$86.33 million at June 30, 2011 from \$85.41 million at September 30, 2010. The increase was primarily due to net income for the nine months ended June 30, 2011.

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

**Cash Equivalents and CDs Held for Investment:** Cash equivalents and CDs held for investment increased by \$2.56 million, or 2.0%, to \$132.39 million at June 30, 2011 from \$129.83 million at September 30, 2010. The increase in cash equivalents and short-term CDs was primarily due to the Company's decision to increase its liquidity position for asset-liability management purposes.

**MBS (Mortgage-backed Securities) and Other Investments:** Mortgage-backed securities and other investments decreased by \$4.22 million, or 26.1%, to \$11.96 million at June 30, 2011 from \$16.19 million at September 30, 2010. The decrease was primarily as a result of the sale of \$2.27 million in agency MBS, scheduled amortization and prepayments on MBS and OTTI charges recorded on private label residential MBS. The securities on which the OTTI charges were recognized were acquired from the in-kind redemption of the Company's investment in the AMF family of mutual funds in June 2008. For additional information on MBS and other investments, see Note 4 of the Notes to Condensed Consolidated Financial Statements contained in "Item 1, Financial Statements."

**Loans:** Net loans receivable decreased by \$6.29 million, or 1.2%, to \$521.30

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million at June 30, 2011 from \$527.59 million at September 30, 2010. The decrease in the portfolio was primarily a result of a \$12.76 million decrease in land loans, an \$8.18 million decrease in one- to four-family loan balances, a \$6.02 million decrease in construction and land development loan balances (net of undisbursed portion of construction loans in process), a \$2.29 million decrease in consumer loan balances and a \$1.25 million decrease in multi-family loan balances. These decreases to net loans receivable were partially offset by a \$21.80 million increase in commercial real estate loan balances and a \$2.64 million increase in commercial business loan balances.

Loan originations decreased to \$123.20 million for the nine months ended June 30, 2011 from \$133.24 million for the nine months ended June 30, 2010. The Company continued to sell longer-term fixed rate loans for asset liability management purposes and to generate non-interest income. The Company sold fixed rate one- to four- family mortgage loans totaling \$46.43 million for the nine months ended June 30, 2011 compared to \$44.38 million for the nine months ended June 30, 2010.

For additional information, see Note 6 of the Notes to Condensed Consolidated Financial Statements contained in "Item 1, Financial Statements."

**Premises and Equipment:** Premises and equipment decreased by \$402,000, or 2.3%, to \$16.98 million at June 30, 2011 from \$17.38 million at September 30, 2010. The decrease was primarily a result of depreciation.

**OREO (Other Real Estate Owned):** OREO and other repossessed assets decreased by \$523,000, or 4.5%, to \$11.00 million at June 30, 2011 from \$11.52 million at September 30, 2010, primarily due to the sale of OREO properties. During the nine months ended June 30, 2011, OREO properties and other repossessed assets totaling \$3.90 million were sold, resulting in a net gain on sale of \$534,000. At June 30, 2011, OREO consisted

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of 42 individual properties and four other repossessed assets. The properties consisted of two condominium projects totaling \$3.65 million, 24 land parcels totaling \$2.66 million, 11 single family homes totaling \$2.36 million, three commercial real estate properties totaling \$1.23 million and two land development projects totaling \$991,000.

**Goodwill and CDI:** The recorded value of goodwill of \$5.65 million at June 30, 2011 remained unchanged from September 30, 2010. The amortized value of the CDI decreased to \$439,000 at June 30, 2011 from \$564,000 at September 30, 2010. The decrease was attributable to scheduled amortization of the CDI.

**Prepaid FDIC Insurance Assessment:** The prepaid FDIC insurance assessment decreased \$933,000, or 28.5%, to \$2.34 million at June 30, 2011 from \$3.27 million at September 30, 2010 as a portion of the prepaid amount was expensed.

**Deposits:** Deposits increased by \$10.63 million, or 1.8%, to \$589.50 million at June 30, 2011 from \$578.87 million at September 30, 2010. The increase was primarily a result of a \$9.94 million increase in savings account balances, a \$5.42 million increase in N.O.W. checking account balances and a \$428,000 increase in money market account balances. These increases were partially offset by a \$4.14 million decrease in certificates of deposit account balances and a \$1.02 million decrease in non-interest bearing account balances.

**FHLB Advances:** FHLB advances and other borrowings decreased by \$20.00

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million, or 26.7%, to \$55.00 million at June 30, 2011 from \$75.00 million at September 30, 2010 as the Bank used a portion of its liquid assets to repay FHLB advances. For additional information, see "Borrowing Maturity Schedule" set forth below.

Shareholders' Equity: Total shareholders' equity increased by \$926,000, or 1.1%, to \$86.33 million at June 30, 2011 from \$85.41 million at September 30, 2010. The increase was primarily due to net income of \$1.16 million for the nine months ended June 30, 2011.

The FRB has denied the Company's requests to pay cash dividends on its outstanding Series A Preferred Stock held by the Treasury for the quarterly dividend payments due for the last five quarters commencing with the payment due May 15, 2010. Cash dividends on the Series A Preferred Stock are cumulative and accrue and compound on each subsequent date. Accordingly, during the deferral period, the Company will continue to accrue, and reflect in the consolidated financial statements, the deferred dividends on the outstanding Series A Preferred Stock. As a result of not receiving permission from the FRB to pay these dividends, the Company had not made these five quarterly dividend payment as of June 30, 2011. At June 30, 2011, the Company had unpaid preferred stock dividends in arrears of \$1.04 million. If the Company does not make six quarterly dividend payments on the Series A Preferred Stock, whether or not consecutive, the Treasury will have the right to appoint two directors to the Company's board of directors until all accrued but unpaid dividends have been paid. In addition, the Company's ability to pay dividends with respect to common stock is restricted until the dividend obligations under the Series A Preferred Stock are brought current.

Non-performing Assets: Non-performing assets consist of non-accrual loans, loans past due 90 days or more and still accruing, non-accrual investment securities, and OREO and other repossessed assets. Non-performing assets decreased by \$480,000, or 1.2%, to \$40.62 million at June 30, 2011 from \$41.10 million at September 30, 2010. The decrease in non-performing assets was primarily a result of a \$3.32 million decrease in non-accrual loans, a \$523,000 decrease in OREO and other repossessed assets and a \$206,000 decrease in non-accrual investment securities. These decreases were partially offset by a \$3.57 million increase in loans past due 90 days or more and still accruing. The increase in loans past due 90 days or more and still accruing was primarily due to the addition of two commercial real estate loans totaling \$3.43 million. These loans were secured and in the process of collection on June 30, 2011.

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For additional information, see Note 6 of the Notes to Condensed Consolidated Financial Statements contained in "Item 1, Financial Statements."

### Deposit Breakdown

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

|                      | At<br>June 30, 2011    | At<br>September 30, 2010 |
|----------------------|------------------------|--------------------------|
|                      | -----                  | -----                    |
|                      | (Dollars in thousands) |                          |
| Non-interest bearing | \$ 57,735              | \$ 58,755                |
| N.O.W. checking      | 158,725                | 153,304                  |

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|                       |           |           |
|-----------------------|-----------|-----------|
| Savings               | 77,391    | 67,448    |
| Money market accounts | 56,151    | 55,723    |
| CDs under \$100       | 146,037   | 150,633   |
| CDs \$100 and over    | 93,459    | 93,006    |
|                       | -----     | -----     |
| Total deposits        | \$589,498 | \$578,869 |
|                       | =====     | =====     |

The Company had no brokered deposits at June 30, 2011 or September 30, 2010.

Borrowing Maturity Schedule

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

|                     | At June 30,<br>2011    |         | At September 30,<br>2010 |         |
|---------------------|------------------------|---------|--------------------------|---------|
|                     | Amount                 | Percent | Amount                   | Percent |
|                     | -----                  | -----   | -----                    | -----   |
|                     | (Dollars in thousands) |         |                          |         |
| Short-term          | \$ - -                 | - -%    | \$ - -                   | - -%    |
| Long-term           | 55,000                 | 100.0   | 75,000                   | 100.0   |
|                     | -----                  | -----   | -----                    | -----   |
| Total FHLB advances | \$55,000               | 100.0%  | \$75,000                 | 100.0%  |
|                     | =====                  | =====   | =====                    | =====   |

The long-term borrowings mature at various dates through September 2017 and bear interest at rates ranging from 3.49% to 4.34%. The weighted average interest rate on FHLB borrowings at June 30, 2011 was 4.01%. Principal reduction amounts due for future years ending September 30 are as follows (dollars in thousands):

|                   |          |
|-------------------|----------|
| Remainder of 2011 | \$ - -   |
| 2012              | 10,000   |
| 2013              | - -      |
| 2014              | - -      |
| 2015              | - -      |
| 2016              | - -      |
| 2017              | 45,000   |
|                   | -----    |
| Total             | \$55,000 |
|                   | =====    |

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

The Company also maintains a short-term borrowing line with the FRB with total credit based on eligible collateral. As of June 30, 2011, the Company had a borrowing line capacity with the FRB of \$55.98 million of which none was

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outstanding.

Comparison of Operating Results for the Three and Nine Months Ended June 30, 2011 and 2010

The Company reported a net loss of \$(1.28 million) for the quarter ended June 30, 2011 compared to net income of \$804,000 for the quarter ended June 30, 2010. Net loss to common shareholders after adjusting for the preferred stock dividend and the preferred stock discount accretion was \$(1.55 million) for the quarter ended June 30, 2011 compared to net income of \$543,000 for the quarter ended June 30, 2010. The decrease in earnings was primarily a result of an increased provision for loan losses, decreased non-interest income and increased non-interest expense as net interest income was essentially unchanged. Diluted net loss per common share was \$(0.23) for the quarter ended June 30, 2011 compared to net income per diluted common share of \$0.08 for the quarter ended June 30, 2010.

The Company reported net income of \$1.16 million for the nine months ended June 30, 2011 compared to a net loss of \$(2.15 million) for the nine months ended June 30, 2010. Net income to common shareholders after adjusting for the preferred stock dividend and the preferred stock discount accretion was \$370,000 for the nine months ended June 30, 2011 compared to a net loss of \$(2.93 million) for the nine months ended June 30, 2010. The increase in net income was primarily a result of a decreased provision for loan losses and increased non-interest income, which was partially offset by decreased net interest income and increased non-interest expense. Diluted net income per common share was \$0.05 for the nine months ended June 30, 2011 compared to a loss of \$(0.44) per diluted common share for the nine months ended June 30, 2010.

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

**Net Income (Loss):** The Company reported a net loss of \$(1.28 million) for the quarter ended June 30, 2011 compared to net income of \$804,000 for the quarter ended June 30, 2010. Net loss to common shareholders after adjusting for preferred stock dividends of \$208,000 and preferred stock discount accretion of \$57,000 was \$(1.55 million), or \$(0.23) per diluted common share for the quarter ended June 30, 2011, compared to \$543,000, or \$0.08 per diluted common share for the quarter ended June 30, 2010.

The decrease in net income for the quarter ended June 30, 2011 was primarily the result of a \$2.65 million increase in the provision for loan losses, a \$180,000 decrease in non-interest income and a \$360,000 increase in non-interest expense. These decreases to net income were partially offset by a \$21,000 increase in net interest income and a \$1.09 million change in the provision (benefit) for federal and state income taxes.

Net income for the nine months ended June 30, 2011 increased by \$3.31 million to \$1.16 million from a net loss of \$(2.15 million) for the nine months ended June 30, 2010. Net income to common shareholders after adjusting for preferred stock dividends of \$624,000 and preferred stock discount accretion of \$168,000 was \$370,000, or \$0.05 per diluted common share for the nine months ended June 30, 2011, compared to a net loss of \$(2.93 million), or \$(0.44) per diluted common share for the nine months ended June 30, 2010.

The increase in net income for the nine months ended June 30, 2011 was primarily the result of a \$3.55 million decrease in the provision for loan losses and a \$2.48 million increase in non-interest income. These increases to net income were partially offset by a \$724,000 increase to non-interest expense, a \$133,000 decrease to net interest income and a \$1.86 million change

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in the provision (benefit) for federal and state income taxes.

Net Interest Income: Net interest income increased by \$21,000, or 0.3%, to \$6.41 million for the quarter ended June 30, 2011 from \$6.39 million for the quarter ended June 30, 2010. The increase in net interest income was

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primarily attributable to an increase in the level of total interest-earning assets, which was partially offset by a decrease in the net interest margin.

Total interest and dividend income decreased by \$671,000 or 7.4%, to \$8.43 million for the quarter ended June 30, 2011 from \$9.10 million for the quarter ended June 30, 2010 as the yield on interest earning assets decreased to 4.94% from 5.49% and average loans receivable declined \$14.2 million as compared the same period last year. The decrease in the weighted average yield on interest earning assets was primarily a result of decreased market rates for loans and an increase in the amount of lower yielding cash equivalents and other liquid assets. Total interest expense decreased by \$692,000, or 25.5%, to \$2.02 million for the quarter ended June 30, 2011 from \$2.71 million for the quarter ended June 30, 2010 as the average rate paid on interest bearing liabilities decreased to 1.37% for the quarter ended June 30, 2011 from 1.86% for the quarter ended June 30, 2010. The decrease in funding costs was primarily a result of a decrease in overall market rates and a decrease in the level of average FHLB advances. The net interest margin decreased to 3.76% for the quarter ended June 30, 2011 from 3.85% for the quarter ended June 30, 2010.

Net interest income decreased by \$133,000, or 0.7%, to \$19.10 million for the nine months ended June 30, 2011 from \$19.23 million for the nine months ended June 30, 2010. The decrease in net interest income was primarily attributable to a change in the composition of average interest earning assets as the percentage of lower yielding cash equivalents and other liquid assets increased and the percentage of higher yielding loans decreased for the nine months ended June 30, 2011 relative to the nine months ended June 30, 2010.

Total interest and dividend income decreased by \$1.87 million or 6.8%, to \$25.74 million for the nine months ended June 30, 2011 from \$27.6 million for the nine months ended June 30, 2010 as the yield on interest earning assets decreased to 5.10% from 5.61%. The decrease in the weighted average yield on interest earning assets was primarily a result of decreased market rates for loans, an increase in the amount of lower yielding cash equivalents and other liquid assets and a change in the composition of the loan portfolio as the level of higher yielding construction loans decreased. Total interest expense decreased by \$1.73 million, or 20.7%, to \$6.64 million for the nine months ended June 30, 2011 from \$8.37 million for the nine months ended June 30, 2010 as the average rate paid on interest bearing liabilities decreased to 1.52% for the nine months ended June 30, 2011 from 1.96% for the nine months ended June 30, 2010. The decrease in funding costs was primarily a result of a decrease in overall market rates and a decrease in the level of average FHLB advances. The net interest margin decreased to 3.78% for the nine months ended June 30, 2011 from 3.91% for the nine months ended June 30, 2010.

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Average Balances, Interest and Average Yields/Cost

The following tables sets forth, for the periods indicated, information

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regarding average balances of assets and liabilities as well as the total dollar amounts (in thousands) 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.

|   | Three Months Ended June 30, |                              |                |                    |                              |                |
|---|-----------------------------|------------------------------|----------------|--------------------|------------------------------|----------------|
|   | 2011                        |                              |                | 2010               |                              |                |
|   | Average<br>Balance          | Interest<br>and<br>Dividends | Yield/<br>Cost | Average<br>Balance | Interest<br>and<br>Dividends | Yield/<br>Cost |
| Interest-earning assets: (1)                      |                             |                              |                |                    |                              |                |
| Loans receivable (2)                              | \$537,858                   | \$8,192                      | 6.09%          | \$552,055          | \$8,764                      | 6.35%          |
| MBS and other investments (2)                     | 11,256                      | 141                          | 5.01           | 16,822             | 239                          | 5.68           |
| FHLB stock and equity securities                  | 6,676                       | 8                            | 0.48           | 6,676              | 9                            | 0.54           |
| Interest-bearing deposits                         | 126,739                     | 90                           | 0.28           | 87,958             | 90                           | 0.41           |
| <b>Total interest-earning assets</b>              | <b>682,529</b>              | <b>8,431</b>                 | <b>4.94</b>    | <b>663,511</b>     | <b>9,102</b>                 | <b>5.49</b>    |
| Non-interest-earning assets                       | 60,678                      |                              |                | 57,490             |                              |                |
| <b>Total assets</b>                               | <b>\$743,207</b>            |                              |                | <b>\$721,001</b>   |                              |                |
| Interest-bearing liabilities:                     |                             |                              |                |                    |                              |                |
| Savings accounts                                  | \$ 76,411                   | 107                          | 0.56           | \$ 64,965          | 115                          | 0.71           |
| Money market accounts                             | 57,984                      | 94                           | 0.65           | 57,163             | 148                          | 1.04           |
| N.O.W. accounts                                   | 158,905                     | 340                          | 0.86           | 148,660            | 488                          | 1.32           |
| Certificates of deposit                           | 242,573                     | 922                          | 1.52           | 237,397            | 1,199                        | 2.03           |
| Short-term borrowings (3)                         | 509                         | -                            | 0.05           | 859                | 1                            | 0.32           |
| Long-term borrowings (4)                          | 55,000                      | 556                          | 4.05           | 75,000             | 760                          | 4.06           |
| <b>Total interest-bearing liabilities</b>         | <b>591,382</b>              | <b>2,019</b>                 | <b>1.37</b>    | <b>584,044</b>     | <b>2,711</b>                 | <b>1.86</b>    |
| Non-interest-bearing liabilities                  | 64,028                      |                              |                | 51,856             |                              |                |
| <b>Total liabilities</b>                          | <b>655,410</b>              |                              |                | <b>635,900</b>     |                              |                |
| Shareholders' equity                              | 87,797                      |                              |                | 85,101             |                              |                |
| <b>Total liabilities and shareholders' equity</b> | <b>\$743,207</b>            |                              |                | <b>\$721,001</b>   |                              |                |
| Net interest income                               |                             | \$6,412                      |                |                    | \$6,391                      |                |



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|  |                         |                         |
|--|-------------------------|-------------------------|
| Interest rate spread   | -----<br>3.57%<br>===== | -----<br>3.63%<br>===== |
| Net interest margin (5)  | 3.76%<br>=====          | 3.85%<br>=====          |
| Ratio of average<br>interest-earning<br>assets to average<br>interest-bearing<br>liabilities | 115.41%<br>=====        | 113.61%<br>=====        |

- 
- (1) Interest yield on loans and MBS is calculated assuming a 30/360 basis; interest yield on all other categories is based on daily interest basis.
  - (2) Average balances include loans and MBS on non-accrual status.
  - (3) Includes FHLB and FRB advances with original maturities of less than one year and other short-term borrowings repurchase agreements.
  - (4) Includes FHLB advances with original maturities of one year or greater.
  - (5) Net interest income divided by total average interest earning assets, annualized.

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|                                     | -----<br>Nine Months Ended June 30,<br>----- |                              |                |                    |                              |                |
|-------------------------------------|--|------------------------------|----------------|--------------------|------------------------------|----------------|
|                                     | 2011   |                              |                | 2010               |                              |                |
|                                     | Average<br>Balance                           | Interest<br>and<br>Dividends | Yield/<br>Cost | Average<br>Balance | Interest<br>and<br>Dividends | Yield/<br>Cost |
|                                     | -----  | -----                        | ----           | -----              | -----                        | ----           |
| Interest-earning assets: (1)        |  |                              |                |                    |                              |                |
| Loans receivable (2)                | \$537,782                                    | \$24,966                     | 6.19%          | \$558,587          | \$26,661                     | 6.38%          |
| MBS and other<br>investments (2)    | 12,056                                       | 486                          | 5.37           | 18,045             | 695                          | 5.14           |
| FHLB stock and equity<br>securities | 6,677  | 23                           | 0.46           | 6,672              | 27                           | 0.52           |
| Interest-bearing<br>deposits        | 116,257                                      | 260                          | 0.30           | 72,543             | 218                          | 0.40           |
|                                     | -----  | -----                        |                | -----              | -----                        |                |
| Total interest-earning<br>assets    | 672,772                                      | 25,735                       | 5.10           | 655,847            | 27,601                       | 5.61           |
| Non-interest-earning<br>assets      | 59,269                                       |                              |                | 55,704             |                              |                |
|                                     | -----  |                              |                | -----              |                              |                |
| Total assets                        | \$732,041                                    |                              |                | \$711,551          |                              |                |
|                                     | =====  |                              |                | =====              |                              |                |
| Interest-bearing liabilities:       |  |                              |                |                    |                              |                |
| Savings accounts                    | \$ 71,723                                    | 355                          | 0.66           | \$ 62,596          | 333                          | 0.71           |
| Money market accounts               | 57,919                                       | 342                          | 0.79           | 61,403             | 544                          | 1.18           |
| N.O.W. accounts                     | 157,397                                      | 1,140                        | 0.97           | 136,403            | 1,324                        | 1.30           |

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|  |           |          |         |           |          |         |
|--|-----------|----------|---------|-----------|----------|---------|
| Certificates of deposit  | 242,697   | 2,968    | 1.64    | 232,598   | 3,785    | 2.18    |
| Short-term borrowings  |           |          |         |           |          |         |
| (3)  | 514       | -        | 0.05    | 1,037     | 3        | 0.39    |
| Long-term borrowings   |           |          |         |           |          |         |
| (4)  | 55,000    | 1,835    | 4.46    | 78,315    | 2,384    | 4.07    |
|  | -----     | -----    |         | -----     | -----    |         |
| Total interest-bearing liabilities   | 585,250   | 6,640    | 1.52    | 572,352   | 8,373    | 1.96    |
|  |           | -----    |         |           | -----    |         |
| Non-interest-bearing liabilities   | 60,105    |          |         | 52,467    |          |         |
|  | -----     |          |         | -----     |          |         |
| Total liabilities  | 645,355   |          |         | 624,819   |          |         |
|  |           |          |         |           |          |         |
| Shareholders' equity   | 86,686    |          |         | 86,732    |          |         |
|  | -----     |          |         | -----     |          |         |
| Total liabilities and shareholders' equity                                       | \$732,041 |          |         | \$711,551 |          |         |
|  | =====     |          |         | =====     |          |         |
|  |           |          |         |           |          |         |
| Net interest income  |           | \$19,095 |         |           | \$19,228 |         |
|  |           | =====    |         |           | =====    |         |
|  |           |          |         |           |          |         |
| Interest rate spread   |           |          | 3.58%   |           |          | 3.65%   |
|  |           |          | =====   |           |          | =====   |
|  |           |          |         |           |          |         |
| Net interest margin (5)  |           |          | 3.78%   |           |          | 3.91%   |
|  |           |          | =====   |           |          | =====   |
|  |           |          |         |           |          |         |
| Ratio of average interest-earning assets to average interest-bearing liabilities |           |          | 114.95% |           |          | 114.59% |
|  |           |          | =====   |           |          | =====   |

- 
- (1) Interest yield on loans and MBS is calculated assuming a 30/360 basis; interest yield on all other categories is based on daily interest basis.
  - (2) Average balances include loans and MBS on non-accrual status.
  - (3) Includes FHLB and FRB advances with original maturities of less than one year and other short-term borrowings repurchase agreements.
  - (4) Includes FHLB advances with original maturities of one year or greater.
  - (5) Net interest income divided by total average interest earning assets, annualized.

Rate Volume Analysis

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

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rate/volume have been allocated to rate and volume variances based on the absolute values of each.

|   | Three months ended<br>June 30, 2011<br>compared to three months<br>ended June 30, 2010<br>increase (decrease)<br>due to |                |               | Nine months ended<br>June 30, 2011<br>compared to nine months<br>ended June 30, 2010<br>increase (decrease)<br>due to |                 |                 |
|---|---|----------------|---------------|---|-----------------|-----------------|
|   | Rate  | Volume         | Net<br>Change | Rate  | Volume          | Net<br>Change   |
|   | (Dollars in thousands)  |                |               |   |                 |                 |
| <b>Interest-earning assets:</b>   |   |                |               |   |                 |                 |
| Loans receivable (1)  | \$(350)   | \$(222)        | \$(572)       | \$ (718)  | \$ (977)        | \$(1,695)       |
| MBS and other<br>investments  | (26)  | (72)           | (98)          | (7)   | (202)           | (209)           |
| Equity securities   | (1)   | - -            | (1)           | (4)   | - -             | (4)             |
| Interest-bearing<br>deposits  | (33)  | 33             | - -           | (14)  | 56              | 42              |
| <b>Total net decrease in<br/>income on interest-<br/>earning assets</b>       | <b>(410)</b>  | <b>(261)</b>   | <b>(671)</b>  | <b>(743)</b>  | <b>(1,123)</b>  | <b>(1,866)</b>  |
| <b>Interest-bearing liabilities:</b>  |   |                |               |   |                 |                 |
| Savings accounts  | (26)  | 18             | (8)           | (4)   | 26              | 22              |
| N.O.W accounts  | (180)   | 32             | (148)         | (199)   | 15              | (184)           |
| Money market accounts   | (56)  | 2              | (54)          | (173)   | (29)            | (202)           |
| CD accounts   | (302)   | 25             | (277)         | (789)   | (28)            | (817)           |
| Short-term borrowings   | (1)   | - -            | (1)           | (2)   | (1)             | (3)             |
| Long-term borrowings  | (2)   | (202)          | (204)         | (17)  | (532)           | (549)           |
| <b>Total net decrease<br/>in expense on interest-<br/>bearing liabilities</b> | <b>(567)</b>  | <b>(125)</b>   | <b>(692)</b>  | <b>(1,184)</b>  | <b>(549)</b>    | <b>(1,733)</b>  |
| <b>Net increase (decrease)<br/>in net interest income</b>                     | <b>\$157</b>  | <b>\$(136)</b> | <b>\$ 21</b>  | <b>\$ 441</b>   | <b>\$ (574)</b> | <b>\$ (133)</b> |

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

**Provision for Loan Losses:** The provision for loan losses increased \$2.65 million, or 353.3%, to \$3.40 million for the quarter ended June 30, 2011 from \$750,000 for the quarter ended June 30, 2010. The increased provision for loan losses for the quarter ended June 30, 2011 was primarily the result of

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receiving updated appraisals reflecting decreased valuations for three properties involving two borrowing relationships. The Company had net charge-offs of \$3.41 million during the quarter ended June 30, 2011 compared to net charge-off of \$6.54 million during the quarter ended June 30, 2010. Net charge-offs during the three months ended June 30, 2010 exceeded the quarterly provision expense primarily due to charge-offs of \$5.1 million in impairments previously identified and factored into prior quarter's provisions.

The provision for loan losses decreased \$3.55 million, or 41.5%, to \$5.00 million for the nine months ended June 30, 2011 from \$8.55 million for the nine months ended June 30, 2010. The decreased provision for loan losses for the nine months ended June 30, 2011 was primarily due to a decreased level of net charge-offs and a decrease in the Company's construction and land development portfolio. The Company had net charge-offs of \$4.47 million during the nine months ended June 30, 2011 and net charge-offs of \$11.82 million for the nine months ended June 30, 2010.

The Company has established a comprehensive methodology for determining the provision for loan losses. On a quarterly basis the Company performs an analysis that considers pertinent factors underlying the quality of the loan portfolio. The factors include changes in the amount and composition of the loan portfolio, historic loss experience for various loan segments, changes in economic conditions, delinquency rates, a detailed analysis of impaired loans, and other factors to determine an appropriate level of allowance for loan losses. Based on its comprehensive analysis, management believes the allowance for loan losses of \$11.79 million at June 30, 2011 (2.21% of loans receivable and loans held for sale and 44.6% of non-performing loans) was adequate to provide for probable losses based on an evaluation of known and inherent risks in the loan portfolio at that date. Impaired loans are subjected to an impairment analysis to determine an appropriate reserve amount to be held against each loan. The aggregate principal impairment amount determined at June 30, 2011 was \$2.23 million. The allowance for loan losses was \$10.90 million (2.00% of loans receivable and loans held for sale and 51.8% of non-performing loans) at June 30, 2010.

Non-accrual and loans past due 90 days or more and still accruing increased \$249,000 to \$26.44 million at June 30, 2011 from \$26.19 million at September 30, 2010. For additional information, see the section entitled "Comparison of Financial Condition at June 30, 2011 and September 30, 2010 - Non-performing Assets" included herein.

While management believes the estimates and assumptions used in its determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact the Company's consolidated financial condition and results of operations. In addition, the determination of the amount of the Bank's allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the establishment of additional reserves based upon their analysis of information available to them at the time of their examination. 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 Company's financial condition and results of operations. For additional information, see Note 6 of the Notes to Condensed Consolidated Financial Statements contained in "Item 1, Financial Statements."

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Non-interest Income: Total non-interest income decreased \$180,000, or 9.3%, to \$1.76 million for the quarter ended June 30, 2011 from \$1.94 million for the quarter ended June 30, 2010. The decrease was primarily a result of a \$159,000 change in the valuation recovery (allowance) on MSRs and a \$73,000 decrease in service

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charges on deposits. These decreases to non-interest income were partially offset by a \$76,000 increase in ATM transaction fees.

The \$137,000 valuation allowance on MSRs during the quarter ended June 30, 2011 was primarily a result of a decrease in mortgage interest rates at June 30, 2011 relative to March 31, 2011. The decrease in mortgage interest rates increased estimated mortgage prepayment speeds, shortened the estimated average life of loans comprising the MSR asset and reduced the fair value of the MSR asset.

Total non-interest income increased by \$2.48 million, or 57.1%, to \$6.82 million for the nine months ended June 30, 2011 from \$4.34 million for the nine months ended June 30, 2010. The increase was primarily a result of a \$1.69 million reduction in net OTTI on MBS and other investments, a \$703,000 valuation recovery on MSRs, a \$227,000 increase in gain on sale of loans, a \$197,000 increase in ATM transaction fees and a \$79,000 gain on sale of MBS and other investments. These increases to non-interest income were partially offset by a \$343,000 decrease in service charges on deposits.

The OTTI charges were higher during the first nine months of the previous fiscal year partially due to changes in the third party model that the Company uses to evaluate projected cash flows on certain private label MBS. The changes in the model were implemented during the quarter ended March 31, 2010 and incorporated harsher assumptions relative to earlier periods. The securities on which the OTTI charges were recognized were private label MBS acquired from the in-kind redemption of the Company's investment in the AMF family of mutual funds in June 2008. At June 30, 2011, the Company's remaining private label MBS portfolio had been reduced to \$4.09 million from an original acquired balance of \$15.30 million.

The \$703,000 MSR valuation recovery during the nine months ended June 30, 2011 represents the majority of the \$890,000 valuation allowance that was recorded during the quarter ended September 30, 2010. The recovery was primarily due to increased mortgage rates at December 31, 2010 and March 31, 2011 relative to September 30, 2010, which reduced estimated prepayment speeds and increased the expected life and corresponding value of the MSR portfolio. The increased gain on sale of loans was primarily due to an increase in the dollar volume of fixed rate one- to four-family mortgage loans sold during the nine months ended June 30, 2011, relative to the nine months ended June 30, 2010 and an increased pricing spread.

Non-interest Expense: Total non-interest expense increased by \$360,000, or 5.6%, to \$6.78 million for the quarter ended June 30, 2011 from \$6.42 million for the quarter ended June 30, 2010. The increase was primarily the result of a \$284,000 increase in foreclosure and loan administration related expenses (which are reflected in the other non-interest expense category) and a \$123,000 increase OREO and other repossessed assets expense. These increases to non-interest expense were partially offset by a \$98,000 decrease in insurance expense and a \$69,000 decrease in FDIC insurance expense.

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Total non-interest expense increased by \$724,000, or 3.9%, to \$19.34 million for the nine months ended June 30, 2011 from \$18.61 million for the nine months ended June 30, 2010. The increase was primarily due to a \$374,000 increase in salaries and employee benefits and a \$361,000 increase in foreclosure and loan administration related expenses, a \$163,000 increase in OREO and other repossessed assets expense, and a \$93,000 increase in ATM expenses. These increases to expense were partially offset by a \$404,000 decrease in FDIC insurance expense. The comparison between periods for salaries and employee benefits expense was affected by a change in the Bank's vacation accrual policy during the prior year which reduced salaries and employee benefits expense by \$340,000 during the nine months ended June 30, 2010.

Provision (Benefit) for Income Taxes: As a result of a loss before taxes for the current quarter, the Company recorded a benefit for income taxes of \$(729,000) for the quarter ended June 30, 2011 compared to a provision for income taxes of \$356,000 for the quarter ended June 30, 2010. The Company's effective tax (benefit) rate was (36.29)% for the quarter ended June 30, 2011 and 30.70% for the quarter ended June 30, 2010.

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The provision for income taxes increased to \$417,000 for the nine months ended June 30, 2011 from a \$(1.44 million) benefit for the nine months ended June 30, 2010 primarily as a result of increased income before taxes. The Company's effective tax (benefit) rate was 26.41% for the nine months ended June 30, 2011 and (40.09)% for the nine months ended June 30, 2010.

The change in the effective tax (benefit) rate between periods is primarily due to the loss before taxes and the non-taxable BOLI earnings. The BOLI earnings reduce the effective tax rate in periods with income before taxes and increase the effective tax benefit in periods with a loss before taxes.

### Liquidity

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

An analysis of liquidity should include a review of the Condensed Consolidated Statement of Cash Flows for the nine months ended June 30, 2011. The Condensed Consolidated Statement of Cash Flows includes operating, investing and financing categories. Operating activities include net income, which is adjusted for non-cash items, and increases or decreases in cash due to changes in certain assets and liabilities. Investing activities consist primarily of proceeds from maturities and sales of securities, purchases of securities, the net change in loans and proceeds from the sale of OREO and other repossessed assets. Financing activities present the cash flows associated with the Company's deposit accounts, other borrowings and stock related transactions.

The Company's total cash and cash equivalents increased by \$2.52 million, or 2.3% to \$114.30 million at June 30, 2011 from \$111.79 million at September 30, 2010. The increase in liquid assets was primarily a result of an increase in deposits.

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The Bank must maintain an adequate level of liquidity to ensure the availability of sufficient funds for loan originations and deposit withdrawals, to satisfy other financial commitments and to take advantage of investment opportunities. The Bank generally maintains sufficient cash and short-term investments to meet short-term liquidity needs. At June 30, 2011, 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 22.18%. The Bank maintained an uncommitted credit facility with the FHLB that provided for immediately available advances up to an aggregate amount equal to 30% of total assets, limited by available collateral, under which \$55.00 million was outstanding and \$100.82 million was available for additional borrowings at June 30, 2011. The Bank also maintains a short-term borrowing line with the FRB with total credit based on eligible collateral. At June 30, 2011, the Bank had \$55.98 million available for borrowings with the FRB and there was no 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, federal funds sold, and other short-term investments. If the Bank requires funds that exceed its ability to generate them internally, it has additional borrowing capacity with the FHLB and the FRB.

The Bank's primary investing activity is the origination of one- to four-family mortgage loans, commercial mortgage loans, construction loans, consumer loans, and commercial business loans. At June 30, 2011, the Bank had loan commitments totaling \$31.82 million and undisbursed construction loans in process totaling \$22.71 million. The Bank anticipates that it will have sufficient funds available to meet current loan commitments. CDs that are scheduled to mature in less than one year from June 30, 2011 totaled \$164.68

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million. Historically, the Bank has been able to retain a significant amount of its non-brokered CDs as they mature. At June 30, 2011, the Bank had no brokered deposits.

### Capital Resources

-----  
Federally-insured state-chartered banks are required to maintain minimum levels of regulatory capital. Under current FDIC regulations, insured state-chartered banks generally must maintain (i) a ratio of Tier 1 leverage capital to total assets of at least 4.0%, (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%. The Bank is currently required to maintain a "well capitalized" status and a Tier 1 leverage capital ratio of at least 10.0% under terms of the Bank MOU.

At June 30, 2011, the Bank was in compliance with all applicable capital requirements.

The following table compares the Company's and the Bank's actual capital amounts at June 30, 2011 to its minimum regulatory capital requirements at that date (dollars in thousands):

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|                               | Actual   |        | Regulatory Minimum To Be "Adequately Capitalized" |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|-------------------------------|----------|--------|---|-------|--|--------|
|                               | Amount   | Ratio  | Amount  | Ratio | Amount   | Ratio  |
| Tier 1 leverage capital:      |          |        |   |       |  |        |
| Consolidated                  | \$81,204 | 11.01% | \$29,499  | 4.00% | N/A  | N/A    |
| Timberland Bank (1)           | 74,442   | 10.15  | 73,371  | 10.00 | \$73,371   | 10.00% |
| Tier 1 risk adjusted capital: |          |        |   |       |  |        |
| Consolidated                  | 81,204   | 15.34  | 21,181  | 4.00  | N/A  | N/A    |
| Timberland Bank (1)           | 74,442   | 14.09  | 31,695  | 6.00  | 31,695   | 6.00   |
| Total risk-based capital      |          |        |   |       |  |        |
| Consolidated                  | 87,887   | 16.60  | 42,362  | 8.00  | N/A  | N/A    |
| Timberland Bank (1)           | 81,109   | 15.35  | 52,825  | 10.00 | 52,825   | 10.00  |

(1) Reflects the higher Tier 1 leverage capital ratio that the Bank is required to comply with under terms of the Bank MOU with the FDIC and the Division. Also reflects that the Bank is required to maintain Tier 1 risk adjusted capital ratio and Total risk-based capital ratio at or above the "well capitalized" thresholds under the terms of the Bank MOU.

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TIMBERLAND BANCORP, INC. AND SUBSIDIARIES  
KEY FINANCIAL RATIOS AND DATA  
(Dollars in thousands, except per share data)

|                                     | Three Months Ended |        | Nine Months Ended |         |
|-------------------------------------|--------------------|--------|-------------------|---------|
|                                     | June 30,           |        | June 30,          |         |
|                                     | 2011               | 2010   | 2011              | 2010    |
| PERFORMANCE RATIOS:                 |                    |        |                   |         |
| Return (loss) on average assets (1) | (0.69)%            | 0.45%  | 0.21%             | (0.40)% |
| Return (loss) on average equity (1) | (5.83)%            | 3.78%  | 1.79%             | (3.31)% |
| Net interest margin (1)             | 3.76%              | 3.85%  | 3.78%             | 3.91%   |
| Efficiency ratio                    | 82.98%             | 77.08% | 74.61%            | 78.97%  |

|   | At            | At                 | At            |
|---|---------------|--------------------|---------------|
|   | June 30, 2011 | September 30, 2010 | June 30, 2010 |
| ASSET QUALITY RATIOS:                     |               |                    |               |
| Non-accrual loans                         | \$21,545      | \$24,864           | \$21,031      |
| Loans past due 90 days and still accruing | 4,893         | 1,325              | 1,198         |
| Non-performing investment securities      | 3,184         | 3,390              | 3,482         |
| OREO & other repossessed assets           | 10,996        | 11,519             | 12,957        |
| Total non-performing assets               | \$40,618      | \$41,098           | \$38,668      |



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|  |          |          |          |
|--|----------|----------|----------|
| Non-performing assets to total assets                  | 5.53%    | 5.53%    | 5.28%    |
| Allowance for loan losses to non-accrual loans         | 55%      | 45%      | 52%      |
| Troubled debt restructured loans on accrual status (2) | \$20,783 | \$ 8,995 | \$ 8,895 |

### BOOK VALUES:

|  |         |         |         |
|--|---------|---------|---------|
| Book value per common share              | \$ 9.99 | \$ 9.89 | \$ 9.93 |
| Tangible book value per common share (3) | \$ 9.13 | \$ 9.00 | \$ 9.04 |

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- (1) Annualized
- (2) Does not include troubled debt restructured loans totaling \$4,956, \$7,405 and \$5,464 that were included as non-accrual loans at June 30, 2011, September 30, 2010 and June 30, 2010, respectively.
- (3) Calculation subtracts goodwill and core deposit intangible from the equity component.

|  | Three Months Ended<br>June 30, |           | Nine Months Ended<br>June 30, |           |
|--|--------------------------------|-----------|-------------------------------|-----------|
|  | 2011                           | 2010      | 2011                          | 2010      |
|  | -----                          |           | -----                         |           |
| <b>AVERAGE BALANCE SHEET:</b>              |                                |           |                               |           |
| Average total loans                        | \$537,858                      | \$552,055 | \$537,782                     | \$558,587 |
| Average total interest earning assets (1)  | 682,529                        | 663,511   | 672,772                       | 655,847   |
| Average total assets                       | 743,207                        | 721,001   | 732,041                       | 711,551   |
| Average total interest bearing deposits    | 535,873                        | 508,185   | 529,736                       | 492,999   |
| Average FHLB advances and other borrowings | 55,509                         | 75,859    | 55,514                        | 79,352    |
| Average shareholders' equity               | 87,797                         | 85,101    | 86,686                        | 86,732    |

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- (1) Includes loans and MBS on non-accrual status.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

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There were no material changes in information concerning market risk from the information provided in the Company's Form 10-K for the fiscal year ended September 30, 2010.

### Item 4. Controls and Procedures

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- (a) **Evaluation of Disclosure Controls and Procedures:** An evaluation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act")) was carried out under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and several other members of the Company's senior management as of the end of the period covered by this report. The Company's Chief Executive Officer and Chief Financial Officer concluded that as of June 30, 2011 the Company's disclosure controls and procedures were effective in ensuring

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that the information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is (i) accumulated and communicated to the Company's management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner to allow timely decisions regarding required disclosure, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

- (b) **Changes in Internal Controls:** There have been no changes in our internal control over financial reporting (as defined in 13a-15(f) of the Exchange Act) that occurred during the quarter ended June 30, 2011, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. The Company continued, however, to implement suggestions from its internal auditor and independent auditors to strengthen existing controls. The Company does not expect that its disclosure controls and procedures and internal control over financial reporting will prevent all errors and fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns in controls or procedures can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any control procedure is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; as over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

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

### Item 1A. Risk Factors

There have been no material changes in the Risk Factors previously disclosed in Item 1A of the Company's 2010 Form 10-K.

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

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Not applicable

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### Item 3. Defaults Upon Senior Securities

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See discussion in Item 2 of Part 1 with respect to cumulative preferred stock dividends in arrears, which discussion is incorporated here by reference.

### Item 4. (Removed and Reserved)

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### Item 5. Other Information

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None to be reported.

### Item 6. Exhibits

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#### (a) Exhibits

- 3.1 Articles of Incorporation of the Registrant (1)
- 3.2 Certificate of Designation relating to the Company's Fixed Rate Cumulative Perpetual Preferred Stock Series A (2)
- 3.3 Bylaws of the Registrant (1)
- 3.4 Amendment to Bylaws (3)
- 4.1 Warrant to purchase shares of Company's common stock dated December 23, 2008 (2)
- 4.2 Letter Agreement (including Securities Purchase Agreement Standard Terms attached as Exhibit A) dated December 23, 2008 between the Company and the United States Department of the Treasury (2)
- 10.1 Employee Severance Compensation Plan, as revised (4)
- 10.2 Employee Stock Ownership Plan (4)
- 10.3 1999 Stock Option Plan (5)
- 10.4 Management Recognition and Development Plan (5)
- 10.5 2003 Stock Option Plan (6)
- 10.6 Form of Incentive Stock Option Agreement (7)
- 10.7 Form of Non-qualified Stock Option Agreement (7)
- 10.8 Form of Management Recognition and Development Award Agreement (7)
- 10.9 Form of Compensation Modification Agreements (2)
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes Oxley Act
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes Oxley Act
- 32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes Oxley Act
- 101 The following materials from Timberland Bancorp, Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 30, 2011, formatted in Extensible Business Reporting Language (XBRL): (a) Condensed Consolidated Balance Sheets; (b) Condensed Consolidated Statements of Operations; (c) Condensed Consolidated Statements of Shareholders' Equity; (d) Condensed Consolidated Statements of Cash Flows; (e) Condensed Consolidated Statements of Comprehensive Income (Loss); and (f) Notes to Unaudited Condensed Consolidated Financial Statements (8)

- 
- (1) Incorporated by reference to the Registrant's Registration Statement on Form S-1 (333- 35817).
  - (2) Incorporated by reference to the Registrant's Current Report on Form 8-K filed on December 23, 2008.
  - (3) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended September 30, 2002.

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- (4) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 1997; and to the Registrant's Current Report on Form 8-K

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dated April 13, 2007, and to the Registrant's Current Report on Form 8-K dated December 18, 2007.

- (5) Incorporated by reference to the Registrant's 1999 Annual Meeting Proxy Statement dated December 15, 1998.
- (6) Incorporated by reference to the Registrant's 2004 Annual Meeting Proxy Statement dated December 24, 2003.
- (7) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended September 30, 2005.
- (8) Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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SIGNATURES

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

Timberland Bancorp, Inc.

Date: August 5, 2011

By: /s/ Michael R. Sand

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

Date: August 5, 2011

By: /s/ Dean J. Brydon

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

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EXHIBIT INDEX

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| Exhibit No. | Description of Exhibit   |
|-------------|--|
| 31.1        | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act   |
| 31.2        | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act   |
| 32          | Certification Pursuant to Section 906 of the Sarbanes-Oxley Act  |
| 101         | The following materials from Timberland Bancorp, Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 30, 2011, formatted in Extensible Business Reporting Language (XBRL): (a) Condensed Consolidated Balance Sheets; (b) Condensed Consolidated Statements of Operations; (c) Condensed Consolidated Statements of Shareholders' Equity; (d) Condensed Consolidated Statements of Cash Flows; (e) Condensed Consolidated Statements of Comprehensive Income (Loss); and (f) Notes to Unaudited Condensed Consolidated Financial Statements. |