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TIMBERLAND BANCORP INC  
Form 10-Q  
August 08, 2008

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, 2008

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 91-1863696  
(State of Incorporation) (IRS Employer Identification No.)

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

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

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

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

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

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

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

| CLASS                         | SHARES OUTSTANDING AT JULY 31, 2008 |
|-------------------------------|-------------------------------------|
| -----                         | -----                               |
| Common stock, \$.01 par value | 6,901,453                           |

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| PART I. FINANCIAL INFORMATION                                                                 |       |
| Item 1. Financial Statements                                                                  |       |
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TIMBERLAND BANCORP, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS  
June 30, 2008 and September 30, 2007  
Dollars in thousands, except share amounts

June 30, September 30,  
2008 2007  
-----

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| Assets                                                                     | (Unaudited) |            |
|----------------------------------------------------------------------------|-------------|------------|
| Cash equivalents:                                                          |             |            |
| Non-interest bearing                                                       | \$ 14,776   | \$ 10,813  |
| Interest bearing deposits in banks                                         | 3,196       | 2,082      |
| Federal funds sold                                                         | 5,565       | 3,775      |
|                                                                            | -----       | -----      |
|                                                                            | 23,537      | 16,670     |
|                                                                            | -----       | -----      |
| Investments and mortgage-backed securities: held to maturity               | 14,684      | 71         |
| Investments and mortgage-backed securities: available for sale             | 18,828      | 63,898     |
| Federal Home Loan Bank ("FHLB") stock                                      | 5,705       | 5,705      |
| Loans receivable                                                           | 562,664     | 519,381    |
| Loans held for sale                                                        | 1,065       | 757        |
| Less: Allowance for loan losses                                            | (7,076)     | (4,797)    |
|                                                                            | -----       | -----      |
| Net loans receivable                                                       | 556,653     | 515,341    |
|                                                                            | -----       | -----      |
| Accrued interest receivable                                                | 2,932       | 3,424      |
| Premises and equipment                                                     | 16,286      | 16,575     |
| Other real estate owned ("OREO") and other repossessed items               | 879         | --         |
| Bank owned life insurance ("BOLI")                                         | 12,775      | 12,415     |
| Goodwill                                                                   | 5,650       | 5,650      |
| Core deposit intangible ("CDI")                                            | 1,034       | 1,221      |
| Mortgage servicing rights                                                  | 1,277       | 1,051      |
| Other assets                                                               | 3,514       | 2,827      |
|                                                                            | -----       | -----      |
| Total assets                                                               | \$ 663,754  | \$ 644,848 |
|                                                                            | =====       | =====      |
| Liabilities and shareholders' equity                                       |             |            |
| Deposits                                                                   | \$ 479,934  | \$ 466,735 |
| FHLB advances                                                              | 104,645     | 99,697     |
| Other borrowings: repurchase agreements                                    | 1,007       | 595        |
| Other liabilities and accrued expenses                                     | 3,393       | 3,274      |
|                                                                            | -----       | -----      |
| Total liabilities                                                          | 588,979     | 570,301    |
|                                                                            | -----       | -----      |
| Commitments and contingencies                                              | --          | --         |
| Shareholders' equity                                                       |             |            |
| Preferred stock, \$.01 par value; 1,000,000 shares authorized; none issued | --          | --         |
| Common stock, \$.01 par value; 50,000,000 shares authorized;               |             |            |
| June 30, 2008 6,901,453 shares issued and outstanding                      |             |            |
| September 30, 2007 6,953,360 shares issued and outstanding                 | 69          | 70         |
| Additional paid in capital                                                 | 8,706       | 9,923      |
| Unearned shares-Employee Stock Ownership Plan("ESOP")                      | (2,842)     | (3,040)    |
| Retained earnings                                                          | 68,822      | 68,378     |
| Accumulated other comprehensive income (loss)                              | 20          | (784)      |
|                                                                            | -----       | -----      |
| Total shareholders' equity                                                 | 74,775      | 74,547     |
|                                                                            | -----       | -----      |
| Total liabilities and shareholders' equity                                 | \$ 663,754  | \$ 644,848 |
|                                                                            | =====       | =====      |

See notes to unaudited condensed consolidated financial statements

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TIMBERLAND BANCORP, INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF INCOME  
 For the three and nine months ended June 30, 2008 and 2007  
 Dollars in thousands, except per share amounts  
 (unaudited)

|                                                     | Three Months Ended<br>June 30, |               | Nine Months Ended<br>June 30, |               |
|-----------------------------------------------------|--------------------------------|---------------|-------------------------------|---------------|
|                                                     | 2008                           | 2007          | 2008                          | 2007          |
| Interest and dividend income                        |                                |               |                               |               |
| Loans receivable                                    | \$ 9,825                       | \$ 9,981      | \$30,947                      | \$28,050      |
| Investments and mortgage-backed securities          | 235                            | 350           | 625                           | 1,185         |
| Dividends from mutual funds and FHLB stock          | 272                            | 426           | 1,090                         | 1,259         |
| Federal funds sold                                  | 28                             | 49            | 87                            | 192           |
| Interest bearing deposits in banks                  | 8                              | 8             | 22                            | 61            |
| <b>Total interest and dividend income</b>           | <b>10,368</b>                  | <b>10,814</b> | <b>32,771</b>                 | <b>30,747</b> |
| Interest expense                                    |                                |               |                               |               |
| Deposits                                            | 2,703                          | 2,866         | 9,153                         | 8,113         |
| FHLB advances -- short term                         | 57                             | 651           | 591                           | 1,298         |
| FHLB advances -- long term                          | 1,104                          | 627           | 2,919                         | 1,875         |
| Other borrowings                                    | 4                              | 12            | 18                            | 39            |
| <b>Total interest expense</b>                       | <b>3,868</b>                   | <b>4,156</b>  | <b>12,681</b>                 | <b>11,325</b> |
| Net interest income                                 | 6,500                          | 6,658         | 20,090                        | 19,422        |
| Provision for loan losses                           | 500                            | 260           | 2,400                         | 416           |
| Net interest income after provision for loan losses | 6,000                          | 6,398         | 17,690                        | 19,006        |
| Non-interest income                                 |                                |               |                               |               |
| Service charges on deposits                         | 948                            | 692           | 2,292                         | 2,061         |
| Gain on sale of loans, net                          | 127                            | 79            | 364                           | 250           |
| Loss on redemption of mutual funds                  | (2,822)                        | --            | (2,822)                       | --            |
| BOLI net earnings                                   | 121                            | 116           | 360                           | 343           |
| Servicing income on loans sold                      | 234                            | 127           | 531                           | 373           |
| ATM transaction fees                                | 329                            | 295           | 930                           | 830           |
| Fee income from non-deposit investment sales        | 31                             | 37            | 87                            | 98            |
| Other                                               | 139                            | 155           | 417                           | 450           |
| <b>Total non-interest income (loss)</b>             | <b>(893)</b>                   | <b>1,501</b>  | <b>2,159</b>                  | <b>4,405</b>  |
| Non-interest expense                                |                                |               |                               |               |
| Salaries and employee benefits                      | 2,812                          | 2,752         | 8,718                         | 8,303         |
| Premises and equipment                              | 519                            | 557           | 1,634                         | 1,827         |
| Advertising                                         | 228                            | 190           | 678                           | 569           |
| Loss (gain) from real estate operations             | --                             | 1             | --                            | (14)          |
| ATM expenses                                        | 136                            | 128           | 426                           | 354           |
| Postage and courier                                 | 129                            | 113           | 376                           | 347           |
| Amortization of CDI                                 | 62                             | 71            | 186                           | 214           |
| State and local taxes                               | 149                            | 148           | 447                           | 420           |
| Professional fees                                   | 175                            | 175           | 467                           | 524           |
| Other                                               | 709                            | 626           | 2,044                         | 2,052         |
| <b>Total non-interest expense</b>                   | <b>4,919</b>                   | <b>4,761</b>  | <b>14,976</b>                 | <b>14,596</b> |
| Income before federal income taxes                  | 188                            | 3,138         | 4,873                         | 8,815         |
| Federal income taxes                                | 734                            | 1,000         | 2,218                         | 2,806         |

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|                                                                    |           |           |           |           |
|--------------------------------------------------------------------|-----------|-----------|-----------|-----------|
| Net income (loss)                                                  | \$ (546)  | \$ 2,138  | \$ 2,655  | \$ 6,009  |
| Earnings (loss) per common share:                                  | =====     |           | =====     |           |
| Basic                                                              | \$ (0.08) | \$ 0.32   | \$ 0.41   | \$ 0.88   |
| Diluted                                                            | \$ (0.08) | \$ 0.31   | \$ 0.40   | \$ 0.85   |
| Weighted average shares outstanding:                               |           |           |           |           |
| Basic                                                              | 6,446,303 | 6,713,777 | 6,467,874 | 6,863,253 |
| Diluted                                                            | 6,524,818 | 6,910,165 | 6,587,120 | 7,080,530 |
| Dividends paid per share:                                          | \$ 0.11   | \$ 0.09   | \$ 0.32   | \$ 0.27   |
| See notes to unaudited condensed consolidated financial statements |           |           |           |           |

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TIMBERLAND BANCORP, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
For the year ended September 30, 2007 and the nine months ended June 30, 2008  
Dollars in thousands, except per share amounts and common stock shares

|                                                                                   | Common<br>Stock Shares<br>Outstanding | Common<br>Stock<br>Amount | Additional<br>Paid-In<br>Capital | Unearned<br>Shares<br>Issued to<br>ESOP | Retained<br>Earnings | Accumul-<br>Other<br>Compre-<br>hensive<br>Income<br>(Loss) |
|-----------------------------------------------------------------------------------|---------------------------------------|---------------------------|----------------------------------|-----------------------------------------|----------------------|-------------------------------------------------------------|
|                                                                                   | -----                                 | -----                     | -----                            | -----                                   | -----                | -----                                                       |
| Balance, Sept. 30, 2006                                                           | 7,515,352                             | \$38                      | \$20,700                         | (\$3,305)                               | \$62,933             | (\$1,001)                                                   |
| Net income                                                                        | --                                    | --                        | --                               | --                                      | 8,163                | --                                                          |
| Stock split                                                                       | --                                    | 36                        | --                               | --                                      | (36)                 | --                                                          |
| Issuance of MRDP (1) shares                                                       | 15,080                                | --                        | --                               | --                                      | --                   | --                                                          |
| Repurchase of<br>common stock                                                     | (687,542)                             | (4)                       | (12,427)                         | --                                      | --                   | --                                                          |
| Exercise of stock options                                                         | 110,470                               | --                        | 1,207                            | --                                      | --                   | --                                                          |
| Cash dividends<br>(\$0.37 per share)                                              | --                                    | --                        | --                               | --                                      | (2,682)              | --                                                          |
| Earned ESOP shares                                                                | --                                    | --                        | 354                              | 265                                     | --                   | --                                                          |
| MRDP compensation expense                                                         | --                                    | --                        | 64                               | --                                      | --                   | --                                                          |
| Stock option compensation exp.                                                    | --                                    | --                        | 25                               | --                                      | --                   | --                                                          |
| Unrealized holding gain on<br>securities available<br>for sale, net of tax        | --                                    | --                        | --                               | --                                      | --                   | 217                                                         |
| Balance, Sept. 30, 2007                                                           | 6,953,360                             | \$70                      | \$9,923                          | (\$3,040)                               | \$68,378             | (\$784)                                                     |
| (Unaudited)                                                                       |                                       |                           |                                  |                                         |                      |                                                             |
| Net income                                                                        | --                                    | --                        | --                               | --                                      | 2,655                | --                                                          |
| Issuance of MRDP shares                                                           | 20,315                                | --                        | --                               | --                                      | --                   | --                                                          |
| Repurchase of<br>common stock                                                     | (144,950)                             | (2)                       | (1,920)                          | --                                      | --                   | --                                                          |
| Exercise of stock options                                                         | 72,728                                | 1                         | 459                              | --                                      | --                   | --                                                          |
| Cash dividends<br>(\$0.32 per share)                                              | --                                    | --                        | --                               | --                                      | (2,211)              | --                                                          |
| Earned ESOP shares                                                                | --                                    | --                        | 132                              | 198                                     | --                   | --                                                          |
| MRDP compensation expense                                                         | --                                    | --                        | 109                              | --                                      | --                   | --                                                          |
| Stock option compensation exp.                                                    | --                                    | --                        | 3                                | --                                      | --                   | --                                                          |
| Unrealized holding gain (loss) on<br>securities available<br>for sale, net of tax | --                                    | --                        | --                               | --                                      | --                   | 804                                                         |

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Balance, June 30, 2008                      6,901,453                      \$69                      \$8,706                      (\$2,842)                      \$68,822                      \$20

(1) 1998 Management Recognition and Development Plan.  
See notes to unaudited condensed consolidated financial statements

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TIMBERLAND BANCORP, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
For the nine months ended June 30, 2008 and 2007  
In thousands (unaudited)

| Cash flow from operating activities                               | Nine Months Ended June 30, |          |
|-------------------------------------------------------------------|----------------------------|----------|
|                                                                   | 2008                       | 2007     |
| Net income                                                        | \$2,655                    | \$6,009  |
| Non-cash revenues, expenses, gains and losses included in income: |                            |          |
| Provision for loan losses                                         | 2,400                      | 416      |
| Depreciation                                                      | 830                        | 760      |
| Deferred federal income taxes                                     | (1,076)                    | (178)    |
| Amortization of CDI                                               | 186                        | 214      |
| Earned ESOP shares                                                | 198                        | 199      |
| MRDP compensation expense                                         | 97                         | 36       |
| Stock option compensation expense                                 | 3                          | 19       |
| Stock option tax effect less excess tax benefit                   | 4                          | 110      |
| Gain on sale of OREO, net                                         | -                          | (19)     |
| Gain on the disposition of premises and equipment                 | (294)                      | (64)     |
| BOLI cash surrender value increase                                | (360)                      | (343)    |
| Gain on sale of loans                                             | (364)                      | (250)    |
| Increase (decrease) in deferred loan origination fees             | (103)                      | 123      |
| Loss on sale of investment securities                             | 2,822                      | --       |
| Loans originated for sale                                         | (35,253)                   | (20,102) |
| Proceeds from sale of loans                                       | 35,309                     | 21,636   |
| Decrease (increase) in other assets, net                          | 226                        | (412)    |
| Decrease in other liabilities and accrued expenses, net           | 119                        | 449      |
| Net cash provided by operating activities                         | 7,399                      | 8,603    |
| Cash flow from investing activities                               |                            |          |
| Decrease in certificates of deposit held for investment           | --                         | 100      |
| Proceeds from maturities of securities available for sale         | 21,867                     | 16,630   |
| Proceeds from maturities of securities held to maturity           | 73                         | 2        |
| Proceeds from sale of securities available for sale               | 6,929                      | --       |
| Increase in loans receivable, net                                 | (44,180)                   | (74,580) |
| Additions to premises and equipment                               | (621)                      | (847)    |
| Proceeds from the disposition of premises and equipment           | 374                        | 324      |
| Proceeds from sale of OREO                                        | --                         | 37       |
| Net cash used in investing activities                             | (15,558)                   | (58,334) |
| Cash flow from financing activities                               |                            |          |
| Increase in deposits, net                                         | 13,199                     | 2,453    |
| Proceeds from FHLB advances    long term                          | 50,000                     | 30,000   |
| Repayment of FHLB advances    long term                           | (15,052)                   | (24,048) |
| Proceeds from FHLB advances    short term                         | (30,000)                   | 43,750   |
| Increase (decrease) in repurchase agreements                      | 412                        | (172)    |
| Proceeds from exercise of stock options                           | 444                        | 744      |

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|                                           |         |          |
|-------------------------------------------|---------|----------|
| ESOP tax effect                           | 132     | 280      |
| MRDP compensation tax effect              | 12      | --       |
| Stock option excess tax benefit           | 12      | 353      |
| Repurchase of common stock                | (1,922) | (11,236) |
| Payment of dividends                      | (2,211) | (1,991)  |
|                                           | -----   | -----    |
| Net cash provided by financing activities | 15,026  | 40,133   |

See notes to unaudited condensed consolidated financial statements (continued)

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TIMBERLAND BANCORP, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (concluded)  
For the nine months ended June 30, 2008 and 2007  
In thousands  
(unaudited)

|                                                                                  | Nine Months Ended June 30, |           |
|----------------------------------------------------------------------------------|----------------------------|-----------|
|                                                                                  | 2008                       | 2007      |
|                                                                                  | -----                      | -----     |
| Net (increase) decrease in cash equivalents                                      | 6,867                      | (9,958)   |
| Cash equivalents                                                                 |                            |           |
| Beginning of period                                                              | 16,670                     | 22,789    |
|                                                                                  | -----                      | -----     |
| End of period                                                                    | \$ 23,537                  | \$ 13,191 |
|                                                                                  | -----                      | -----     |
| Supplemental disclosure of cash flow information                                 |                            |           |
| Income taxes paid                                                                | \$ 3,288                   | \$2,674   |
| Interest paid                                                                    | 12,834                     | 11,222    |
| Supplemental disclosure of non-cash investing activities                         |                            |           |
| Change in unrealized holding gain (loss) on securities held for sale, net of tax | \$ 804                     | \$ 104    |
| Loans transferred to OREO and other repossessed assets                           | 879                        | 71        |
| Mutual funds redeemed for mortgage-backed securities                             | 22,188                     | --        |
| Supplemental disclosure of non-cash financing activities                         |                            |           |
| Shares issued to MRDP                                                            | \$ 259                     | \$ 263    |

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See notes to unaudited condensed consolidated financial statements

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TIMBERLAND BANCORP, INC. AND SUBSIDIARIES  
 CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
 For the three and nine months ended June 30, 2008 and 2007  
 In thousands  
 (unaudited)

|                                                                                   | Three Months Ended |          | Nine Months Ended |          |
|-----------------------------------------------------------------------------------|--------------------|----------|-------------------|----------|
|                                                                                   | June 30,           |          | June 30,          |          |
|                                                                                   | 2008               | 2007     | 2008              | 2007     |
| Comprehensive income:                                                             |                    |          |                   |          |
| Net income (loss)                                                                 | \$ (546)           | \$ 2,138 | \$ 2,655          | \$ 6,009 |
| Unrealized holding gain (loss) on<br>securities available for sale,<br>net of tax | 991                | (162)    | 804               | 104      |
| Total comprehensive income                                                        | \$ 445             | \$ 1,976 | \$ 3,459          | \$ 6,113 |

See notes to unaudited condensed consolidated financial statements

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

### (1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) **Basis of Presentation:** The accompanying unaudited condensed consolidated financial statements for Timberland Bancorp, Inc. ("Company") were prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with instructions for Form 10-Q and therefore, do not include all disclosures necessary for a complete presentation of financial condition, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America. However, all adjustments which are in the opinion of management, necessary for a fair presentation of the interim condensed consolidated financial statements have been included. All such adjustments are of a normal recurring nature. The unaudited condensed consolidated financial statements should be read in conjunction with the audited financial statements included in the Company's Annual Report on Form 10-K for the year ended September 30, 2007 ("2007 Form 10-K"). The results of operations for the nine months ended June 30, 2008 are not necessarily indicative of the results that may be expected for the entire fiscal year.

(b) **Stock Split:** On June 5, 2007 the Company's common stock was split two-for-one in the form of a 100% stock dividend. Each shareholder of record as of May 22, 2007 received one additional share for every share owned. All share and per share amounts (including stock options) in the condensed consolidated financial statements and accompanying notes were restated to reflect the split, except as otherwise noted.

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

(d) **Operating Segment:** The Company provides a broad range of financial services to individuals and companies located primarily in western Washington. These services include demand, time and savings deposits; real estate, business and consumer lending; and investment advisory services. While the Company's chief decision maker monitors the revenue streams from the various products and services, operations are managed and financial performance is evaluated on a Company-wide basis. Accordingly, all of the Company's operations are considered by management to be one reportable operating segment.

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

(f) Certain prior period amounts have been reclassified to conform to the June 30, 2008 presentation with no change to net income or shareholders' equity previously reported.

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(2) INVESTMENTS AND MORTGAGE-BACKED SECURITIES

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

|                            | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|----------------------------|-------------------|------------------------------|-------------------------------|---------------|
| June 30, 2008              |                   |                              |                               |               |
| Held to Maturity           |                   |                              |                               |               |
| Mortgage-backed securities | \$14,656          | \$ 1                         | (\$30)                        | \$14,627      |
| U.S. agency securities     | 28                | --                           | (1)                           | 27            |
| Total                      | \$14,684          | \$ 1                         | (\$31)                        | \$14,654      |
| Available for Sale         |                   |                              |                               |               |
| Mortgage-backed securities | \$17,797          | \$111                        | (\$14)                        | \$17,894      |
| Mutual funds               | 1,000             | --                           | (66)                          | 934           |
| Total                      | \$18,797          | \$111                        | (\$80)                        | \$18,828      |
| September 30, 2007         |                   |                              |                               |               |
| Held to Maturity           |                   |                              |                               |               |
| Mortgage-backed securities | \$ 71             | \$ --                        | (\$1)                         | \$70          |
| Available for Sale         |                   |                              |                               |               |
| Mortgage-backed securities | \$13,147          | \$31                         | (\$131)                       | \$13,047      |
| Mutual funds               | 32,939            | --                           | (1,063)                       | 31,876        |
| U.S. agency securities     | 19,000            | --                           | (25)                          | 18,975        |
| Total                      | \$65,086          | \$31                         | (\$1,219)                     | \$63,898      |

The fair value of temporarily impaired securities, the amount of unrealized losses and the length these unrealized losses existed as of June 30, 2008 are as follows (in thousands):

| Description of Securities  | Less Than 12 Months |                      | 12 Months or Longer |                      | Total<br>Fair<br>Value |
|----------------------------|---------------------|----------------------|---------------------|----------------------|------------------------|
|                            | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value       | Unrealized<br>Losses |                        |
| Held to Maturity           |                     |                      |                     |                      |                        |
| U.S. agency securities     | \$ 27               | (\$1)                | \$ --               | \$ --                | \$ 27                  |
| Mortgage-backed securities | 13,501              | (30)                 | --                  | --                   | 13,501                 |
| Total                      | 13,528              | (31)                 | --                  | --                   | 13,528                 |
| Available for Sale         |                     |                      |                     |                      |                        |
| Mortgage-backed securities | 7,602               | (11)                 | 124                 | (3)                  | 7,726                  |
| Mutual funds               | --                  | --                   | 934                 | (66)                 | 934                    |
| Total                      | \$ 7,602            | (\$11)               | \$1,058             | (\$69)               | \$8,660                |

The Company has evaluated these securities and has determined that the decline in their value is

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The unrealized losses are generally due to the unusually large spreads in the market for mortgage products. The fair value of the mortgage-backed securities and the U.S. agency securities is expected to recover

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as the securities approach their maturity date and/or as market interest rates decrease. The fair value of the mutual funds is expected to recover as spreads narrow on mortgage-related securities. The Company has the ability and intent to hold the investments until the market value recovers.

Mortgage-backed and agency securities pledged as collateral for public fund deposits, federal treasury tax and loan deposits, FHLB collateral, retail repurchase agreements and other non-profit organization deposits totaled \$32,548,000 and \$31,869,000 at June 30, 2008 and September 30, 2007, respectively.

The contractual maturities of debt securities at June 30, 2008 are as follows (in thousands). Expected maturities may differ from scheduled maturities due to the prepayment of principal or call provisions.

|                                  | Held to Maturity  |               | Available for Sale |               |
|----------------------------------|-------------------|---------------|--------------------|---------------|
|                                  | Amortized<br>Cost | Fair<br>Value | Amortized<br>Cost  | Fair<br>Value |
|                                  | -----             |               | -----              |               |
| Due within one year              | \$ --             | \$ --         | \$ --              | \$ --         |
| Due after one year to five years | 15                | 15            | 688                | 690           |
| Due after five to ten years      | 75                | 75            | 286                | 290           |
| Due after ten years              | 14,594            | 14,565        | 16,737             | 16,914        |
| Mutual funds                     | --                | --            | 1,000              | 934           |
| <br>Total                        | <br>\$14,684      | <br>\$14,655  | <br>\$18,711       | <br>\$18,828  |

There were gross realized losses on sales of securities available for sale for the three and nine months ended June 30, 2008 of \$2,822,000 and no gross realized gains or losses for the three and nine months ended June 30, 2007.

### (3) LOANS

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

|                                      | At June 30,<br>2008 |         | At September 30,<br>2007 |         |
|--------------------------------------|---------------------|---------|--------------------------|---------|
|                                      | Amount              | Percent | Amount                   | Percent |
|                                      | -----               |         | -----                    |         |
| <b>Mortgage loans:</b>               |                     |         |                          |         |
| One- to four-family (1)              | \$ 105,791          | 17.0%   | \$ 102,434               | 17.4%   |
| Multi-family                         | 37,465              | 6.0     | 35,157                   | 6.0     |
| Commercial                           | 140,785             | 22.6    | 127,866                  | 21.7    |
| Construction and land<br>development | 202,029             | 32.4    | 186,261                  | 31.6    |
| Land                                 | 56,489              | 9.0     | 60,706                   | 10.3    |
| Total mortgage loans                 | 542,559             | 87.0    | 512,424                  | 87.0    |
| <br><b>Consumer loans:</b>           |                     |         |                          |         |
| Home equity and second mortgage      | 46,771              | 7.5     | 47,269                   | 8.0     |
| Other                                | 11,292              | 1.8     | 10,922                   | 1.9     |
| Total consumer loans                 | 58,063              | 9.3     | 58,191                   | 9.9     |

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|                                                         |           |        |           |        |
|---------------------------------------------------------|-----------|--------|-----------|--------|
| Commercial business loans                               | 23,307    | 3.7    | 18,164    | 3.1    |
| Total loans receivable                                  | 623,929   | 100.0% | 588,779   | 100.0% |
| Less:                                                   |           |        |           |        |
| Undisbursed portion of<br>construction loans in process | 57,335    |        | 65,673    |        |
| Deferred loan origination fees                          | 2,865     |        | 2,968     |        |
| Allowance for loan losses                               | 7,076     |        | 4,797     |        |
|                                                         | 67,276    |        | 73,438    |        |
| Total Loans receivable, net                             | \$556,653 |        | \$515,341 |        |

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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,<br>2008    |         | At September 30,<br>2007 |         |
|---------------------------------|------------------------|---------|--------------------------|---------|
|                                 | Amount                 | Percent | Amount                   | Percent |
|                                 | -----                  |         |                          |         |
|                                 | (Dollars in thousands) |         |                          |         |
| Custom and owner/builder const. | \$ 48,384              | 24.0%   | \$ 52,375                | 28.1%   |
| Speculative construction        | 36,979                 | 18.3    | 43,012                   | 23.1    |
| Commercial real estate          | 66,846                 | 33.1    | 50,518                   | 27.1    |
| Multi-family                    | 19,044                 | 9.4     | 18,064                   | 9.7     |
| Land development                | 30,776                 | 15.2    | 22,292                   | 12.0    |
|                                 | -----                  | -----   | -----                    | -----   |
| Total construction loans        | \$202,029              | 100.0%  | \$186,261                | 100.0%  |
|                                 | =====                  | =====   | =====                    | =====   |

Allowance for Loan Losses

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

|                                            | Three Months Ended<br>June 30, |          |
|--------------------------------------------|--------------------------------|----------|
|                                            | 2008                           | 2007     |
|                                            | -----                          |          |
|                                            | (In thousands)                 |          |
| Balance at beginning of period             | \$ 6,697                       | \$ 4,272 |
| Provision for loan losses                  | 500                            | 260      |
| Loans charged off                          | (121)                          | (3)      |
| Recoveries on loans previously charged off | --                             | --       |
| Net charge-offs                            | (121)                          | (3)      |
| Balance at end of period                   | \$ 7,076                       | \$ 4,529 |
|                                            |                                |          |
|                                            |                                |          |
|                                            | Nine Months Ended<br>June 30,  |          |
|                                            | 2008                           | 2007     |
|                                            | -----                          |          |
|                                            | (In thousands)                 |          |
| Balance at beginning of period             | \$ 4,797                       | \$ 4,122 |
| Provision for loan losses                  | 2,400                          | 416      |

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|                                            |          |          |
|--------------------------------------------|----------|----------|
| Loans charged off                          | (121)    | (10)     |
| Recoveries on loans previously charged off | --       | 1        |
|                                            | -----    | -----    |
| Net charge-offs                            | (121)    | (9)      |
|                                            | -----    | -----    |
| Balance at end of period                   | \$ 7,076 | \$ 4,529 |
|                                            | =====    | =====    |

At June 30, 2008 and September 30, 2007, the Bank had non-accruing loans totaling approximately \$9,391,000 and \$1,490,000, respectively. At June 30, 2008 and September 30, 2007, no loans were 90 days or more past due and still accruing interest. Interest income recognized on a cash basis on non-accrual loans for the three months ended June 30, 2008 and 2007 was \$8,000 and \$11,000, respectively, and for the nine months ended June 30, 2008 and 2007 was \$20,000 and \$22,000, respectively. The average investment in non-accrual loans for the nine months ended June 30, 2008 and the year ended September 30, 2007 was \$5,294,000 and \$623,000, respectively.

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Non-performing Assets

The following table sets forth information with respect to the Company's non-performing assets.

|                                                                                              | At<br>June 30,<br>2008 | At<br>September 30,<br>2007 |
|----------------------------------------------------------------------------------------------|------------------------|-----------------------------|
|                                                                                              | -----                  |                             |
|                                                                                              | (In thousands)         |                             |
| Loans accounted for on a non-accrual basis:                                                  |                        |                             |
| Mortgage loans:                                                                              |                        |                             |
| One- to four-family                                                                          | \$ 101                 | \$ 252                      |
| Commercial real estate                                                                       | 717                    | 90                          |
| Construction and land development                                                            | 7,393                  | 1,000                       |
| Land                                                                                         | 933                    | 28                          |
| Consumer loans                                                                               | 233                    | --                          |
| Commercial business loans                                                                    | 14                     | 120                         |
|                                                                                              | -----                  | -----                       |
| Total                                                                                        | 9,391                  | 1,490                       |
| Accruing loans which are contractually<br>past due 90 days or more:                          | --                     | --                          |
|                                                                                              | -----                  | -----                       |
| Total                                                                                        | --                     | --                          |
| Total of non-accrual and<br>90 days past due loans                                           | 9,391                  | 1,490                       |
| OREO and other<br>repossessed items                                                          | 879                    | --                          |
|                                                                                              | -----                  | -----                       |
| Total non-performing assets                                                                  | \$ 10,270              | \$ 1,490                    |
|                                                                                              | =====                  | =====                       |
| Restructured loans                                                                           | \$ --                  | \$ --                       |
| Non-accrual and 90 days or more past<br>due loans as a percentage of loans<br>receivable (1) | 1.67%                  | 0.29%                       |

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|                                                                                |           |           |
|--------------------------------------------------------------------------------|-----------|-----------|
| Non-accrual and 90 days or more past due loans as a percentage of total assets | 1.41%     | 0.23%     |
| Non-performing assets as a percentage of total assets                          | 1.55%     | 0.23%     |
| Loans receivable (1)                                                           | \$563,729 | \$520,138 |
|                                                                                | =====     | =====     |
| Total assets                                                                   | \$663,754 | \$644,848 |
|                                                                                | =====     | =====     |

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

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

|                                               | At June 30, |        |
|-----------------------------------------------|-------------|--------|
|                                               | 2008        | 2007   |
|                                               | -----       |        |
| Impaired loans without a valuation allowance  | \$4,904     | \$ 982 |
| Impaired loans with a valuation allowance     | 4,487       | --     |
|                                               | \$9,391     | \$ 982 |
| Valuation allowance related to impaired loans | \$ 540      | \$ --  |

#### (4) EARNINGS PER SHARE

Basic earnings per share ("EPS") is computed by dividing net income by the weighted average number of common shares outstanding during the period, without considering any dilutive items. Diluted EPS is computed by dividing net income by the weighted average number of common shares and common stock equivalents for items that are dilutive, net of shares assumed to be repurchased using the treasury stock method at the average share price for the Company's common stock during the period. Common stock equivalents arise from assumed conversion of outstanding stock options and awarded but not released MRDP shares. In accordance with Statement of Position ("SOP") 93-6, Employers' Accounting for Employee Stock Ownership Plans, issued by the American Institute of Certified Public Accountants, shares owned by the Bank's ESOP that have not been allocated are not considered to be outstanding for the purpose of computing earnings per share. At June 30, 2008 and 2007, there were 405,562 and 440,830 ESOP shares, respectively, that had not been allocated.

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

|                                                        | Three Months Ended |           | Nine Months Ended |           |
|--------------------------------------------------------|--------------------|-----------|-------------------|-----------|
|                                                        | June 30,           |           | June 30,          |           |
|                                                        | 2008               | 2007      | 2008              | 2007      |
|                                                        | -----              |           | -----             |           |
| Basic EPS computation                                  |                    |           |                   |           |
| Numerator-net income (loss)                            | \$ (546)           | \$ 2,138  | \$2,655           | \$6,009   |
| Denominator-weighted average common shares outstanding | 6,446,303          | 6,713,777 | 6,467,874         | 6,863,253 |
|                                                        | -----              | -----     | -----             | -----     |
| Basic EPS                                              | \$ (0.08)          | \$ 0.32   | \$ 0.41           | \$0.88    |
| Diluted EPS computation                                |                    |           |                   |           |
| Numerator-net income (loss)                            | \$ (546)           | \$ 2,138  | \$ 2,655          | \$6,009   |

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|                                                             |           |           |           |           |
|-------------------------------------------------------------|-----------|-----------|-----------|-----------|
| Denominator-weighted average common shares outstanding      | 6,446,303 | 6,713,777 | 6,467,874 | 6,863,253 |
| Effect of dilutive stock options (1)                        | 78,515    | 193,827   | 119,246   | 215,232   |
| Effect of dilutive MRDP shares                              | --        | 2,561     | -         | 2,045     |
|                                                             | -----     | -----     | -----     | -----     |
| Weighted average common shares and common stock equivalents | 6,524,818 | 6,910,165 | 6,587,120 | 7,080,530 |
|                                                             | -----     | -----     | -----     | -----     |
| Diluted EPS                                                 | \$ (0.08) | \$ 0.31   | \$ 0.40   | \$ 0.85   |

(1) For the three months ended June 30, 2008, stock options of 49,546 were excluded from the computation of diluted earnings per share due to their anti-dilutive effect.

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### (5) STOCK BASED COMPENSATION

The Company accounts for stock-based compensation in accordance with Statement of Financial Accounting Standards ("SFAS" or "Statement") No. 123(R), Share Based Payment, which requires measurement of the compensation cost for all stock-based awards based on the grant-date fair value and recognition of compensation cost over the service period of stock-based awards. The fair value of stock options is determined using the Black-Scholes valuation model, which is consistent with the Company's valuation methodology previously utilized for options in footnote disclosures required under SFAS No. 123. The Company has adopted SFAS No. 123(R) using the modified prospective method, which provides for no restatement of prior periods and no cumulative adjustment to equity accounts. It also provides for expense recognition, for both new and existing stock-based awards.

### (6) STOCK COMPENSATION PLANS

Stock Option Plans Under the Company's stock option plans (i.e., the 1999 Stock Option Plan and the 2003 Stock Option Plan), the Company may grant options for up to a combined total of 1,622,500 shares of common stock to employees, officers and directors. Shares issued may be purchased in the open market or may be issued from authorized and unissued shares. The exercise price of each option equals the fair market value of the Company's common stock on the date of grant. The options generally vest over a ten-year period, which may be accelerated if the Company meets certain performance criteria. Generally, options vest in 10% annual installments on each of the ten anniversaries from the date of the grant and if the Company meets three of four established performance criteria the vesting is accelerated to 20% for that year. These four performance criteria are: (i) generating a return on assets which exceeds that of the median of all thrifts in the 12th FHLB District having assets within \$250 million of the Company; (ii) generating an efficiency ratio which is less than that of the median of all thrifts in the 12th FHLB District having assets within \$250 million of the Company; (iii) generating a net interest margin which exceeds the median of all thrifts in the 12th FHLB District having assets within \$250 million of the Company; and (iv) increasing the Company's earnings per share over the prior fiscal year. The Company performs the accelerated vesting analysis in February of each year based on the results of the most recently completed fiscal year. At June 30, 2008, options for 279,416 shares are available for future grant under these plans.

Following is activity under the plans:

|                                                                                      |
|--------------------------------------------------------------------------------------|
| Nine Months Ended<br>June 30, 2008<br>Total Options Outstanding<br>-----<br>Weighted |
|--------------------------------------------------------------------------------------|

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|                                          | Shares  | Weighted<br>Average<br>Exercise<br>Price | Average<br>Grant Date<br>Fair<br>Value |
|------------------------------------------|---------|------------------------------------------|----------------------------------------|
|                                          | -----   | -----                                    | -----                                  |
| Options outstanding, beginning of period | 412,674 | \$ 7.39                                  | \$1.87                                 |
| Exercised                                | 72,728  | 6.12                                     | 1.66                                   |
| Forfeited                                | --      | --                                       | --                                     |
| Granted                                  | --      | --                                       | --                                     |
|                                          | -----   |                                          |                                        |
| Options outstanding, end of period       | 339,946 | \$ 7.67                                  | \$1.92                                 |
| Options exercisable, end of period       | 333,278 | \$ 7.63                                  | \$1.91                                 |

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|                                                                          | Shares    | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Grant Date<br>Fair<br>Value |
|--------------------------------------------------------------------------|-----------|------------------------------------------|----------------------------------------------------|
|                                                                          | -----     | -----                                    | -----                                              |
| Nine Months Ended<br>June 30, 2007<br>Total Options Outstanding<br>----- |           |                                          |                                                    |
| Options outstanding, beginning of period                                 | 524,144   | \$ 7.26                                  | \$1.85                                             |
| Exercised                                                                | (110,470) | 6.73                                     | 1.76                                               |
| Forfeited                                                                | (1,000)   | 7.61                                     | 1.99                                               |
| Granted                                                                  | --        | --                                       | --                                                 |
|                                                                          | -----     |                                          |                                                    |
| Options outstanding, end of period                                       | 412,674   | \$ 7.39                                  | \$1.87                                             |
| Options exercisable, end of period                                       | 391,670   | \$ 7.30                                  | \$1.85                                             |

The aggregate intrinsic value of all options outstanding (with exercise prices below the stock's current fair market value) at June 30, 2008 was \$395,000. The aggregate intrinsic value of all options (with exercise prices below the stock's current market value) that were exercisable at June 30, 2008 was \$395,000. The aggregate intrinsic value of all options outstanding at June 30, 2007 was \$3.43 million. The aggregate intrinsic value of all options that were exercisable at June 30, 2007 was \$3.29 million.

At June 30, 2008 there were 6,668 unvested options, all of which are assumed to vest. The aggregate intrinsic value of unvested options (with exercise prices below the stock's current fair market value) was \$100 on June 30, 2008.

There were 12,336 options that vested during the nine months ended June 30, 2008 with an aggregate grant date fair value of \$28,000. There were 23,004 options that vested during the nine months ended June 30, 2007 with an aggregate grant date fair value of \$48,000.

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

Nine Months Ended  
 June 30,  
 -----  
 (In thousands)



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|                                      | 2008  | 2007   |
|--------------------------------------|-------|--------|
|                                      | ----  | ----   |
| Proceeds from options exercised      | \$445 | \$ 744 |
| Related tax benefit recognized       | 15    | 463    |
| Intrinsic value of options exercised | 451   | 1,231  |

Options outstanding at June 30, 2008 were as follows:

| Range<br>Exercise<br>Prices | Outstanding                              |                                                                 |        | Exercisable                              |                                                                 |        |
|-----------------------------|------------------------------------------|-----------------------------------------------------------------|--------|------------------------------------------|-----------------------------------------------------------------|--------|
|                             | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life (Years) | Shares | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life (Years) | Shares |

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|              |         |         |     |         |         |     |
|--------------|---------|---------|-----|---------|---------|-----|
| \$ 6.00-6.19 | 171,082 | \$ 6.00 | 0.6 | 171,082 | \$ 6.00 | 0.6 |
| 6.80-7.45    | 56,638  | 7.45    | 2.9 | 56,638  | 7.45    | 2.9 |
| 7.60-7.98    | 6,000   | 7.91    | 3.9 | 5,000   | 7.90    | 3.9 |
| 9.53         | 56,680  | 9.52    | 4.7 | 51,012  | 9.52    | 4.7 |
| 11.46-11.63  | 49,546  | 11.51   | 5.5 | 49,546  | 11.51   | 5.5 |
|              | -----   |         |     | -----   |         |     |
|              | 339,946 | \$ 7.67 | 2.4 | 333,278 | \$ 7.63 | 2.4 |

There were no options granted during the nine months ended June 30, 2008 and June 30, 2007.

Stock Grant Plans

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

The MRDP allows for the issuance to participants of up to 529,000 shares of the Company's common stock. Shares may be purchased in the open market or may be issued from authorized and unissued shares. Awards under the MRDP are made in the form of restricted shares of common stock that are subject to restrictions on the transfer of ownership. Compensation expense in the amount of the fair value of the common stock at the date of the grant to the plan participants is recognized over a five-year vesting period, with 20% vesting on each of the five anniversaries from the date of the grant. During the nine months ended June 30, 2008, the Company awarded 20,315 MRDP shares to officers and directors. These shares had a weighted average grant date fair value of \$12.76 per share. During the nine months ended June 30, 2007 the Company awarded 15,080 shares to officers and directors. These shares had a weighted average grant date fair value of \$17.44 per share.

At June 30, 2008, there were a total of 41,979 unvested MRDP shares with an aggregated grant date fair value of \$667,000. There were 3,016 MRDP shares that vested during the nine months ended June 30, 2008 with an aggregated grant date fair value of \$53,000. There were no MRDP shares that vested during the nine months ended June 30, 2007. At June 30, 2008, there were 71,751 shares available for future award under the MRDP.

Expenses for Stock Compensation Plans

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

|                                           | Nine Months Ended June 30, |                 |                  |                 |
|-------------------------------------------|----------------------------|-----------------|------------------|-----------------|
|                                           | 2008                       |                 | 2007             |                 |
|                                           | (In thousands)             |                 |                  |                 |
|                                           | Stock<br>Options           | Stock<br>Grants | Stock<br>Options | Stock<br>Grants |
| Compensation expense recognized in income | \$ 4                       | \$ 93           | \$ 19            | \$ 40           |
| Related tax benefit recognized            | 1                          | 32              | 7                | 14              |

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

|                   | Stock<br>Options | Stock<br>Grants | Total<br>Awards |
|-------------------|------------------|-----------------|-----------------|
| Remainder of 2008 | \$ 1             | \$ 36           | \$ 37           |
| 2009              | 2                | 143             | 145             |
| 2010              | 1                | 143             | 144             |
| 2011              | --               | 137             | 137             |
| 2012              | --               | 84              | 84              |
| 2013              | --               | 11              | 11              |
| Total             | \$ 4             | \$ 554          | \$ 558          |

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### (7) INCOME TAXES

In June 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109 ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement 109, Accounting for Income Taxes. FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company adopted the provisions of FIN 48 on October 1, 2007, which did not have a material impact on the Company's consolidated financial statements. As of June 30, 2008, the Company had an insignificant amount of unrecognized tax benefits.

The Company and its subsidiary file income tax returns in the U.S. federal jurisdiction. The Company is no longer subject to U.S. federal examination by tax authorities for tax years before 2003. The Company's policy is to recognize interest and penalties accrued related to unrecognized tax benefits in income tax expense. The amount of interest and penalties accrued for the nine months ended June 30, 2008 was immaterial.

The components of the provision (benefit) for income taxes for the nine months ended June 30, 2008 and 2007 are as follows (in thousands):

|                            | Nine Months Ended June 30, |          |
|----------------------------|----------------------------|----------|
|                            | 2008                       | 2007     |
| Current                    | \$ 3,255                   | \$ 2,984 |
| Deferred                   | (1,037)                    | (178)    |
| Total federal income taxes | \$ 2,218                   | \$ 2,806 |

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The components of the Company's prepaid federal income taxes and net deferred tax assets included in other assets as of June 30, 2008 and September 30, 2007 are as follows (in thousands):

|                              | At June 30,<br>2008 | At September 30,<br>2007 |
|------------------------------|---------------------|--------------------------|
|                              | -----               | -----                    |
| Prepaid federal income taxes | \$ 1,072            | \$ 1,154                 |
| Net deferred tax assets      | 1,506               | 884                      |
|                              | -----               | -----                    |
| Total                        | \$ 2,578            | \$ 2,038                 |

The components of the Company's deferred tax assets and liabilities at June 30, 2008 and September 30, 2007 are as follows (in thousands):

|                           | At June 30,<br>2008 | At September 30,<br>2007 |
|---------------------------|---------------------|--------------------------|
|                           | -----               | -----                    |
| Deferred tax assets       |                     |                          |
| Accrued interest on loans | \$ 13               | \$ 1                     |

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|                                                               |          |        |
|---------------------------------------------------------------|----------|--------|
| Accrued vacation                                              | 137      | 106    |
| Deferred compensation                                         | 52       | 69     |
| Unearned ESOP shares                                          | 448      | 438    |
| Allowance for loan losses                                     | 2,476    | 1,679  |
| CDI                                                           | 216      | 189    |
| Unearned MRDP shares                                          | 47       | 26     |
| Net unrealized securities losses                              | --       | 404    |
| Capital loss carry-forward                                    | 928      | --     |
| Stock option compensation expense                             | 21       | 20     |
|                                                               | -----    | -----  |
| Total deferred tax assets                                     | 4,338    | 2,932  |
| Deferred tax liabilities                                      |          |        |
| FHLB stock dividends                                          | 906      | 906    |
| Depreciation                                                  | 190      | 243    |
| Goodwill                                                      | 494      | 396    |
| Certificate of deposit valuation                              | 22       | 23     |
| Mortgage servicing rights                                     | 447      | 368    |
| Net unrealized securities gains                               | 11       | --     |
| Prepaid expenses                                              | 91       | 112    |
|                                                               | -----    | -----  |
| Total deferred tax liabilities                                | 2,161    | 2,048  |
| Valuation allowance for capital loss on<br>sale of securities | (671)    | --     |
|                                                               | -----    | -----  |
| Net deferred tax assets                                       | \$ 1,506 | \$ 884 |

The provision for federal income taxes for the nine months ended June 30, 2008 and 2007 differs from that computed at the statutory corporate tax rate as follows (in thousands):

|                         | 2008     |         | Nine Months Ended June 30,<br>2007 |         |
|-------------------------|----------|---------|------------------------------------|---------|
|                         | Amount   | Percent | Amount                             | Percent |
|                         | -----    | -----   | -----                              | -----   |
| Taxes at statutory rate | \$ 1,705 | 35.0%   | \$ 3,085                           | 35.0%   |

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|                             |          |       |          |       |
|-----------------------------|----------|-------|----------|-------|
| Non-taxable BOLI income     | (126)    | (2.6) | (120)    | (1.4) |
| Non-deductible capital loss | 729      | 15.0  | --       | --    |
| Other-net                   | (90)     | (1.9) | (159)    | (1.8) |
| <br>                        |          |       |          |       |
| Federal income taxes        | \$ 2,218 | 45.5% | \$ 2,806 | 31.8% |

### (8) DIVIDEND / SUBSEQUENT EVENT

On July 8, 2008, the Company announced a quarterly cash dividend of \$0.11 per common share, payable August 22, 2008, to shareholders of record as of the close of business on August 8, 2008.

On July 22, 2008, the Bank's Board of Directors approved plans to convert the Bank's loan production office located in Centralia Washington (Lewis County) into a full service branch that will be constructed in Chehalis, Washington (Lewis County). The Bank anticipates that the branch will open in early 2009.

### (9) RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value under Generally Accepted Accounting Principles ("GAAP"),

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and expands disclosures about fair value measurements. SFAS No. 157 also emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and sets out a fair value hierarchy with the highest priority being quoted prices in active markets. Under SFAS No. 157, fair value measurements are disclosed by level within that hierarchy. This Statement is effective for fiscal years beginning after November 15, 2007. The Company is currently assessing the impact of adoption of SFAS 157 on the Company's consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115. This Statement permits companies to elect to follow fair value accounting for certain financial assets and liabilities in an effort to mitigate volatility in earnings without having to apply complex hedge accounting provisions. The standard also establishes presentation and disclosure requirements designed to facilitate comparison between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The adoption of this Statement is not expected to have a material impact on the Company's consolidated financial statements.

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

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The following analysis discusses the material changes in the financial condition and results of operations of the Company at and for the three and nine months ended June 30, 2008. This analysis as well as other sections of this report contains certain "forward-looking statements." The Company desires to take advantage of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 and is including this statement for the express purpose of availing itself of the protection of such safe harbor with forward looking statements. These forward looking statements may describe future plans or strategies and include the Company's expectations of future financial results. The words "believe," "expect," "anticipate," "estimate," "project," and similar expressions identify forward-looking

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statements. The Company's ability to predict results or the effect of future plans or strategies is inherently uncertain. Factors which could cause actual results to differ materially, include, but are not limited to, the credit risks of lending activities, including changes in the level and trend of loan delinquencies and charge-offs; changes in the general economic conditions, either nationally or in our market areas; changes in the level of general interest rates, deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas; results of examinations of the Company by the Federal Reserve and of the Bank by the Federal Deposit Insurance Corporation, the Washington Department of Financial Institutions or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our reserve for loan losses or to write-down assets; our ability to control operating costs and expenses; our ability to implement our branch expansion strategy; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired or may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; our ability to manage loan delinquency rates; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; increased competitive pressures among financial service companies; changes in consumer spending, borrowing and savings habits; legislative or regulatory changes that adversely affect our business; 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; war or terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and other risks detailed in the Company's reports filed with the Securities and Exchange Commission, including the Annual Report on Form 10-K for the fiscal year ended September 30, 2007. The Company undertakes no responsibility to update or revise any forward-looking statements.

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### Overview

Timberland Bancorp, Inc., a Washington corporation, was organized on September 8, 1997 for the purpose of becoming the holding company for Timberland Savings Bank, SSB upon the Bank's conversion from a Washington-chartered mutual savings bank to a Washington-chartered stock savings bank ("Conversion"). The Conversion was completed on January 12, 1998 through the sale and issuance of 13,225,000 shares of common stock by the Company. At June 30, 2008, the Company had total assets of \$663.75 million and total shareholders' equity of \$74.78 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.

The Bank was established in 1915 as "Southwest Washington Savings and Loan Association." In 1935, the Bank converted from a state-chartered mutual savings and loan association to a federally-chartered mutual savings and loan association, and in 1972 changed its name to "Timberland Federal Savings and Loan Association." In 1990, the Bank converted to a federally chartered mutual savings bank under the name "Timberland Savings Bank, FSB." In 1991, the Bank converted to a Washington-chartered mutual savings bank and changed its name to "Timberland Savings Bank, SSB." In 2000, the Bank changed its name to "Timberland Bank." The Bank's deposits are insured by the Federal Deposit Insurance Corporation ("FDIC") up to applicable legal limits. The

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Bank has been a member of the Federal Home Loan Bank System since 1937. The Bank is regulated by the Washington State Department of Financial Institutions, Division of Banks and the FDIC.

The Bank is a community-oriented bank which offers a variety of deposit and loan products to its customers. The Bank operates 21 branches (including its main office in Hoquiam) and a loan production office (which is in the process of being converted to a full service branch) in the following market areas:

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

Historically, the principal lending activity of the Bank has consisted of the origination of loans secured by first mortgages on owner-occupied, one- to four-family residences and loans for the construction of one- to four-family residences. The Bank does not participate in the subprime mortgage market. Since 2001, the Bank has expanded its business banking capabilities and has emphasized the origination of commercial real estate and commercial and industrial loans.

In recent years, national real estate and home values have increased substantially, as a result of the generally strong national economy, speculative investing, and aggressive lending practices that provided loans to marginal borrowers (generally termed as "subprime" loans). The strong economy also resulted in significant increases in residential and commercial real estate values and commercial and residential construction. The national and the Pacific Northwest residential lending market has experienced a noted slowdown in recent months, as loan delinquencies and foreclosure rates have increased. Nationally, foreclosures and delinquencies are also being driven by investor speculation in the states of Arizona, California, Florida and Nevada, while job losses and depressed economic conditions in Indiana, Michigan and Ohio have resulted in the highest level of seriously delinquent loans. Louisiana and Mississippi also have high residential loan delinquencies as a result of Katrina-related economic factors.

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### Critical Accounting Policies and Estimates

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

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

While the Company believes it has established its existing allowance for loan

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losses in accordance with accounting principles generally accepted in the United States, there can be no assurance that regulators, in reviewing the Company's loan portfolio, will not request the Company to significantly increase or decrease its allowance for loan losses. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is adequate or that substantial increases will not be necessary should the quality of any loans deteriorate as a result of the factors discussed elsewhere in this document. Although management believes the levels of the allowance as of both June 30, 2008 and September 30, 2007 were adequate to absorb probable losses inherent in the loan portfolio, a decline in local economic conditions, or other factors, could result in a material increase in the allowance for loan losses and may adversely affect the Company's financial condition and results of operations.

**Mortgage Servicing Rights.** Mortgage servicing rights ("MSRs") are capitalized when acquired through the origination of loans that are subsequently sold with servicing rights retained and are amortized to servicing income on loans sold in proportion to and over the period of estimated net servicing income. The value of MSRs at the date of the sale of loans is determined based on the discounted present value of expected future cash flows using key assumptions for servicing income and costs and prepayment rates on the underlying loans. The estimated fair value is periodically evaluated for impairment by comparing actual cash flows and estimated cash flows from the servicing assets to those estimated at the time servicing assets were originated. The effect of changes in market interest rates on estimated rates of loan prepayments represents the predominant risk characteristic underlying the MSRs portfolio. The Company's methodology for estimating the fair value of MSRs is highly sensitive to changes in assumptions. For example, the determination of fair value uses anticipated prepayment speeds. Actual prepayment experience may differ and any difference may have a material effect on the fair value. Thus, any measurement of MSRs' fair value is limited by the conditions existing and assumptions as of the date made. Those assumptions may not be appropriate if they are applied at different times.

### Comparison of Financial Condition at June 30, 2008 and September 30, 2007

The Company's total assets increased by \$18.91 million, or 2.9%, to \$663.75 million at June 30, 2008 from \$644.85 million at September 30, 2007, primarily attributable to a \$41.31 million, or 8.0%, increase in net loans receivable and a \$6.87 million, or 41.2% increase in cash equivalents. These increases were partially offset by a \$30.46 million, or 47.6% decrease in investment and mortgage-backed securities.

Total deposits increased by \$13.20 million, or 2.8%, to \$479.93 million at June 30, 2008 from \$466.74 million at September 30, 2007, primarily attributable to an increase in N.O.W. checking account balances, certificate of deposit account balances, and savings account balances. These increases were partially offset by a decrease in non-interest bearing account balances.

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Shareholders' equity increased by \$228,000, or 0.3%, to \$74.78 million at June 30, 2008 from \$74.55 million at September 30, 2007. The increase in shareholders' equity was primarily a result of retained net income, an increase in the accumulated other comprehensive income category and stock option exercises. These increases were partially offset by share repurchases and cash dividends.

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

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Cash Equivalents: Cash equivalents increased by \$6.87 million, or 41.2%, to \$23.54 million at June 30, 2008 from \$16.67 million at September 30, 2007. The increase was primarily a result of increases in non-interest bearing balances, federal funds sold and interest bearing deposits in banks.

Investment Securities and Mortgage-backed Securities: Investment and mortgage-backed securities decreased by \$30.46 million, or 47.6%, to \$33.51 million at June 30, 2008 from \$63.97 million at September 30, 2007, as a result of the maturity or call of U.S. agency securities, regular amortization and prepayments on mortgage-backed securities, and the redemption of mutual funds. At June 30, 2008, the Company's securities' portfolio was comprised of mortgage-backed securities of \$32.55 million (of which \$14.66 million were classified as held to maturity), mutual funds of \$934,000 and U.S. agency securities of \$28,000.

During the quarter ended June 30, 2008, the Company redeemed its investment in the AMF family of mutual funds and recognized a \$2.82 million non-recurring loss on the redemption. The net asset value of the mutual funds had declined primarily as a result of the uncertainty in spreads in the bond market for mortgage-related securities and downgrades to a small percentage of the underlying securities. The Company redeemed \$29.12 million in mutual funds and received \$22.19 million in underlying mortgage-backed securities and \$6.93 million in cash. For additional information, see Note 2 of the Notes to Condensed Consolidated Financial Statements contained in "Item 1, Financial Statements."

Loans: Net loans receivable increased by \$41.31 million, or 8.0%, to \$556.65 million at June 30, 2008 from \$515.34 million at September 30, 2007. The increase in the portfolio was primarily a result of a \$24.11 million increase in construction loans (net of undisbursed portion of construction loans in process), a \$12.92 million increase in commercial real estate loans, a \$5.14 million increase in commercial business loans, a \$3.36 million increase in one- to four-family loans, and a \$2.31 million increase in multi-family loans. The increase in construction loans has been primarily centered in commercial real estate, which increased \$16.33 million and land development loans, which increased \$8.48 million. Construction loans on a speculative basis decreased \$6.03 million during the nine months ended June 30, 2008. A \$4.22 million decrease in land loans also partially offset the increases.

Loan originations decreased to \$204.60 million for the nine months ended June 30, 2008 compared to \$233.37 million for the nine months ended June 30, 2007. The reduction in loan volume was primarily attributable to a slowdown in the Pacific Northwest economy. The Bank also continued to sell longer-term fixed rate loans for asset liability management purposes. The Bank sold fixed rate one- to four-family mortgage loans totaling \$35.31 million for the nine months ended June 30, 2008 compared to \$21.64 million for the nine months ended June 30, 2007.

For additional information, see Note 3 of the Notes to Condensed Consolidated Financial Statements contained in "Item 1, Financial Statements."

Premises and Equipment: Premises and equipment decreased to \$16.29 million at June 30, 2008 from \$16.58 million at September 30, 2007, primarily as a result of depreciation recorded on depreciable assets.

Goodwill and Core Deposit Intangible: The value of goodwill remained unchanged at \$5.65 million at June 30, 2008 from September 30, 2007. The amortized value of core deposit intangible decreased to \$1.03 million at June



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30, 2008 from \$1.22 million at September 30, 2007. The decrease is attributable to scheduled amortization of the core deposit intangible.

**Deposits:** Deposits increased by \$13.20 million, or 2.8%, to \$479.93 million at June 30, 2008 from \$466.74 million at September 30, 2007. The increase was primarily a result of a \$10.10 million increase in N.O.W. checking account balances, a \$3.29 million increase in non-brokered certificate of deposit account balances, a \$2.19 million increase in savings account balances and a \$1.86 million increase in brokered certificate of deposit account balances. These increases were partially offset by a \$4.26 million decrease in non-interest bearing account balances. For additional information, see the section entitled "Deposit Breakdown" included herein.

**FHLB Advances and Other Borrowings:** FHLB advances and other borrowings increased by \$5.36 million to \$105.65 million at June 30, 2008 from \$100.29 million at September 30, 2007 as the Bank used additional advances to fund loan portfolio growth. For additional information, see "FHLB Advance Maturity Schedule" included herein.

**Shareholders' Equity:** Total shareholders' equity increased by \$228,000 to \$74.78 million at June 30, 2008 from \$74.55 million at September 30, 2007, primarily as a result of net income of \$2.65 million, an increase in the accumulated other comprehensive income equity category of \$804,000, proceeds from stock option exercises of \$460,000, and increases to additional paid in capital of \$244,000 and unearned ESOP shares of \$198,000 due to vesting associated with the Company's benefit plans. The increase from these items was partially offset by share repurchases of \$1.92 million and cash dividends to shareholders of \$2.21 million.

During the nine months ended June 30, 2008 the Company repurchased 144,950 shares of its common stock for \$1.92 million, an average price of \$13.26 per share. No shares were, however, repurchased during the quarter ended June 30, 2008. Cumulatively, the Company has repurchased 7,783,934 shares (58.9%) of the 13,225,000 shares that were issued in its 1998 initial public offering, at an average price of \$8.98 per share. For additional information, see Item 2 of Part II of this Form 10-Q.

**Non-performing Assets:** Non-performing assets to total assets increased to 1.55% at June 30, 2008 from 0.23% at September 30, 2007, as non-performing loans ("NPLs") increased to \$9.39 million at June 30, 2008 from \$1.49 million at September 30, 2007 and OREO increased to \$879,000.

Total NPLs of \$9.39 million at June 30, 2008 were comprised of 31 loans including 16 single family speculative home loans (eleven located in Pierce County and five located in Thurston County) totaling \$5.6 million, a \$1.81 million participation interest in a land development loan located in Clark County, eight land loans totaling \$933,000, one commercial real estate loan (located in Kitsap County) for \$717,000, three home equity loans totaling \$233,000, one single family home loan for \$101,000 and one commercial business loan for \$14,000. These non-performing loans represent 13 credit relationships. The Company had net charge-offs totaling \$121,000 during the nine months ended June 30, 2008, and the reserve for principal impairments on non-accrual loans was increased by \$465,000 to \$540,000 during this period. Impairments may result in actual charge-offs in the future.

OREO increased to \$879,000 at June 30, 2008 and consisted of one single-family residence in Pierce County.

For additional information, see Note 3 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 June 30, 2008 | At September 30, 2007 |
|----------------------------------------|------------------|-----------------------|
|                                        | -----            | -----                 |
|                                        | (In thousands)   |                       |
| Non-interest bearing                   | \$ 50,701        | \$ 54,962             |
| N.O.W. checking                        | 90,476           | 80,372                |
| Savings                                | 58,604           | 56,412                |
| Money market accounts                  | 48,082           | 48,068                |
| Certificates of deposit under \$100    | 128,791          | 135,528               |
| Certificates of deposit \$100 and over | 77,343           | 67,316                |
| Certificates of deposit - brokered     | 25,937           | 24,077                |
|                                        | -----            | -----                 |
| Total deposits                         | \$479,934        | \$466,735             |
|                                        | =====            | =====                 |

FHLB Advance Maturity Schedule

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

|                     | At June 30,<br>2008    |         | At September 30,<br>2007 |         |
|---------------------|------------------------|---------|--------------------------|---------|
|                     | Amount                 | Percent | Amount                   | Percent |
|                     | -----                  | -----   | -----                    | -----   |
|                     | (Dollars in thousands) |         |                          |         |
| Short-term          | \$ --                  | 0.0%    | \$30,000                 | 30.1%   |
| Long-term           | 104,645                | 100.0   | 69,697                   | 69.9    |
|                     | -----                  | -----   | -----                    | -----   |
| Total FHLB advances | \$104,645              | 100.0%  | \$99,697                 | 100.0%  |
|                     | =====                  | =====   | =====                    | =====   |

The Bank's FHLB borrowings mature at various dates through September 2017 and bear interest at rates ranging from 3.49% to 5.54%. The weighted average interest rate on FHLB borrowings at June 30, 2008 was 4.22%. Principal reduction amounts due for future years ending September 30 are as follows (in thousands):

|                   |            |
|-------------------|------------|
| Remainder of 2008 | \$ 18      |
| 2009              | 4,627      |
| 2010              | 20,000     |
| 2011              | 20,000     |
| 2012              | 10,000     |
| Thereafter        | 50,000     |
|                   | -----      |
| Total             | \$ 104,645 |
|                   | =====      |

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

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

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2008 and 2007

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The Company reported a net loss of \$(546,000) for the quarter ended June 30, 2008 compared to net income of \$2.14 million for the quarter ended June 30, 2007. The loss was the result of a non-recurring impairment charge of \$2.82 million (\$2.59 million net of income tax) resulting from the redemption of the Company's investment in the AMF family of mutual funds. Diluted earnings per share decreased to a loss of \$(0.08) for the quarter ended June 30, 2008 from earnings of \$0.31 for the quarter ended June 30, 2007. The non-recurring impairment charge reduced diluted earnings per share by \$0.39 for the quarter ended June 30, 2008.

The Company's net income decreased by \$3.35 million, or 55.8%, to \$2.66 million for the nine months ended June 30, 2008 from \$6.01 million for the nine months ended June 30, 2007. Diluted earnings per share decreased 52.9% to \$0.40 for the nine months ended June 30, 2008 from \$0.85 for the nine months ended June 30, 2007.

The decreases in diluted earnings per share were primarily a result of a non-recurring impairment charge on the redemption of the Company's investment in the AMF family of mutual funds and increases in the provision for loan losses during the three and nine months ended June 30, 2008. The increased provisions were primarily a result of an increase in the level of non-performing loans, the reclassification of certain loans, continued loan portfolio growth, and a weakening in the housing market in certain market areas.

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

Net Income: Earnings for the quarter ended June 30, 2008 decreased by \$2.68 million to a loss of \$(546,000) from \$2.14 million for the quarter ended June 30, 2007. Earnings per diluted share for the quarter ended June 30, 2008 decreased to a loss of \$(0.08) from \$0.31 for the quarter ended June 30, 2007. The \$0.39 decrease in diluted earnings per share for the quarter ended June 30, 2008 was primarily a result of a \$2.82 million (\$2.59 million net of income tax - \$0.39 per diluted share) loss on the redemption of mutual funds, a \$240,000 (\$159,000 net of income tax - \$0.02 per diluted share) increase in the provision for loan losses, a \$158,000 (\$104,000 net of income tax - \$0.02 per diluted share) decrease in net interest income, and a \$158,000 (\$104,000 net of income tax - \$0.02 per diluted share) increase in non-interest expense. These decreases to earnings per share were partially offset by a \$428,000 (\$282,000 net of income tax - \$0.04 per diluted share) increase in non-interest income exclusive of the \$2.82 million non-recurring impairment charge on the mutual fund redemption, and a decrease in the number of weighted average shares outstanding (\$0.02 per diluted share) primarily as a result of share repurchases.

Net income for the nine months ended June 30, 2008 decreased by \$3.35 million, or 55.8%, to \$2.66 million from \$6.01 million for the nine months ended June 30, 2007. Earnings per diluted share for the nine months ended June 30, 2008 decreased to \$0.40 from \$0.85 for the nine months ended June 30, 2007. The \$0.45 decrease in diluted earnings per share for the nine months ended June 30, 2008 was primarily a result of a \$2.82 million (\$2.59 million net of income tax - \$0.38 per diluted share) loss on the redemption of mutual funds, a \$1.98 million (\$1.31 million net of income tax - \$0.18 per diluted share) increase in the provision for loan losses and a \$380,000 (\$251,000 net of income tax - \$0.03 per diluted share) increase in non-interest expense.

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These decreases to earnings per share were partially offset by a \$668,000 (\$441,000 net of income tax - \$0.06 per diluted share) increase in net interest income, a \$576,000 (\$380,000 net of income tax - \$0.05 per diluted share) increase in non-interest income exclusive of the \$2.82 million non-recurring impairment charge on the mutual fund redemption, and a decrease in the number of weighted average shares outstanding (\$0.03 per diluted share) primarily as a result of share repurchases.

**Net Interest Income:** Net interest income decreased by \$158,000, or 2.4%, to \$6.50 million for the quarter ended June 30, 2008 from \$6.66 million for the quarter ended June 30, 2007. The decrease in net interest income was primarily attributable to interest rate decreases, which compressed margins, and the reversal of interest on loans placed on non-accrual status. These decreases were, however, partially offset by a larger interest earning asset base. Total interest and dividend income decreased by \$446,000, or 4.1%, to \$10.37

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million for the quarter ended June 30, 2008 from \$10.81 million for the quarter ended June 30, 2007 as the yield on interest earning assets decreased to 6.75% from 7.58%. Total average interest earning assets increased by \$43.78 million to \$614.38 million for the quarter ended June 30, 2008 from \$570.60 million for quarter ended June 30, 2007. Total interest expense decreased by \$288,000, or 6.9%, to \$3.87 million for the quarter ended June 30, 2008 from \$4.16 million for the quarter ended June 30, 2007 as the average rate paid on interest bearing liabilities decreased to 2.96% for the quarter ended June 30, 2008 from 3.42% for the quarter ended June 30, 2007. Total average interest bearing liabilities increased by \$39.32 million to \$526.40 million for the quarter ended June 30, 2008 from \$487.08 million for the quarter ended June 30, 2007. The net interest margin decreased to 4.23% for the quarter ended June 30, 2008 from 4.67% for the quarter ended June 30, 2007. The margin compression was primarily attributable to significant interest rate decreases by the Federal Reserve which reduced the yield on interest earning assets at a faster pace than the Bank was able to reduce its funding costs. The reversal of interest income on loans placed on non-accrual status also contributed to the margin compression and reduced the net interest margin by approximately eight basis points during the quarter ended June 30, 2008. For additional information, see the section below entitled "Rate Volume Analysis."

Net interest income increased by \$668,000, or 3.4%, to \$20.09 million for the nine months ended June 30, 2008 from \$19.42 million for the nine months ended June 30, 2007. The increase in net interest income was primarily attributable to a larger interest earning asset base, which was partially offset by margin compression. Total interest and dividend income increased by \$2.02 million, or 6.6%, to \$32.77 million for the nine months ended June 30, 2008 from \$30.75 million for the nine months ended June 30, 2007 as average total interest earning assets increased by \$57.01 million. The yield on interest earning assets decreased to 7.21% for the nine months ended June 30, 2008 from 7.47% for the nine months ended June 30, 2007. Total interest expense increased by \$1.36 million, or 12.0%, to \$12.68 million for the nine months ended June 30, 2008 from \$11.33 million for the nine months ended June 30, 2007 as average total interest bearing liabilities increased by \$58.61 million. The average rate paid on interest bearing liabilities decreased to 3.24% for the nine months ended June 30, 2008 from 3.26% for the nine months ended June 30, 2007. The net interest margin decreased to 4.42% for the nine months ended June 30, 2008 from 4.72% for the nine months ended June 30, 2007. The margin compression was primarily attributable to significant interest rate cuts by the Federal Reserve which reduced the yield on interest earnings assets at a

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greater level than the Bank was able to reduce its funding costs. The reversal of interest income on loans placed on non-accrual status also contributed to the margin compression and reduced the net interest margin by approximately eleven basis points during the nine months ended June 30, 2008. For additional information, see the section below entitled "Rate Volume Analysis."

### Rate Volume Analysis

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

|                                                                                | Three months ended<br>June 30, 2008<br>compared to three months<br>ended June 30, 2007<br>increase (decrease)<br>due to |         |               | Nine months ended<br>June 30, 2008<br>compared to nine months<br>ended June 30, 2007<br>increase (decrease)<br>due to |         |               |
|--------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------|---------|---------------|-----------------------------------------------------------------------------------------------------------------------|---------|---------------|
|                                                                                | Rate                                                                                                                    | Volume  | Net<br>Change | Rate                                                                                                                  | Volume  | Net<br>Change |
|                                                                                | ----                                                                                                                    | -----   | -----         | ----                                                                                                                  | -----   | -----         |
|                                                                                | (In thousands)                                                                                                          |         |               |                                                                                                                       |         |               |
| <b>Interest-earning assets:</b>                                                |                                                                                                                         |         |               |                                                                                                                       |         |               |
| Loans receivable(1)                                                            | (\$1,407)                                                                                                               | \$1,252 | \$155)        | (\$105)                                                                                                               | \$3,001 | \$2,896       |
|                                                                                |                                                                                                                         |         |               |                                                                                                                       |         | 27            |
| <br>                                                                           |                                                                                                                         |         |               |                                                                                                                       |         |               |
| Investments and<br>mortgage-backed<br>securities                               | 220                                                                                                                     | (335)   | (115)         | (30)                                                                                                                  | (530)   | (560)         |
| FHLB stock and<br>equity securities                                            | (131)                                                                                                                   | (23)    | (154)         | (151)                                                                                                                 | (18)    | (169)         |
| Federal funds sold                                                             | (39)                                                                                                                    | 17      | (22)          | (73)                                                                                                                  | (31)    | (104)         |
| Interest-bearing deposits                                                      | (7)                                                                                                                     | 7       | --            | (22)                                                                                                                  | (17)    | (39)          |
| Total net increase (decrease)<br>in income on interest-<br>earning assets      | (1,364)                                                                                                                 | 918     | (446)         | (381)                                                                                                                 | 2,405   | 2,024         |
| <br>                                                                           |                                                                                                                         |         |               |                                                                                                                       |         |               |
| <b>Interest-bearing<br/>liabilities:</b>                                       |                                                                                                                         |         |               |                                                                                                                       |         |               |
| Savings accounts                                                               | --                                                                                                                      | (5)     | (5)           | (3)                                                                                                                   | (23)    | (26)          |
| NOW accounts                                                                   | 22                                                                                                                      | 15      | 37            | 67                                                                                                                    | 12      | 79            |
| Money market Accounts                                                          | (92)                                                                                                                    | 6       | (86)          | (3)                                                                                                                   | 27      | 24            |
| Certificate accounts                                                           | (334)                                                                                                                   | 225     | (109)         | 17                                                                                                                    | 946     | 963           |
| Short-term borrowings                                                          | (252)                                                                                                                   | (351)   | (603)         | (243)                                                                                                                 | (486)   | (729)         |
| Long-term borrowings                                                           | (82)                                                                                                                    | 560     | 478           | --                                                                                                                    | 1,045   | 1,045         |
| Total net increase (decrease)<br>in expense on interest<br>bearing liabilities | (738)                                                                                                                   | 450     | (288)         | (165)                                                                                                                 | 1,521   | 1,356         |
| <br>                                                                           |                                                                                                                         |         |               |                                                                                                                       |         |               |
| Net increase (decrease) in<br>net interest income                              | (\$626)                                                                                                                 | \$ 468  | (\$158)       | (\$216)                                                                                                               | \$ 884  | \$ 668        |

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

Provision for Loan Losses: Provisions for loan losses of \$500,000 and \$2.40 million were made during the three and nine months ended June 30, 2008 compared to provisions of \$260,000 and \$416,000 made during the three and nine months ended June 30, 2007. The increased provisions were made primarily as a result of an increase in non-performing loans, an increase in the level of performing loans classified as substandard to \$12.70 million at June 30, 2008 compared to \$7.32 million at September 30, 2007 under the Bank's loan grading system, loan portfolio growth, and uncertainties in the housing market in certain market areas of the Pacific Northwest.

The Bank has established a comprehensive methodology for determining the provision for loan losses. On a quarterly basis the Bank performs an analysis that considers pertinent factors underlying the quality of the loan portfolio. The factors include changes in the amount and composition of the loan portfolio, historic loss experience for various loan segments, changes in economic conditions, delinquency rates, a detailed analysis of loans on non-accrual status, and other factors to determine an appropriate level of allowance for loan losses. Management's analysis, however, for the nine months ended June 30, 2008, placed greater emphasis on the Bank's construction and land development loan portfolio and the effect of various factors such as geographic and loan type concentrations. The Bank also reviewed the national trend of declining home sales with potential housing market value depreciation. Based on its comprehensive analysis, management deemed the allowance for loan losses of \$7.08 million at June 30, 2008 (1.26% of loans receivable and 75% of non-performing loans)

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adequate to provide for probable losses based on an evaluation of known and inherent risks in the loan portfolio at that date. Loans placed on non-accrual status are subjected to an impairment analysis to determine an appropriate reserve amount to be held against each loan. The aggregate impairment amount determined at June 30, 2008 was \$540,000. The allowance for loan losses was \$4.53 million (0.90% of loans receivable and 461% of non-performing loans) at June 30, 2007. The Company had net charge-offs of \$121,000 during the three and nine months ended June 30, 2008 and net charge-offs of \$3,000 and \$9,000 for the three and nine months ended June 30, 2007, respectively.

Non-performing loans increased by \$7.90 million to \$9.39 million during the nine months ended June 30, 2008 primarily as a result of five speculative construction builders becoming delinquent on their loans (which totaled \$5.58 million) from the Bank and a one-eighth participation interest of \$1.81 million in a residential land development loan being placed on non-accrual status.

Management also downgraded additional loans to its substandard loan grade classifications during the nine months ended June 30, 2008. Under the Bank's Classification of Assets Policy, substandard loans have one or more defined weaknesses and are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Under the Bank's comprehensive allowance for loan loss methodology loans classified as substandard are assumed to have more risk and therefore have higher loss factors associated with them. A majority of the loans downgraded during the nine months ended June 30, 2008 were to borrowers involved in construction and land development activities. As a result of a slowdown in the sales of one- to four-family homes and other uncertain economic conditions, management believes that certain speculative construction and land development loans have

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assumed a higher risk profile and were therefore downgraded during the period.

Management believes that the allowance for loan losses as of June 30, 2008 was adequate to absorb the known and inherent risks of loss in the loan portfolio at that date. While management believes the estimates and assumptions used in its determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact the Company's financial condition and results of operations. In addition, the determination of the amount of the Bank's allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the establishment of additional reserves based upon their judgment of information available to them at the time of their examination. For additional information, see Note 3 of the Notes to Condensed Consolidated Financial Statements contained in "Item 1, Financial Statements."

Non-interest Income: Total non-interest income decreased by \$2.39 million to a loss of \$(893,000) for the quarter ended June 30, 2008 from income of \$1.50 million for the quarter ended June 30, 2007, primarily as a result of a \$2.82 million non-recurring loss on the redemption of investments in the AMF family of mutual funds. Non-interest income, excluding the non-recurring mutual fund redemption loss increased by \$428,000, or 28.5%, to \$1.93 million for the quarter ended June 30, 2008 from \$1.50 million for the quarter ended June 30, 2007. This increase was primarily a result of increased service charges on deposits and increased income from loan sales (gain on sale of loans and servicing income on loans sold). The increase in service charges on deposits was primarily a result of implementing a new automated overdraft decisioning system during the quarter and increasing the fee charged for overdrafts. The increased income from loan sales was primarily a result of an increase in the dollar value of residential mortgage loans sold in the secondary market during the quarter. The sale of fixed rate one-to four-family mortgage loans totaled \$16.02 million for the quarter ended June 30, 2008 compared to \$7.76 million for the quarter ended June 30, 2007. The increase in loan sales was primarily attributable to lower interest rates for 30-year fixed rates loans which increased refinancing activity.

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Total non-interest income decreased by \$2.25 million, or 51.0%, to \$2.16 million for the nine months ended June 30, 2008 from \$4.41 million for the nine months ended June 30, 2007, primarily as a result of a \$2.82 million non-recurring loss on the redemption of investments in the AMF family of mutual funds. Non-interest income, excluding the non-recurring mutual fund redemption loss increased by \$576,000, or 13.1% to \$4.98 million for the nine months ended June 30, 2008 from \$4.41 million for the nine months ended June 30, 2007. This increase was primarily a result of increased income from loan sales (gain on sale of loans and servicing income on loans sold), increased service charges on deposits and increased ATM transaction fees. The increase in income from loan sales was primarily a result of an increase in the dollar value of residential mortgage loans sold in the secondary market during the quarter. The sale of fixed rate one-to four-family mortgage loans totaled \$35.31 million for the nine months ended June 30, 2008 compared to \$21.64 million for the nine months ended June 30, 2007. The increase in loan sales was primarily attributable to lower interest rates for 30-year fixed rate loans which increased refinancing activity. The increase in service charges on deposits was primarily a result of implementing a new automated overdraft decisioning system and increasing the fee charged for overdrafts. The increase in ATM transaction fees was a result of increased ATM usage.

Non-interest Expense: Total non-interest expense increased by \$158,000, or

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3.3%, to \$4.92 million for the quarter ended June 30, 2008 from \$4.76 million for the quarter ended June 30, 2007. The increase was primarily attributable to a \$60,000 increase in salaries and employee benefits expense, a \$49,000 increase in deposit related expenses, and a \$38,000 increase in advertising expense. The increased salary and benefit expense was primarily attributable to annual salary adjustments (effective October 1, 2007). The increased deposit related expenses were primarily attributable to expenses associated with several new deposit related programs. The increased advertising expense was primarily attributable to marketing efforts associated with deposit gathering initiatives. Partially offsetting these increased expenses was a \$38,000 decrease in premises and equipment. The decrease in premises and equipment expense was primarily attributable to the sale of a building that previously served as a branch facility. The gain on the sale of the building resulted in a \$123,000 decrease to premises and equipment expenses during the quarter ended June 30, 2008.

Total non-interest expense increased by \$380,000, or 2.6%, to \$14.98 million for the nine months ended June 30, 2008 from \$14.60 million for the nine months ended June 30, 2007. The increase was primarily attributable to a \$415,000 increase in salaries and employee benefits expense and smaller increases in advertising expense and ATM expense. The increased salary and benefit expense was primarily attributable to annual salary adjustments (effective October 1, 2007) and the addition of several employees. The increased expenses were partially offset by a \$193,000 decrease in premises and equipment expense. The decrease in premises and equipment expense was primarily attributable to an insurance settlement for damage to the Bank's previous data center facility that reduced expenses \$171,000 and a gain on the sale of a building that reduced expenses by \$123,000. Provision for Income Taxes: The provision for income taxes decreased to \$734,000 for the quarter ended June 30, 2008 from \$1.00 million for the quarter ended June 30, 2007 primarily as a result of lower income before taxes. The provision for income taxes was also impacted by the \$2.82 million loss on the redemption of mutual funds. The redemption of the mutual funds resulted in a capital loss which can only be deducted for tax purposes to the extent that capital gains are realized within a three year carry back period and a five year carry forward period. The Company has estimated that it will have \$679,000 in capital gains during the allowable tax periods to offset the capital loss. Therefore \$2.14 million of the \$2.82 million loss has been treated as non-deductible for tax purposes. The Company's effective tax rate exclusive of the mutual fund redemption loss (and associated tax impact) was 32.06% for the quarter ended June 30, 2008 and 31.87% for the quarter ended June 30, 2007.

The provision for income taxes decreased to \$2.22 million for the nine months ended June 30, 2008 from \$2.81 million for the nine months ended June 30, 2007 primarily as a result of lower income before taxes.

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The Company's effective tax rate exclusive of the mutual fund redemption loss (and associated tax impact) was 31.83% for the nine months ended June 30, 2008 and 31.83% for the nine months ended June 30, 2007.

### Liquidity and Capital Resources

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



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An analysis of liquidity should include a review of the Condensed Consolidated Statement of Cash Flows for the nine months ended June 30, 2008. The statement of cash flows includes operating, investing and financing categories. Operating activities include net income, which is adjusted for non-cash items, and increases or decreases in cash due to changes in assets and liabilities. Investing activities consist primarily of proceeds from maturities and sales of securities, purchases of securities, and the net change in loans. Financing activities present the cash flows associated with the Company's deposit accounts, other borrowings and stock related transactions.

The Company's total cash equivalents increased by 41.2% to \$23.54 million at June 30, 2008 from \$16.67 million at September 30, 2007. The increase in liquid assets was primarily reflected in an increase in federal funds sold, interest bearing deposits in banks and non-interest bearing cash equivalents.

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, 2008, 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 6.36%. The Bank maintained an uncommitted credit facility with the FHLB of Seattle that provided for immediately available advances up to an aggregate amount equal to 30% of total assets, limited by available collateral, under which \$104.65 million was outstanding and \$78.31 million was available for additional borrowings at June 30, 2008. The Bank also has a \$10.00 million overnight credit line with Pacific Coast Banker's Bank ("PCBB"). At June 30, 2008, the Bank did not have any outstanding advances on this credit 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 of Seattle and PCBB.

The Bank's primary investing activity is the origination of one- to four-family mortgage loans, commercial mortgage loans, construction and land development loans, land loans, consumer loans, and commercial business loans. At June 30, 2008, the Bank had loan commitments totaling \$46.61 million and undisbursed loans in process totaling \$57.34 million. The Bank anticipates that it will have sufficient funds available to meet current loan commitments. Certificates of deposit that are scheduled to mature in less than one year from June 30, 2008 totaled \$186.71 million. Historically, the Bank has been able to retain a significant amount of its non-brokered certificates of deposit as they mature. At June 30, 2008, the Bank had \$25.94 million in brokered certificate of deposit accounts, all of which are scheduled to mature in less than one year. As these brokered certificate of deposit accounts approach maturity, the Bank will evaluate its liquidity needs and the cost of other alternative funding sources before determining if additional brokered deposits will be acquired to replace the maturing brokered deposits.

Federally-insured state-chartered banks are required to maintain minimum levels of regulatory capital. Under current FDIC regulations, insured

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state-chartered banks generally must maintain (i) a ratio of Tier 1 leverage capital to total assets of at least 3.0% (4.0% to 5.0% for all but the most highly rated banks), (ii) a ratio of Tier 1 capital to risk weighted assets of at least 4.0% and (iii) a ratio of total capital to risk weighted assets of at least 8.0%. At June 30, 2008, the Bank was in compliance with all applicable capital requirements. For additional details see the section below entitled "Regulatory Capital."

### Regulatory Capital

The following table compares the Company's and the Bank's actual capital amounts at June 30, 2008 to its minimum regulatory capital requirements at that date (dollars in thousands):

|                                           | Actual   |        | Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |       |
|-------------------------------------------|----------|--------|---------------------------|-------|------------------------------------------------------------------|-------|
|                                           | Amount   | Ratio  | Amount                    | Ratio | Amount                                                           | Ratio |
| Tier 1 capital (to average assets):       |          |        |                           |       |                                                                  |       |
| Consolidated                              | \$68,005 | 10.41% | \$26,133                  | 4.00% | N/A                                                              | N/A   |
| Timberland Bank                           | 60,205   | 9.23   | 26,078                    | 4.00  | \$32,598                                                         | 5.00% |
| Tier 1 capital (to risk-weighted assets): |          |        |                           |       |                                                                  |       |
| Consolidated                              | 68,005   | 12.08  | 22,511                    | 4.00  | N/A                                                              | N/A   |
| Timberland Bank                           | 60,205   | 10.71  | 22,480                    | 4.00  | 33,719                                                           | 6.00  |
| Total capital (to risk-weighted assets):  |          |        |                           |       |                                                                  |       |
| Consolidated                              | 75,040   | 13.33  | 45,023                    | 8.00  | N/A                                                              | N/A   |
| Timberland Bank                           | 67,240   | 11.96  | 44,959                    | 8.00  | 56,199                                                           | 10.00 |

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

|                                     | Three Months Ended |        | Nine Months Ended |        |
|-------------------------------------|--------------------|--------|-------------------|--------|
|                                     | June 30,           |        | June 30,          |        |
|                                     | 2008               | 2007   | 2008              | 2007   |
| PERFORMANCE RATIOS:                 |                    |        |                   |        |
| Return (loss) on average assets (1) | (0.33)%            | 1.38%  | 0.54%             | 1.34%  |
| Return (loss) on average equity (1) | (2.91)%            | 11.24% | 4.73%             | 10.36% |
| Net interest margin (1)             | 4.23%              | 4.67%  | 4.42%             | 4.72%  |
| Efficiency ratio                    | 87.73%             | 58.35% | 67.31%            | 61.26% |

At

At

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|                                                      | June 30,<br>2008 | September 30,<br>2007 |
|------------------------------------------------------|------------------|-----------------------|
| ASSET QUALITY RATIOS:                                |                  |                       |
| Non-performing loans                                 | \$ 9,391         | \$ 1,490              |
| OREO and other repossessed assets                    | 879              | --                    |
| Total non-performing assets                          | \$10,270         | \$ 1,490              |
| Non-performing assets to total assets                | 1.55%            | 0.23%                 |
| Allowance for loan losses to<br>non-performing loans | 75%              | 322%                  |
| Restructured loans                                   | \$ --            | --                    |
| Book value per share (2)                             | \$ 10.83         | \$ 10.72              |
| Book value per share (3)                             | \$ 11.46         | \$ 11.39              |
| Tangible book value per share (2) (4)                | \$ 9.87          | \$ 9.73               |
| Tangible book value per share (3) (4)                | \$ 10.44         | \$ 10.34              |

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- (1) Annualized  
(2) Calculation includes ESOP shares not committed to be released  
(3) Calculation excludes ESOP shares not committed to be released  
(4) Calculation subtracts goodwill and core deposit intangible from the equity component

|                                             | Three Months Ended<br>June 30, |            | Nine Months Ended<br>June 30, |            |
|---------------------------------------------|--------------------------------|------------|-------------------------------|------------|
|                                             | 2008                           | 2007       | 2008                          | 2007       |
| AVERAGE BALANCE SHEET:                      |                                |            |                               |            |
| Average total loans                         | \$ 560,515                     | \$ 494,137 | \$ 548,346                    | \$ 466,200 |
| Average total interest earning<br>assets    | 614,383                        | 570,597    | 605,949                       | 548,942    |
| Average total assets                        | 659,998                        | 619,120    | 652,804                       | 598,688    |
| Average total interest bearing<br>deposits  | 415,495                        | 388,610    | 412,904                       | 381,946    |
| Average FHLB advances & other<br>borrowings | 110,903                        | 98,467     | 109,794                       | 82,139     |
| Average shareholders' equity                | 74,956                         | 76,087     | 74,901                        | 77,364     |

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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, 2007.

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

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and Chief Financial Officer concluded that as of June 30, 2008 the Company's disclosure controls and procedures were effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is (i) accumulated and communicated to the Company's management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

- (b) Changes in Internal Controls: There have been no changes in our internal control over financial reporting (as defined in 13a-15(f) of the Exchange Act) that occurred during the quarter ended June 30, 2008, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. The Company continued, however, to implement suggestions from its internal auditor and independent auditors to strengthen existing controls. The Company does not expect that its disclosure controls and procedures and internal controls over financial reporting will prevent all errors and fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns in controls or procedures can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any control procedure is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; as over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

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

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### Item 1A. Risk Factors

Listed below are updates to the market risk information provided in the Company's Annual Report of Form 10-K for the fiscal year ended September 30, 2007 ("2007 Form 10-K"). These updates should be read in conjunction with the 2007 Form 10-K.

Our business is subject to general economic risks that could adversely impact our results of operations and financial condition.

\* Change in economic conditions, particularly a further economic slowdown

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in western Washington could hurt our business.

Our business is directly affected by market conditions, trends in the industry and finance, legislative and regulatory changes, and changes in governmental monetary and fiscal policies and inflation, all of which are beyond our control. In 2007, the housing and real estate sectors experienced an economic slowdown that has continued into 2008. Further deterioration in economic conditions, in particular within our primary market areas could result in the following consequences, among others, any of which could hurt our business materially: loan delinquencies may increase; problem assets and foreclosures may increase; demand for our products and services may decline; and collateral for loans made by us, especially real estate, may decline in value, in turn reducing a customer's borrowing power and reducing the value of assets and collateral securing our loans.

- \* Downturns in the real estate markets in our primary market areas could hurt our business.

Our business activities and credit exposure are primarily concentrated in western Washington. While we do not have any sub-prime loans, our construction and land development loan portfolios, our land loan portfolio, our commercial and multi-family loan portfolios and certain of our other loans have been affected by the downturn in the residential real estate market. We anticipate that further declines in the real estate markets in our primary market areas would hurt our business. If real estate values continue to decline the collateral for our loans will provide less security. As a result, our ability to recover on defaulted loans by selling the underlying real estate will be diminished, and we would be more likely to suffer losses on defaulted loans. The events and conditions described in this risk factor could therefore have a material adverse effect on our business, results of operations and financial condition.

- \* We may suffer losses in our loan portfolio despite our underwriting practices.

We seek to mitigate the risks inherent in our loan portfolio by adhering to specific underwriting practices. Although we believe that our underwriting criteria are appropriate for the various kinds of loans we make, we may incur losses on loans that meet our underwriting criteria, and these losses may exceed the amounts set aside as reserves in our allowance for loan losses.

Recent negative developments in the financial industry and credit markets may continue to adversely impact our financial condition and results of operations.

Negative developments beginning in the latter half of 2007 in the sub-prime mortgage market and the securitization markets for such loans, together with substantially increased oil prices and other factors, have resulted in uncertainty in the financial markets in general and a related general economic downturn, which have continued in 2008. Many lending institutions, including us, have experienced substantial declines in the performance of their loans, including construction and land development loans and land loans. Moreover, competition among depository institutions for deposits and quality loans has increased significantly. In addition, the value of real estate collateral supporting many construction and land development loans, land loans, commercial loans, multi-family loans, and home mortgages have declined and may continue to decline. Bank and holding company stock prices have been negatively affected, as has the ability of banks and holding

companies to raise capital or borrow in the debt markets compared to recent years. These conditions may have a material effect on our financial condition

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and results of operations. In addition, as a result of the foregoing factors, there is a potential for new federal or state laws and regulations regarding lending and funding practices and liquidity standards, and bank regulatory agencies are expected to be very aggressive in responding to concerns and trends identified in examinations, including the expected issuance of formal enforcement orders. Negative developments in the financial industry and the impact of new legislation in response to those developments could restrict our business operations, including our ability to originate or sell loans, and adversely impact our results of operations and financial condition.

We may be required to make further increases in our provisions for loan losses and to charge off additional loans in the future, which could adversely affect our results of operations.

For the nine months ended June 30, 2008 we recorded a provision for loan losses of \$2.40 million compared to \$416,000 for the nine months ended June 30, 2007, which reduced our net income for the nine months ended June 30, 2008. We also recorded net loan charge-offs of \$121,000 for the nine months ended June 30, 2008 compared to \$9,000 for the nine months ended June 30, 2007. We are experiencing increases in non-performing loans and credit losses. Generally, our non-performing loans and assets reflect operating difficulties of individual borrowers resulting from weakness in the economy of western Washington. In addition, slowing sales have been a contributing factor to the increase in non-performing loans as well as the increase in delinquencies. At June 30, 2008 our total non-performing loans had increased to \$9.39 million compared to \$982,000 at June 30, 2007. While construction and land development loans represented 32.4% of our total loan portfolio at June 30, 2008 they represented 78.7% of our non-performing loans at that date. If current trends in the housing and real estate markets continue, we expect that we will continue to experience increased delinquencies and credit losses. Moreover, if a recession occurs, we expect that it would negatively impact economic conditions in our market areas and that we could experience significantly higher delinquencies and credit losses. An increase in our credit losses or our provision for loan losses would adversely affect our financial condition and results of operations.

Our loan portfolio is concentrated in loans with a higher risk of loss.

We originate construction and land development loans, land loans, commercial and multi-family mortgage loans, commercial business loans, consumer loans, and residential mortgage loans primarily within our market areas. Generally, these types of loans, other than the residential mortgage loans, have a higher risk of loss than the residential mortgage loans. We had approximately \$518.13 million (including \$57.34 million in undisbursed construction loans in process) outstanding in these types of higher risk loans at June 30, 2008. These loans have greater credit risk than residential real estate loans for a number of reasons, including those described below:

Construction and Land Development Loans. This type of lending contains the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost (including interest) of the project. If the estimate of construction cost proves to be inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value upon completion proves to be inaccurate, we may be confronted at, or prior to, the maturity of the loan with a project the value of which is insufficient to assure full repayment. In addition, speculative construction loans to a builder are often associated with homes that are not pre-sold, and thus pose a greater potential risk to us than construction loans to individuals on their personal residences. Loans on land under development or held for future construction also poses additional risk because of the lack of income being produced by the property and the potential illiquid nature of the collateral. These risks can be

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significantly impacted by supply and demand conditions. As a result, this type of lending often involves the disbursement of substantial funds with repayment on the success of

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the ultimate project and the ability of the borrower to sell or lease the property, rather than the ability of the borrower or guarantor themselves to repay principal and interest. At June 30, 2008, we had \$202.03 million (including \$57.34 million of undisbursed loans in process) or 32.4% of total loans in construction and land development loans.

Land Loans. These loans are secured by undeveloped land or improved lots and involve a greater risks than residential mortgage loans because these loans are more difficult to evaluate. If the estimate of property value proves to be inaccurate, in the event of default or foreclosure the Bank may be confronted with a property the value of which is insufficient to assure full repayment. Land loans also expose a lender to greater credit risk than loans secured by residential real estate because the collateral securing these loans typically cannot be sold as easily as residential real estate.

Commercial and Multi-family Mortgage Loans. These loans typically involve higher principal amounts than other types of loans, and repayment is dependent upon income generated, or expected to be generated, by the property securing the loan in amounts sufficient to cover operating expenses and debt service, which may be adversely affected by changes in the economy or local market conditions. Commercial and multi-family mortgage loans also expose a lender to greater credit risk than loans secured by residential real estate because the collateral securing these loans typically cannot be sold as easily as residential real estate. At June 30, 2008, we had \$178.25 million or 28.6% of total loans in commercial and multi-family mortgage loans.

Commercial Business Loans. Commercial business loans are primarily made based on the cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The borrowers' cash flow may be unpredictable, and collateral securing these loans may fluctuate in value. Most often, this collateral is accounts receivable, inventory, equipment or real estate. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. Other collateral securing loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business. At June 30, 2008, we had \$23.3 million or 3.7% of total loans in commercial business loans.

Consumer Loans. Consumer loans include home equity lines of credit, second mortgage loans, automobile loans, boat loans, recreational vehicle loans and unsecured loans. The collateral securing consumer loans may not provide an adequate source of repayment of the loan due to, declining real estate values, depreciation, damage, or loss. In addition, consumer loan collections are generally dependent on the borrower's financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount that can be recovered on these loans. At June 30, 2008, we had \$58.06 million or 9.3% of total loans in consumer loans.

Liquidity risk could impair our ability to fund operations and jeopardize our financial condition.

Liquidity is essential to our business. An inability to raise funds through

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deposits, borrowings, the sale of loans and other sources could have a substantial negative effect on our liquidity. Our access to funding sources in amounts adequate to finance our activities or the terms of which are acceptable to us could be impaired by factors that affect us specifically or the financial services industry or economy in general. Factors that could detrimentally impact our access to liquidity sources include a decrease in the level of our business activity as a result of a downturn in the markets in which our loans are concentrated or adverse regulatory action against us. Our ability to borrow could also be impaired by factors that are not specific to us, such as a disruption in the financial markets or negative views and expectations about the prospects for the financial services industry in light of the recent turmoil faced by banking organizations and the continued deterioration in credit markets.

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If external funds were not available, this could adversely impact our growth and prospects.

We rely on deposits and advances from the FHLB of Seattle and other borrowings to fund our operations. Although we have historically been able to replace maturing deposits and advances as necessary, we might not be able to replace such funds in the future if, among other things, our results of operations or financial condition or the results of operations or financial condition of the FHLB of Seattle or market conditions were to change. Although we consider such sources of funds adequate for liquidity needs, there can be no assurance in this regard and we may be compelled to elect or seek additional sources of financing in the future. Likewise, we may seek additional debt in the future to achieve our long-term business objectives, in connection with future acquisitions or for other reasons. There can be no assurance additional borrowings, if sought, would be available to us or, if available, would be on favorable terms. If additional financing sources are unavailable or not available on reasonable terms, our financial condition, results of operations and future prospects could be materially adversely affected.

We may elect or be compelled to seek additional capital in the future, but that capital may not be available when it is needed.

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. In addition, we may elect to raise additional capital to support our business or to finance acquisitions, if any, or we may otherwise elect to raise additional capital. In that regard, a number of financial institutions have recently raised considerable amounts of capital as a result of a deterioration in their results of operations and financial condition arising from the turmoil in the mortgage loan market, deteriorating economic conditions, declines in real estate values and other factors. Should we be required by regulatory authorities to raise additional capital, we may seek to do so through the issuance of, among other things, our common stock or preferred stock.

Our ability to raise additional capital, if needed, will depend on conditions in the capital markets, economic conditions and a number of other factors, many of which are outside of our control, and on our financial performance. Accordingly, we cannot assure you of our ability to raise additional capital if needed or on terms acceptable to us. If we cannot raise additional capital when needed, it may have a material adverse effect on our financial condition, results of operation and prospects.

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

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Not applicable



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### Stock Repurchases

The following table sets forth the shares repurchased by the Company during the quarter ended June 30, 2008:

| Period                    | Total No. of Shares Purchased | Average Price Paid per Share | Total No. of Shares Purchased as Part of Publicly Announced Plan | Maximum No. of Shares that May Yet Be Purchased Under the Plan(1) |
|---------------------------|-------------------------------|------------------------------|------------------------------------------------------------------|-------------------------------------------------------------------|
| 04/01/2008-<br>04/30/2008 | -                             | -                            | --                                                               | 343,468                                                           |
| 38                        |                               |                              |                                                                  |                                                                   |
| 05/01/2008-<br>05/31/2008 | -                             | --                           | --                                                               | 343,468                                                           |
| 06/01/2008-<br>06/30/2008 | --                            | --                           | --                                                               | 343,468                                                           |
| Total                     | --                            | \$ --                        | --                                                               | 343,468                                                           |

(1) On February 25, 2008, the Company announced a share repurchase plan authorizing the repurchase of up to 5% of its outstanding shares, or 343,468 shares. As of June 30, 2008 no shares under this plan had been repurchased.

### Item 3. Defaults Upon Senior Securities

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None to be reported.

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

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None to be reported.

### Item 5. Other Information

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None to be reported.

### Item 6. Exhibits

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- (a) Exhibits
- 3.1 Articles of Incorporation of the Registrant (1)
  - 3.2 Bylaws of the Registrant (1)
  - 3.3 Amendment to Bylaws (2)
  - 10.1 Employee Severance Compensation Plan, as revised (3)
  - 10.2 Employee Stock Ownership Plan (3)
  - 10.3 1999 Stock Option Plan (4)
  - 10.4 Management Recognition and Development Plan (4)
  - 10.5 2003 Stock Option Plan (5)

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- 10.6 Form of Incentive Stock Option Agreement (6)
- 10.7 Form of Non-qualified Stock Option Agreement (6)
- 10.8 Form of Management Recognition and Development Award Agreement (6)
- 10.9 Employment Agreement between the Company and the Bank and Michael R. Sand (7)
- 10.10 Employment Agreement between the Company and the Bank and Dean J. Brydon (7)
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes Oxley Act
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes Oxley Act
- 32 Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes Oxley Act

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

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

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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 6, 2008

By: \_\_\_\_\_  
Michael R. Sand  
Chief Executive Officer  
(Principal Executive Officer)

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Date: August 6, 2008

By: \_\_\_\_\_  
Dean J. Brydon  
Chief Financial Officer  
(Principal Financial Officer)

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EXHIBIT INDEX

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

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Exhibit 31.1

Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes Oxley Act

I, Michael R. Sand, certify that:

1. I have reviewed this Form 10-Q of Timberland Bancorp, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision,

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to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

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

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

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

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

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

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

Date: August 6, 2008

/s/Michael R. Sand

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Michael R. Sand  
Chief Executive Officer

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Exhibit 31.2

Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes Oxley Act

I, Dean J. Brydon, certify that:

1. I have reviewed this Form 10-Q of Timberland Bancorp, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of

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the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
- (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 6, 2008

/s/Dean J. Brydon

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Dean J. Brydon  
Chief Financial Officer

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

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350), each of the undersigned hereby certifies in his capacity as an officer of Timberland Bancorp, Inc. (the "Company") and in connection with the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2008 ("Report"), that:

- \* the Report fully complies with the requirements of Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, and
- \* the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of the dates and for the periods presented in the financial statements included in the Report.

/s/Michael R. Sand  
-----  
Michael R. Sand  
Chief Executive Officer

/s/Dean J. Brydon  
-----  
Dean J. Brydon  
Chief Financial Officer

Date: August 6, 2008