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TIMBERLAND BANCORP INC  
Form 10-K  
December 10, 2010

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

FORM 10-K

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

For the Fiscal Year Ended September 30, 2010 OR

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

Commission File Number: 0-23333

TIMBERLAND BANCORP, INC.

-----  
(Exact name of registrant as specified in its charter)

Washington

91-1863696

-----  
(State or other jurisdiction of incorporation or organization)

-----  
(I.R.S. Employer Identification Number)

624 Simpson Avenue, Hoquiam, Washington

98550

-----  
(Address of principal executive offices)

-----  
(Zip Code)

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

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

Common Stock, par value \$.01 per share

The Nasdaq Stock Market LLC

-----  
(Title of Each Class)

-----  
(Name of Each Exchange on Which Registered)

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

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES NO X  
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Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 of Section 15(d) of the Act. YES NO X  
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Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES X NO  
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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required



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### Item 1. Business

#### General

Timberland Bancorp, Inc. ("Company"), a Washington corporation, was organized on September 8, 1997 for the purpose of becoming the holding company for Timberland Savings Bank, SSB ("Bank") upon the Bank's conversion from a Washington-chartered mutual savings bank to a Washington-chartered stock savings bank ("Conversion"). The Conversion was completed on January 12, 1998 through the sale and issuance of 13,225,000 shares of common stock by the Company. At September 30, 2010, on a consolidated basis, the Company had total assets of \$742.7 million, total deposits of \$578.9 million and total shareholders' equity of \$85.4 million. The Company's business activities generally are limited to passive investment activities and oversight of its investment in the Bank. Accordingly, the information set forth in this report, including consolidated financial statements and related data, relates primarily to the Bank and its subsidiary.

The Bank was established in 1915 as "Southwest Washington Savings and Loan Association." In 1935, the Bank converted from a state-chartered mutual savings and loan association to a federally chartered mutual savings and loan association, and in 1972, changed its name to "Timberland Federal Savings and Loan Association." In 1990, the Bank converted to a federally chartered mutual savings bank under the name "Timberland Savings Bank, FSB." In 1991, the Bank converted to a Washington-chartered mutual savings bank and changed its name to "Timberland Savings Bank, SSB." On December 29, 2000, the Bank changed its name to "Timberland Bank." The Bank's deposits are insured up to applicable legal limits by the Federal Deposit Insurance Corporation ("FDIC"). The Bank has been a member of the Federal Home Loan Bank ("FHLB") System since 1937. The Bank is regulated by the Washington Department of Financial Institutions, Division of Banks ("Division" or "DFI") and the FDIC.

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

The Company maintains a website at [www.timberlandbank.com](http://www.timberlandbank.com). The information contained on that website is not included as a part of, or incorporated by reference into, this Annual Report on Form 10-K. Other than an investor's own internet access charges, the Company makes available free of charge through that website the Company's Annual Report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after these materials have been electronically filed with, or furnished to, the Securities and Exchange Commission ("SEC").

#### Corporate Developments and Overview

Participation in Troubled Asset Relief Program ("TARP") Capital Purchase Program ("CPP"). On December 19, 2008, as part of the TARP CPP of the United States Department of the Treasury ("Treasury"), the Company sold to Treasury 16,641 shares of Cumulative Perpetual Preferred Stock, Series A ("Series A

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Preferred Stock") and a warrant to purchase 370,889 shares of the Company's common stock, par value \$0.01 per share, for an aggregate purchase price of \$16.6 million in cash. For additional information regarding the TARP CPP transaction, see Item 1A, "Risk Factors Risks specific to our participation in TARP."

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Agreements with Banking Regulators. In December 2009, the FDIC determined that the Bank required supervisory attention and agreed to terms on a Memorandum of Understanding (the "Bank MOU") with the Bank. The terms of the Bank MOU restrict the Bank from certain activities, and require that the Bank obtain the prior written approval, or nonobjection, of the FDIC and/or the DFI to engage in certain activities.

In addition, on February 1, 2010, the Federal Reserve Bank of San Francisco ("FRB") determined that the Company required additional supervisory attention and entered into a Memorandum of Understanding with the Company (the "Company MOU"). Under the agreement, the Company must among other things obtain prior written approval, or non-objection, from the FRB to declare or pay any dividends, or make any other capital distributions; issue any trust preferred securities; or purchase or redeem any of its stock. The FRB has denied the Company's requests to pay dividends on its Series A Preferred Stock issued under the CPP for the payments due May 15, 2010, August 15, 2010 and November 15, 2010. There can be no assurances that our regulators will approve such payments or dividends in the future.

For additional information regarding the Bank MOU and Company MOU, see "Item 1A, Risk Factors - The Company and the Bank are required to comply with the terms of separate memoranda of understanding issued by their respective regulators and lack of compliance could result in additional regulatory actions."

### Market Area

The Bank considers Grays Harbor, Thurston, Pierce, King, Kitsap and Lewis Counties, Washington as its primary market areas. The Bank conducts operations from:

- \* its main office in Hoquiam (Grays Harbor County);
- \* five branch offices in Grays Harbor County (Ocean Shores, Montesano, Elma, and two branches in Aberdeen);
- \* a branch office in King County (Auburn);
- \* five branch offices in Pierce County (Edgewood, Puyallup, Spanaway, Tacoma, and Gig Harbor);
- \* five branch offices in Thurston County (Olympia, Yelm, Tumwater, and two branches in Lacey);
- \* two branch offices in Kitsap County (Poulsbo and Silverdale); and
- \* three branch offices in Lewis County (Winlock, Toledo and Chehalis).

See "Item 2. Properties."

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

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

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Grays Harbor County has a population of 72,000 according to the U.S. Census Bureau 2009 estimates and a median family income of \$55,400 according to 2010 estimates from the Department of Housing and Urban Development (HUD). The economic base in Grays Harbor has been historically dependent on the timber and fishing industries. Other industries that support the economic base are tourism, agriculture, shipping, transportation and technology. According to the Washington State Employment Security Department, the unemployment rate in Grays Harbor County decreased to 11.4% at September 30, 2010 from 11.9% at September 30, 2009. The median price of a resale home in Grays Harbor County for the quarter ended September 30, 2010 decreased 3.3% to \$130,000 from \$134,500 for the comparable prior year period. The number of home sales increased 23.1% for the quarter ended September 30, 2010 compared to the same quarter one year earlier. The Bank has six branches (including its home office) located throughout the county. The downturn in Grays Harbor County's economy and the decline in real estate values since 2008 have had a negative effect on the Bank's profitability in this market area.

Pierce County is the second most populous county in the state and has a population of 797,000 according to the U.S. Census Bureau 2009 estimates. The county's median family income is \$69,000 according to 2010 HUD estimates. The economy in Pierce County is diversified with the presence of military related government employment (Joint Base Lewis-McChord), transportation and shipping employment (Port of Tacoma), and aerospace related employment (Boeing). According to the Washington State Employment Security Department, the unemployment rate for the Pierce County area decreased to 8.7% at September 30, 2010 from 9.0% at September 30, 2009. The median price of a resale home in Pierce County for the quarter ended September 30, 2010 decreased 4.3% to \$220,000 from \$230,000 for the comparable prior year period. The number of home sales increased 21.9% for the quarter ended September 30, 2010 compared to the same quarter one year earlier. The Bank has five branches in Pierce County and these branches have historically been responsible for a substantial portion of the Bank's construction lending activities. The downturn in Pierce County's economy and the decline in real estate values since 2008 have had a negative effect on the Bank's profitability in this market area.

Thurston County has a population of 251,000 according to the U.S. Census Bureau 2009 estimates and a median family income of \$71,900 according to 2010 HUD estimates. Thurston County is home of Washington State's capital (Olympia) and its economic base is largely driven by state government related employment. According to the Washington State Employment Security Department, the unemployment rate for the Thurston County area remained level at 7.2% at September 30, 2010 and 2009. The median price of a resale home in Thurston County for the quarter ended September 30, 2010 decreased 5.0% to \$231,000

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from \$243,100 for the same quarter one year earlier. The number of home sales increased 13.0% for the quarter ended September 30, 2010 compared to the same quarter one year earlier. The Bank has five branches in Thurston County. This county has historically had a stable economic base primarily attributable to the state government presence; however the downturn in Thurston County's economy and the decline in real estate values since 2008 have had a negative effect on the Bank's profitability in this market area.

Kitsap County has a population of 241,000 according to the U.S. Census Bureau 2009 estimates and a median family income of \$71,900 according to 2010 HUD estimates. The Bank has two branches in Kitsap County. The economic base of Kitsap County is largely supported by military related government employment through the United States Navy. According to the Washington State Employment Security Department, the unemployment rate for the Kitsap County area decreased to 7.0% at September 30, 2010 from 7.3% at September 30, 2009. The median price of a resale home in Kitsap County for the quarter ended September 30, 2010 decreased 6.0% to \$235,000 from \$249,900, the same quarter one year earlier. The number of home sales increased 16.5% for the quarter ended September 30, 2010 compared to the same quarter one year earlier. The downturn in Kitsap County's economy and the decline in real estate values since 2008 have had a negative effect on the Bank's profitability in this market area.

King County is the most populous county in the state and has a population of 1.9 million according to the U.S. Census Bureau 2009 estimates. The Bank has one branch in King County. The county's median family income is \$85,600 according to 2010 HUD estimates. King County's economic base is diversified with many industries including shipping, transportation, aerospace (Boeing), computer technology and biotech industries. According to the Washington State Employment Security Department, the unemployment rate for the King County area decreased to 8.4% at September 30, 2010 from 8.8% at September 30, 2009. The median price of a resale home in King County for the quarter ended September 30, 2010 decreased 1.7% to \$375,500 from \$382,000, for the same quarter one year earlier. The

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number of home sales increased 33.0% for the quarter ended September 30, 2010 compared to the same quarter one year earlier. The downturn in King County's economy and the decline in real estate values since 2008 have had a negative effect on the Bank's profitability in this market area.

Lewis County has a population of 75,000 according to the U.S. Census Bureau 2009 estimates and a median family income of \$55,400 according to 2010 HUD estimates. The economic base in Lewis County is supported by manufacturing, retail trade, local government and industrial services. According to the Washington State Employment Security Department, the unemployment rate in Lewis County decreased to 11.7% at September 30, 2010 from 12.1% at September 30, 2009. The median price of a resale home in Lewis County for the quarter ended September 30, 2010 decreased 1.1% to \$161,500 from \$163,300, for the same quarter one year earlier. The number of home sales increased 8.2% for the quarter ended September 30, 2010 compared to the same quarter one year earlier. The Bank currently has three branches located in Lewis County. The downturn in Lewis County's economy and the decline in real estate values since 2008 have had a negative effect on the Bank's profitability in this market area.

Lending Activities

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General. Historically, the principal lending activity of the Bank has consisted of the origination of loans secured by first mortgages on owner-occupied, one- to four-family residences, loans secured by commercial real estate and loans for the construction of one- to four-family residences. During the past several years, the Bank adjusted its lending strategy and began reducing its exposure to speculative construction and land development lending. The Bank's net loans receivable, including loans held for sale, totaled 527.6 million at September 30, 2010, representing 71.0% of consolidated total assets, and at that date commercial real estate, construction and land development loans (including undisbursed loans in process), and land loans were \$340.3 million, or 60.9%, of total loans. Construction and land development loans and commercial real estate loans typically have higher rates of return than one- to four-family loans; however, they also present a higher degree of risk. See "-Lending Activities - Commercial Real Estate Lending," "- Lending Activities - Construction and Land Development Lending" and "- Lending Activities - Land Lending."

The Bank's internal loan policy limits the maximum amount of loans to one borrower to 25% of its Tier 1 capital. At September 30, 2010, the maximum amount which the Bank could have lent to any one borrower and the borrower's related entities was approximately \$18.2 million under this policy. At September 30, 2010, the largest amount outstanding to any one borrower and the borrower's related entities was \$11.5 million (including \$1.1 million in undisbursed loans in process). These loans were secured by commercial buildings and a land parcel, all of which were located in Pierce County. These loans were all performing according to the loan repayment terms at September 30, 2010. The next largest amount outstanding to any one borrower and the borrower's related entities was \$8.9 million. These loans were secured by a condominium construction project, a commercial building, several one- to four-family properties, and several land parcels. All of the loans were secured by properties located in Grays Harbor County, except one land parcel located in Clatsop County, Oregon. These loans were performing according to the loan terms at September 30, 2010.

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

| At September 30,       |           |        |           |        |           |        |           |        |         |
|------------------------|-----------|--------|-----------|--------|-----------|--------|-----------|--------|---------|
| 2010                   |           | 2009   |           | 2008   |           | 2007   |           |        |         |
| Amount                 | Percent   | Amount | Percent   | Amount | Percent   | Amount | Percent   | Amount | Percent |
| (Dollars in thousands) |           |        |           |        |           |        |           |        |         |
| Mortgage Loans:        |           |        |           |        |           |        |           |        |         |
| One- to four-          |           |        |           |        |           |        |           |        |         |
| family(1)....          | \$121,014 | 21.65% | \$110,556 | 18.58% | \$112,299 | 18.35% | \$102,434 | 17.40% | \$ 98,7 |
| Multi-family..         | 32,267    | 5.77   | 25,638    | 4.31   | 25,927    | 4.24   | 35,157    | 5.97   | 17,6    |
| Commercial....         | 208,002   | 37.21  | 188,205   | 31.62  | 146,223   | 23.90  | 127,866   | 21.72  | 137,6   |
| Construction and land  |           |        |           |        |           |        |           |        |         |



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|   |           |         |           |         |           |         |           |         |         |
|---|-----------|---------|-----------|---------|-----------|---------|-----------|---------|---------|
| development..   | 69,271    | 12.39   | 139,728   | 23.48   | 186,344   | 30.46   | 186,261   | 31.64   | 146,8   |
| Land.....   | 62,999    | 11.27   | 65,642    | 11.03   | 60,701    | 9.92    | 60,706    | 10.30   | 29,5    |
|   | -----     | -----   | -----     | -----   | -----     | -----   | -----     | -----   | -----   |
| Total mortgage loans.....                                 | 493,553   | 88.29   | 529,769   | 89.02   | 531,494   | 86.87   | 512,424   | 87.03   | 430,4   |
| Consumer Loans:   |           |         |           |         |           |         |           |         |         |
| Home equity and second mortgage.....                      | 38,418    | 6.87    | 41,746    | 7.01    | 48,690    | 7.96    | 47,269    | 8.02    | 37,4    |
| Other.....  | 9,086     | 1.62    | 9,827     | 1.66    | 10,635    | 1.73    | 10,922    | 1.86    | 11,1    |
|   | -----     | -----   | -----     | -----   | -----     | -----   | -----     | -----   | -----   |
| Total consumer loans.....                                 | 47,504    | 8.49    | 51,573    | 8.67    | 59,325    | 9.69    | 58,191    | 9.88    | 48,5    |
| Commercial business loans.....                            | 17,979    | 3.22    | 13,775    | 2.31    | 21,018    | 3.44    | 18,164    | 3.09    | 11,8    |
|   | -----     | -----   | -----     | -----   | -----     | -----   | -----     | -----   | -----   |
| Total loans..   | 559,036   | 100.00% | 595,117   | 100.00% | 611,837   | 100.00% | 588,779   | 100.00% | 490,8   |
|   | =====     | =====   | =====     | =====   | =====     | =====   | =====     | =====   | =====   |
| Less:   |           |         |           |         |           |         |           |         |         |
| Undisbursed portion of construction loans in process..... | (17,952)  |         | (31,298)  |         | (43,353)  |         | (65,673)  |         | (59,2   |
| Deferred loan origination fees.....                       | (2,229)   |         | (2,439)   |         | (2,747)   |         | (2,968)   |         | (2,7    |
| Allowance for loan losses..                               | (11,264)  |         | (14,172)  |         | (8,050)   |         | (4,797)   |         | (4,1    |
|   | -----     |         | -----     |         | -----     |         | -----     |         | -----   |
| Total loans receivable, net.....                          | \$527,591 |         | \$547,208 |         | \$557,687 |         | \$515,341 |         | \$424,6 |
|   | =====     |         | =====     |         | =====     |         | =====     |         | =====   |

(1) Includes loans held-for-sale of \$3.0 million, \$630,000, \$1.8 million, \$757,000 and \$2.4 million at September 30, 2010, 2009, 2008, 2007 and 2006, respectively.

Residential One- to Four-Family Lending. At September 30, 2010, \$121.0 million, or 21.7%, of the Bank's loan portfolio consisted of loans secured by one- to four-family residences. The Bank originates both fixed-rate loans and adjustable-rate loans.

Generally, one- to four-family fixed-rate loans and five and seven year balloon reset loans (which are loans that are originated with a fixed interest rate for the initial five or seven years, and thereafter incur one interest rate change in which the new rate remains in effect for the remainder of the loan term) are originated to meet the requirements for sale in the secondary market to the FHLMC. From time to time, however, a portion of these fixed-rate loans, which include five and seven year balloon reset loans, may be retained in the loan portfolio to meet the Bank's asset/liability management objectives. The Bank periodically retains some fixed rate loans

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including five and seven year balloon reset loans in its loan portfolio as it intends to hold them to maturity. The Bank uses an automated underwriting program, which preliminarily qualifies a loan as conforming to FHLMC underwriting standards when the loan is originated. At September 30, 2010, \$57.1 million, or 47.2%, of the Bank's one- to four-family loan portfolio consisted of fixed-rate mortgage loans.

The Bank also offers adjustable-rate mortgage ("ARM") loans. All of the Bank's ARM loans are retained in its loan portfolio and not sold. The Bank offers several ARM products which adjust annually after an initial period ranging from one to five years subject to a limitation on the annual increase of 2% and an overall limitation of 6%. These ARM products generally are priced utilizing the weekly average yield on one year U.S. Treasury securities adjusted to a constant maturity of one year plus a margin of 2.88% to 4.00%. Loans tied to the prime rate or to London Inter-Bank Offered Rate ("LIBOR") indices typically do not have periodic, or lifetime adjustment limits. Loans tied to these indices normally have margins ranging up to 3.5%. ARM loans held in the Bank's portfolio do not permit negative amortization of principal. Borrower demand for ARM loans versus fixed-rate mortgage loans is a function of the level of interest

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rates, the expectations of changes in the level of interest rates and the difference between the initial interest rates and fees charged for each type of loan. The relative amount of fixed-rate mortgage loans and ARM loans that can be originated at any time is largely determined by the demand for each in a competitive environment. At September 30, 2010, \$63.9 million, or 52.8%, of the Bank's one- to four- family loan portfolio consisted of ARM loans.

A portion of the Bank's ARM loans are "non-conforming" because they do not satisfy acreage limits, or various other requirements imposed by the FHLMC. Some of these loans are also originated to meet the needs of borrowers who cannot otherwise satisfy the FHLMC credit requirements because of personal and financial reasons (i.e., divorce, bankruptcy, length of time employed, etc.), and other aspects, which do not conform to the FHLMC's guidelines. Many of these borrowers have higher debt-to-income ratios, or the loans are secured by unique properties in rural markets for which there are no sales of comparable properties to support the value according to secondary market requirements. These loans are known as non-conforming loans and the Bank may require additional collateral or lower loan-to-value ratios to reduce the risk of these loans. The Bank believes that these loans satisfy a need in its local market area. As a result, subject to market conditions, the Bank intends to continue to originate these types of loans.

The retention of ARM loans in the Bank's loan portfolio helps reduce the Bank's exposure to changes in interest rates. There are, however, unquantifiable credit risks resulting from the potential of increased interest to be paid by the customer as a result of increases in interest rates. It is possible that during periods of rising interest rates the risk of default on ARM loans may increase as a result of repricing and the increased costs to the borrower. The Bank attempts to reduce the potential for delinquencies and defaults on ARM loans by qualifying the borrower based on the borrower's ability to repay the ARM loan assuming that the maximum interest rate that could be charged at the first adjustment period remains constant during the loan term. Another consideration is that although ARM loans allow the Bank to increase the sensitivity of its asset base due to changes in the interest rates, the extent of this interest sensitivity is limited by the periodic and

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lifetime interest rate adjustment limits. Because of these considerations, the Bank has no assurance that yield increases on ARM loans will be sufficient to offset increases in the Bank's cost of funds.

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

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

The Bank's lending policies generally limit the maximum loan-to-value ratio on mortgage loans secured by owner-occupied properties to 95% of the lesser of the appraised value or the purchase price. However, the Bank usually obtains private mortgage insurance ("PMI") on the portion of the principal amount that exceeds 80% of the appraised value of the security property. The maximum loan-to-value ratio on mortgage loans secured by non-owner-occupied properties is generally 80% (90% for loans originated for sale in the secondary market to the FHLMC). At September 30, 2010, 17 single family loans totaling \$3.7 million were not performing according to their terms. See "- Lending Activities - Non-performing Assets and Delinquencies."

Construction and Land Development Lending. Prompted by unfavorable economic conditions in its primary market area in the 1980s, the Bank sought to establish a market niche and, as a result, began originating construction loans outside of Grays Harbor County. In recent periods, construction lending activities have been primarily in the Pierce, King, Thurston, Grays Harbor, and Kitsap County markets although, as a result of the current economic environment, the Bank has sharply curtailed speculative construction and land development lending.

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The Bank currently originates three types of residential construction loans: (i) custom construction loans, (ii) owner/builder construction loans and (iii) speculative construction loans (on a very limited basis). The Bank believes that its computer tracking system has enabled it to establish processing and disbursement procedures to meet the needs of these borrowers. The Bank also originates construction loans for the development of multi-family and commercial properties.

At September 30, 2010 and 2009, the composition of the Bank's construction and land development loan portfolio was as follows:

| At September 30, |       |
|------------------|-------|
| 2010             | 2009  |
| -----            | ----- |

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|   | Outstanding<br>Balance | Percent of<br>Total | Outstanding<br>Balance | Percent of<br>Total |
|---|------------------------|---------------------|------------------------|---------------------|
|   | -----                  | -----               | -----                  | -----               |
| (In thousands)                                |                        |                     |                        |                     |
| Custom and owner/builder<br>construction..... | \$30,945               | 44.67%              | \$ 35,414              | 25.34%              |
| Speculative construction...                   | 4,777                  | 6.90                | 16,959                 | 12.14               |
| Multi-family (including<br>condominium).....  | 3,587                  | 5.18                | 18,800                 | 13.46               |
| Land development.....                         | 6,434                  | 9.29                | 19,158                 | 13.71               |
| Commercial real estate.....                   | 23,528                 | 33.96               | 49,397                 | 35.35               |
|   | -----                  | -----               | -----                  | -----               |
| Total.....                                    | \$69,271               | 100.00%             | \$139,728              | 100.00%             |
|   | =====                  | =====               | =====                  | =====               |

Custom construction loans are made to home builders who, at the time of construction, have a signed contract with a home buyer who has a commitment to purchase the finished home. Custom construction loans are generally originated for a term of six to 12 months, with fixed interest rates currently ranging from 7.00% to 7.88% and with loan-to-value ratios of 80% of the appraised estimated value of the completed property or sales price, whichever is less.

Owner/builder construction loans are originated to home owners rather than home builders and are typically refinanced into permanent loans at the completion of construction. The construction phase of an owner/builder construction loan generally lasts up to 12 months with fixed interest rates currently ranging from 7.00% to 7.88%, and with loan-to-value ratios of 80% (or up to 95% with PMI) of the appraised estimated value of the completed property. At the completion of construction, the loan is refinanced into either a fixed-rate mortgage loan, which conforms to secondary market standards, or an ARM loan for retention in the Bank's portfolio. At September 30, 2010, custom and owner/builder construction loans totaled \$30.9 million, or 44.7%, of the total construction and land development loan portfolio. At September 30, 2010, the largest outstanding custom and owner/builder construction loan had an outstanding balance of \$600,000 (including \$172,000 of undisbursed loans in process) and was performing according to its repayment terms.

Speculative construction loans are made to home builders and are termed "speculative" because the home builder does not have, at the time of loan origination, a signed contract with a home buyer who has a commitment for permanent financing with either the Bank or another lender for the finished home. The home buyer may be identified either during or after the construction period, with the risk that the builder will have to debt service the speculative construction loan and finance real estate taxes and other carrying costs of the completed home for a significant time after the completion of construction until the home buyer is identified and a sale is consummated. Historically, the Bank has originated loans to approximately 50 builders located in the Bank's primary market area, each of which generally would have one to eight speculative loans outstanding from the Bank during a 12 month period. Rather than originating lines of credit to home builders to construct several homes at once, the Bank generally originates and underwrites a separate loan for each home. Speculative construction loans are generally originated for a term of 12 months, with current rates ranging from 6.50% to 7.88%, and with a loan-to-value ratio of no more than 80% of the appraised estimated value of the completed property. The Bank is currently originating speculative construction loans on a very limited basis. At September 30, 2010, speculative construction loans totaled \$4.8 million, or 6.9%, of the total construction and land development loan portfolio. At September 30, 2010, the Bank had two borrowers each with aggregate outstanding

speculative loan balances of more than \$500,000. The largest aggregate outstanding balance to one borrower for speculative construction loans totaled \$1.7 million (including \$311,000 of undisbursed loans in process), all of which were performing according to the loan repayment terms. The largest outstanding balance for a single speculative loan was \$759,000 and was on non-accrual status. At September 30, 2010, four speculative construction loans with an aggregate balance of \$2.1 million were not performing according to their terms. These non-performing loans were located in Pierce, Thurston and King Counties. See "- Lending Activities - Non-performing Assets and Delinquencies."

The Bank historically originated loans to real estate developers with whom it has established relationships for the purpose of developing residential subdivisions (i.e., installing roads, sewers, water and other utilities) (generally with ten to 50 lots). The Bank is not currently originating any new land development loans. At September 30, 2010, the Bank had 11 land development loans totaling \$6.4 million, or 9.3% of construction and land development loans receivable. Land development loans are secured by a lien on the property and typically made for a period of two to five years with fixed or variable interest rates, and are made with loan-to-value ratios generally not exceeding 75%. Land development loans are generally structured so that the Bank is repaid in full upon the sale by the borrower of approximately 80% of the subdivision lots. A majority of the Bank's land development loans are secured by property located in its primary market area. In addition, in the case of a corporate borrower, the Bank also generally obtains personal guarantees from corporate principals and reviews their personal financial statements. At September 30, 2010, the Bank had eight land development loans totaling \$3.8 million that were not performing according to their terms. The non-performing loans consisted of

- \* Four loans totaling \$1.5 million secured by land development projects in King County;
- \* One loan with a balance of \$1.4 million secured by a land development project in Lewis County;
- \* One loan with a balance of \$534,000 secured by a land development project in Thurston County;
- \* One loan with a balance of \$230,000 secured by a land development project in Pierce County; and
- \* One loan with a balance of \$71,000 secured by a land development project in Grays Harbor County.

Land development loans secured by land under development involve greater risks than one- to four-family residential mortgage loans because these loans are advanced upon the predicted future value of the developed property upon completion. If the estimate of the future value proves to be inaccurate, in the event of default and foreclosure the Bank may be confronted with a property the value of which is insufficient to assure full repayment. The Bank has historically attempted to minimize this risk by generally limiting the maximum loan-to-value ratio on land loans to 75% of the estimated developed value of the secured property. The Bank is not currently originating any new land development loans.

The Bank also provides construction financing for multi-family and commercial properties. At September 30, 2010, these loans amounted to \$27.1 million, or 39.1% of construction and land development loans. These loans are

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secured by condominiums, apartment buildings, mini-storage facilities, office buildings, hotels and retail rental space predominantly located in the Bank's primary market area. At September 30, 2010, the largest outstanding multi-family construction loan was secured by a condominium project in King County and had a balance of \$1.5 million (including \$12,000 of undisbursed loans in process) and was not performing according to its repayment terms. At September 30, 2010, the largest outstanding commercial real estate construction loan had a balance of \$4.0 million (including \$196,000 of undisbursed loans in process). This loan was secured by a hotel being constructed in King County and was performing according to its repayment terms.

All construction loans must be approved by a member of one of the Bank's Loan Committees or the Bank's Board of Directors, or in the case of one- to four-family construction loans meeting FHLMC guidelines, by a qualified Bank underwriter. See "- Lending Activities - Loan Solicitation and Processing." Prior to preliminary approval of any construction loan application, an independent fee appraiser inspects the site and the Bank reviews the existing or proposed improvements, identifies the market for the proposed project and analyzes the pro forma data and assumptions on the project. In the case of a speculative or custom construction loan, the Bank reviews the experience and expertise of the builder. After preliminary approval has been given, the application is processed, which includes obtaining credit reports, financial statements and tax returns on the borrowers and guarantors, an independent appraisal of the project, and any other expert reports necessary to evaluate the proposed project. In the event of cost overruns, the Bank generally

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requires that the borrower increase the funds available for construction by depositing its own funds into a secured savings account, the proceeds of which are used to pay construction costs.

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

The Bank regularly monitors the construction loan disbursements using an internal monitoring system which the Bank believes reduces many of the risks inherent with construction lending.

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

Construction lending affords the Bank the opportunity to achieve higher interest rates and fees with shorter terms to maturity than does its single-family permanent mortgage lending. Construction lending, however, is generally considered to involve a higher degree of risk than single-family permanent mortgage lending because of the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost of the project. The nature of these loans is such that they are generally more difficult to evaluate and monitor. If the estimate of construction cost proves to be inaccurate, the Bank may be required to advance funds beyond the

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amount originally committed to permit completion of the project. If the estimate of value upon completion proves to be inaccurate, the Bank may be confronted with a project whose value is insufficient to assure full repayment and it may incur a loss. Projects may also be jeopardized by disagreements between borrowers and builders and by the failure of builders to pay subcontractors. Loans to builders to construct homes for which no purchaser has been identified carry more risk because the payoff for the loan depends on the builder's ability to sell the property prior to the time that the construction loan is due. The Bank has sought to address these risks by adhering to strict underwriting policies, disbursement procedures, and monitoring practices. The Bank's construction loans are primarily secured by properties in its primary market area, and changes in the local and state economies and real estate markets have adversely affected the Bank's construction loan portfolio.

**Multi-Family Lending.** At September 30, 2010, the Bank had \$32.3 million, or 5.8% of the Bank's total loan portfolio, secured by multi-family dwelling units (more than four units) located primarily in the Bank's primary market area. Multi-family loans are generally originated with variable rates of interest ranging from 2.00% to 3.50% over the one-year constant maturity U.S. Treasury Bill Index or a matched term FHLB advance, with principal and interest payments fully amortizing over terms of up to 30 years. At September 30, 2010, the Bank's largest multi-family loan had an outstanding principal balance of \$4.9 million and was secured by an apartment building located in the Bank's primary market area. At September 30, 2010, this loan was performing according to its terms. At September 30, 2010, there were no non-performing multi-family real estate loans. See "- Lending Activities - Non-performing Assets and Delinquencies."

The maximum loan-to-value ratio for multi-family loans is generally limited to not more than 80%. The Bank generally requests its multi-family loan borrowers with loan balances in excess of \$750,000 to submit financial statements and rent rolls on the subject property annually. The Bank also inspects the subject property annually. The Bank generally imposes a minimum debt coverage ratio of approximately 1.20 for loans secured by multi-family properties.

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

**Commercial Real Estate Lending.** Commercial real estate loans totaled \$208.0 million, or 37.2% of the total loan portfolio at September 30, 2010. The Bank originated \$27.2 million of commercial real-estate loans during the year ended September 30, 2010 compared to \$43.8 million originated during the

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year ended September 30, 2009. The Bank originates commercial real estate loans generally at variable interest rates and these loans are secured by properties, such as restaurants, motels, mini-storage facilities, office buildings and retail/wholesale facilities, located in the Bank's primary market area. At September 30, 2010, the largest commercial real estate loan was secured by an office building in Pierce County, had a balance of \$6.3 million and was performing according to its terms. At September 30, 2010, 12 commercial real estate loans totaling \$7.3 million were not performing according to their terms. See "- Lending Activities - Non-performing Assets and Delinquencies."

The Bank typically requires appraisals of properties securing commercial real estate loans. For loans that are less than \$250,000, the Bank may use the tax assessed value and a property inspection in lieu of an appraisal. Appraisals are performed by independent appraisers designated by the Bank, all of which are reviewed by management. The Bank considers the quality and location of the real estate, the credit history of the borrower, the cash flow of the project and the quality of management involved with the property. The Bank generally imposes a minimum debt coverage ratio of approximately 1.20 for originated loans secured by income producing commercial properties. Loan-to-value ratios on commercial real estate loans are generally limited to not more than 80%. If the borrower is other than an individual, the Bank also generally obtains personal guarantees from the principals based on a review of personal financial statements.

Commercial real estate lending affords the Bank an opportunity to receive interest at rates higher than those generally available from one- to four-family residential lending. However, loans secured by such properties usually are greater in amount, more difficult to evaluate and monitor and, therefore, involve a greater degree of risk than one- to four-family residential mortgage loans. Because payments on loans secured by commercial properties often depend upon the successful operation and management of the properties, repayment of these loans may be affected by adverse conditions in the real estate market or the economy. The Bank seeks to minimize these risks by generally limiting the maximum loan-to-value ratio to 80% and scrutinizing the financial condition of the borrower, the quality of the collateral and the management of the property securing the loan. The Bank also requests annual financial information and rent rolls on the subject property from the borrowers on loans over \$750,000.

Land Lending. The Bank has historically originated loans for the acquisition of land upon which the purchaser can then build or make improvements necessary to build or to sell as improved lots. Currently the Bank is not offering land loans to new customers and is attempting to decrease its land loan portfolio. At September 30, 2010, land loans totaled \$63.0 million, or 11.3% of the Bank's total loan portfolio as compared to \$65.6 million, or 11.0% of the Bank's total loan portfolio at September 30, 2009. Land loans originated by the Bank are generally fixed-rate loans and have maturities of five to ten years. The largest land loan had an outstanding balance of \$4.2 million at September 30, 2010 and was performing according to its repayment terms. At September 30, 2010, 24 land loans totaling \$5.5 million were not performing according to their terms. See "- Lending Activities - Non-performing Assets and Delinquencies."

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



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Consumer Lending. Consumer loans generally have shorter terms to maturity and higher interest rates than mortgage loans. Consumer loans include home equity lines of credit, second mortgage loans, savings account loans, automobile loans, boat loans, motorcycle loans, recreational vehicle loans and unsecured loans. Consumer loans are made with both fixed and variable interest rates and with varying terms. At September 30, 2010, consumer loans amounted to \$47.5 million, or 8.5%, of the total loan portfolio.

At September 30, 2010, the largest component of the consumer loan portfolio consisted of second mortgage loans and home equity lines of credit, which totaled \$38.4 million, or 6.9%, of the total loan portfolio. Home equity lines of credit and second mortgage loans are made for purposes such as the improvement of residential properties, debt

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

Consumer loans entail greater risk than do residential mortgage loans, particularly in the case of consumer loans that are unsecured or secured by rapidly depreciating assets such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. The remaining deficiency often does not warrant further substantial collection efforts against the borrower beyond obtaining a deficiency judgment. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount that can be recovered on such loans. The Bank believes that these risks are not as prevalent in the case of the Bank's consumer loan portfolio because a large percentage of the portfolio consists of second mortgage loans and home equity lines of credit that are underwritten in a manner such that they result in credit risk that is substantially similar to one- to four-family residential mortgage loans. At September 30, 2010, eight consumer loans totaling \$806,000 were delinquent in excess of 90 days. See "- Lending Activities - Non-performing Assets and Delinquencies."

Commercial Business Lending. Commercial business loans totaled \$18.0 million, or 3.2% of the loan portfolio at September 30, 2010. Commercial business loans are generally secured by business equipment, accounts receivable, inventory or other property and are made at variable rates of interest equal to a negotiated margin above the prime rate. The Bank also generally obtains personal guarantees from the principals based on a review of personal financial statements. The largest commercial business loan had an outstanding balance of \$1.8 million at September 30, 2010 and was performing

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according to its terms. At September 30, 2010, two commercial business loans totaling \$46,000 were not performing according to their repayment terms. See "- Lending Activities - Non-performing Assets and Delinquencies."

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

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Loan Maturity. The following table sets forth certain information at September 30, 2010 regarding the dollar amount of loans maturing in the Bank's portfolio based on their contractual terms to maturity, but does not include scheduled payments or potential prepayments. Loans having no stated maturity and overdrafts are reported as due in one year or less.

|                        |           | After<br>1 Year | After<br>3 Years | After<br>5 Years | After<br>10 Years | After<br>10 Years | Total     |
|------------------------|-----------|-----------------|------------------|------------------|-------------------|-------------------|-----------|
| Within                 | Through   | Through         | Through          | Through          | Through           | Through           | Total     |
| 1 Year                 | 3 Years   | 5 Years         | 10 Years         | 10 Years         | 10 Years          | 10 Years          | Total     |
| -----                  | -----     | -----           | -----            | -----            | -----             | -----             | -----     |
| (In thousands)         |           |                 |                  |                  |                   |                   |           |
| Mortgage loans:        |           |                 |                  |                  |                   |                   |           |
| One- to four-family    |           |                 |                  |                  |                   |                   |           |
| (1).....               | \$ 2,718  | \$ 8,252        | \$ 1,255         | \$ 12,242        | \$ 96,547         |                   | \$121,014 |
| Multi-family.....      | 5,482     | 2,698           | 1,066            | 22,466           | 555               |                   | 32,267    |
| Commercial.....        | 9,348     | 31,728          | 37,132           | 123,488          | 6,306             |                   | 208,002   |
| Construction and       |           |                 |                  |                  |                   |                   |           |
| land development(2) .. | 67,820    | 1,451           | -                | -                | -                 |                   | 69,271    |
| Land.....              | 32,770    | 20,974          | 5,217            | 2,211            | 1,827             |                   | 62,999    |
| Consumer loans:        |           |                 |                  |                  |                   |                   |           |
| Home equity and second |           |                 |                  |                  |                   |                   |           |
| mortgage.....          | 10,589    | 1,614           | 748              | 8,149            | 17,318            |                   | 38,418    |
| Other.....             | 3,323     | 1,267           | 228              | 779              | 3,489             |                   | 9,086     |
| Commercial business    |           |                 |                  |                  |                   |                   |           |
| loans.....             | 9,453     | 1,445           | 1,002            | 4,704            | 1,375             |                   | 17,979    |
| Total.....             | \$141,503 | \$69,429        | \$46,648         | \$174,039        | \$127,417         |                   | \$559,036 |
|                        | =====     | =====           | =====            | =====            | =====             |                   | =====     |
| Less:                  |           |                 |                  |                  |                   |                   |           |
| Undisbursed portion    |           |                 |                  |                  |                   |                   |           |
| of construction        |           |                 |                  |                  |                   |                   |           |
| loans in process.....  |           |                 |                  |                  |                   |                   | (17,952)  |
| Deferred loan          |           |                 |                  |                  |                   |                   |           |
| origination fees.....  |           |                 |                  |                  |                   |                   | (2,229)   |
| Allowance for loan     |           |                 |                  |                  |                   |                   |           |

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|                               |           |
|-------------------------------|-----------|
| losses.....                   | (11,264)  |
|                               | -----     |
| Loans receivable,<br>net..... | \$527,591 |
|                               | =====     |

- 
- (1) Includes \$3.0 million of loans held-for-sale.  
(2) Includes construction/permanent loans that convert to permanent mortgage loans once construction is completed.

The following table sets forth the dollar amount of all loans due after one year from September 30, 2010, which have fixed interest rates and have floating or adjustable interest rates.

|                                       | Fixed<br>Rates | Floating or<br>Adjustable Rates | Total     |
|---------------------------------------|----------------|---------------------------------|-----------|
|                                       | -----          | -----                           | -----     |
|                                       | (In thousands) |                                 |           |
| Mortgage loans:                       |                |                                 |           |
| One- to four-family(1).....           | \$ 54,876      | \$ 63,420                       | \$118,296 |
| Multi-family.....                     | 3,352          | 23,433                          | 26,785    |
| Commercial.....                       | 31,935         | 166,719                         | 198,654   |
| Construction and land development.... | --             | 1,451                           | 1,451     |
| Land.....                             | 24,983         | 5,246                           | 30,229    |
| Consumer loans:                       |                |                                 |           |
| Home equity and second mortgage.....  | 18,049         | 9,780                           | 27,829    |
| Other.....                            | 5,659          | 104                             | 5,763     |
| Commercial business loans.....        | 4,071          | 4,455                           | 8,523     |
|                                       | -----          | -----                           | -----     |
| Total.....                            | \$142,925      | \$274,608                       | \$417,533 |
|                                       | =====          | =====                           | =====     |

- 
- (1) Includes loans held-for-sale.

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

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

Loan applications are initiated by loan officers and are required to be

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approved by an authorized loan underwriter, one of the Bank's Loan Committees or the Bank's Board of Directors. The Bank's Consumer Loan Committee consists of three underwriters, each of whom can approve one- to four-family mortgage loans and other consumer loans up to and including the current FHLMC single-family limit. Certain consumer loans up to and including \$25,000 may be approved by individual loan officers and the Bank's Consumer Lending Department Manager may approve consumer loans up to and including \$75,000. The Bank's Regional Manager of Commercial Lending has individual lending authority for loans up to and including \$250,000, excluding speculative construction loans and unsecured loans. The Bank's Commercial Loan Committee, which consists of the Bank's President, Chief Credit Administrator, Executive Vice President of Commercial Lending, Executive Vice President of Community Lending, and Regional Manager of Commercial Lending, may approve commercial real estate loans and commercial business loans up to and including \$1.5 million. The Bank's President, Chief Credit Administrator, Executive Vice President of Commercial Lending and Executive Vice President of Community Lending also have individual lending authority for loans up to and including \$750,000. The Bank's Board Loan Committee, which consists of two rotating non-employee Directors and the Bank's President, may approve loans up to and including \$3.0 million. Loans in excess of \$3.0 million, as well as loans of any amount granted to a single borrower whose aggregate loans exceed \$3.0 million, must be approved by the Bank's Board of Directors.

Loan Originations, Purchases and Sales. During the years ended September 30, 2010 and 2009, the Bank's total gross loan originations were \$182.5 million and \$295.3 million, respectively. Periodically, the Bank purchases participation interests in construction and land development loans, commercial real estate loans, and multi-family loans, secured by properties generally located in Washington State, from other lenders. These purchases are underwritten to the Bank's underwriting guidelines and are without recourse to the seller other than for fraud. There were no loan participation interests purchased during the year ended September 30, 2010. During the year ended September 30, 2009, the Bank purchased loan participation interests of \$1.6 million. The Bank also periodically purchases contracts secured by one- to four-family residences from individuals. During the year ended September 30, 2010, the Bank purchased contracts totaling \$50,000. See "- Lending Activities - Construction and Land Development Lending" and "- Lending Activities - Multi-Family Lending."

Consistent with its asset/liability management strategy, the Bank's policy generally is to retain in its portfolio all ARM loans originated and to sell fixed rate one- to four-family mortgage loans in the secondary market to the FHLMC; however, from time to time, a portion of fixed-rate loans may be retained in the Bank's portfolio to meet its asset-liability objectives. Loans sold in the secondary market are generally sold on a servicing retained basis. At September 30, 2010, the Bank's loan servicing portfolio, which is not included in the Company's consolidated financial statements, totaled \$280.9 million.

The Bank also periodically sells participation interests in construction and land development loans, commercial real estate loans, and land loans to other lenders. These sales are usually made to avoid concentrations in a particular loan type or concentrations to a particular borrower. The Bank did not sell any loan participation interests to other lenders during the years ended September 30, 2010 and 2009.

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

|   | Year Ended September 30, |             |           |
|---|--------------------------|-------------|-----------|
|   | 2010                     | 2009        | 2008      |
| Loans originated:                                   | (In thousands)           |             |           |
| Mortgage loans:                                     |                          |             |           |
| One- to four-family.....                            | \$ 72,015                | \$ 165,972  | \$ 45,844 |
| Multi-family.....                                   | 7,772                    | 1,036       | 4,710     |
| Commercial.....                                     | 27,248                   | 43,821      | 29,306    |
| Construction and land development.....              | 35,369                   | 56,287      | 118,186   |
| Land.....   | 11,712                   | 6,519       | 25,858    |
| Consumer.....                                       | 10,286                   | 14,080      | 22,411    |
| Commercial business loans.....                      | 18,130                   | 7,601       | 12,268    |
|   | 182,532                  | 295,316     | 258,583   |
| Loans purchased:                                    |                          |             |           |
| Mortgage loans:                                     |                          |             |           |
| One- to four-family.....                            | 50                       | --          | --        |
| Commercial.....                                     | --                       | 1,606       | --        |
| Construction and land development.....              | --                       | --          | 2,862     |
|   | 50                       | 1,606       | 2,862     |
| Total loans originated and purchased..              | 182,582                  | 296,922     | 261,445   |
| Loans sold:   |                          |             |           |
| Whole loans sold.....                               | (68,330)                 | (162,913)   | (45,269)  |
| Participation loans sold.....                       | --                       | --          | (17,035)  |
|   | (68,330)                 | (162,913)   | (62,304)  |
| Loan principal repayments.....                      | (150,333)                | (150,729)   | (176,083) |
| Other items, net.....                               | 16,464                   | 6,241       | 19,288    |
|   | (133,869)                | (144,488)   | (156,795) |
| Net increase (decrease) in loans<br>receivable..... | \$ (19,617)              | \$ (10,479) | \$ 42,346 |

Loan Origination Fees. The Bank receives loan origination fees on many of its mortgage loans and commercial business loans. Loan fees are a percentage of the loan which are charged to the borrower for funding the loan. The amount of fees charged by the Bank is generally 0.0% to 2.0% of the loan amount. Current accounting principles generally accepted in the United States of America require fees received and certain loan origination costs for originating loans to be deferred and amortized into interest income over the contractual life of the loan. Net deferred fees or costs associated with loans that are prepaid are recognized as income at the time of prepayment. Unamortized deferred loan origination fees totaled \$2.2 million at September 30, 2010.

Non-performing Loans and Delinquencies. The Bank assesses late fees or penalty charges on delinquent loans of approximately 5% of the monthly loan payment amount. A majority of loan payments are due on the first day of the month; however, the borrower is given a 15 day grace period to make the loan payment. When a mortgage loan borrower fails to make a required payment when due, the Bank institutes collection procedures. A notice is mailed to the borrower 16 days after the date the payment is due. Attempts to contact the borrower by telephone generally begin on or before the 30th day of delinquency. If a satisfactory response is not obtained, continuous follow-up

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contacts are attempted until the loan has been brought current. Before the 90th day of delinquency, attempts are made to establish (i) the cause of the delinquency, (ii) whether the cause is temporary, (iii) the attitude of the borrower toward the debt, and (iv) a mutually satisfactory arrangement for curing the default.

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

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

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

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

|  | At September 30, |          |        |        |       |
|--|------------------|----------|--------|--------|-------|
|  | 2010             | 2009     | 2008   | 2007   | 2006  |
|  | -----            |          |        |        |       |
|  | (In thousands)   |          |        |        |       |
| Loans accounted for on a non-accrual basis:                          |                  |          |        |        |       |
| Mortgage loans:  |                  |          |        |        |       |
| One- to four-family.....   | \$ 3,691         | \$ 1,343 | \$ 300 | \$ 252 | \$ 80 |
| Commercial.....  | 7,252            | 5,004    | 714    | 90     | --    |
| Construction and land development.....                               | 7,609            | 17,594   | 9,840  | 1,000  | --    |
| Land.....  | 5,460            | 5,023    | 726    | 28     | --    |
| Consumer loans.....  | 806              | 258      | 160    | --     | --    |
| Commercial business loans...   | 46               | 65       | 250    | 120    | --    |
|  | -----            | -----    | -----  | -----  | ----- |
| Total.....   | 24,864           | 29,287   | 11,990 | 1,490  | 80    |
| Accruing loans which are contractually past due 90 days or more..... | 1,325            | 796      | --     | --     | --    |
|  | -----            | -----    | -----  | -----  | ----- |
| Total of non-accrual and 90 days past due loans.....                 | 26,189           | 30,083   | 11,990 | 1,490  | 80    |
| Non-accrual investment securities.....                               | 3,390            | 477      | --     | --     | --    |
| Other real estate owned and  |                  |          |        |        |       |

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|   |           |           |           |           |           |
|---|-----------|-----------|-----------|-----------|-----------|
| other repossessed assets...   | 11,519    | 8,185     | 511       | --        | 15        |
|   | -----     | -----     | -----     | -----     | -----     |
| Total non-performing<br>assets (1).....   | \$ 41,098 | \$ 38,745 | \$ 12,501 | \$ 1,490  | \$ 95     |
|   | =====     | =====     | =====     | =====     | =====     |
| Troubled debt restructured<br>loans on accrual status<br>(2).....                                     | \$ 8,995  | \$ --     | \$ 272    | \$ --     | \$ --     |
| Non-accrual and 90 days<br>or more past due loans<br>as a percentage of loans<br>receivable, net..... | 4.86%     | 5.36%     | 2.12%     | 0.29%     | 0.02%     |
| Non-accrual and 90 days or<br>more past due loans as a<br>percentage of total<br>assets.....          | 3.53%     | 4.28%     | 1.76%     | 0.23%     | 0.01%     |
| Non-performing assets as a<br>percentage of total<br>assets.....                                      | 5.53%     | 5.52%     | 1.83%     | 0.23%     | 0.02%     |
| Loans receivable, net (3)...  | \$538,855 | \$561,380 | \$565,737 | \$520,138 | \$428,767 |
|   | =====     | =====     | =====     | =====     | =====     |
| Total assets.....   | \$742,687 | \$701,676 | \$681,883 | \$644,848 | \$577,087 |
|   | =====     | =====     | =====     | =====     | =====     |

- 
- (1) Does not include troubled debt restructured loans on accrual status.
  - (2) Does not include troubled debt restructured loans totaling \$7.4 million and \$9.5 million reported as non-accrual loans at September 30, 2010 and 2009, respectively.
  - (3) Includes loans held-for-sale and is before the allowance for loan losses.

The Bank's non-accrual loans decreased by \$4.4 million to \$24.9 million at September 30, 2010 from \$29.3 million at September 30, 2009, primarily as a result of a \$10.0 million decrease in construction and land development

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loans on non-accrual status, which was partially offset by a \$2.3 million increase in one to four-family loans on non-accrual status and a \$2.2 million increase in commercial real estate loans on non-accrual status. The largest non-performing loan was secured by a mini-storage facility in King County and had a balance of \$2.7 million at September 30, 2010. A discussion of our largest non-performing loans is set forth below under "Asset Classification."

Additional interest income which would have been recorded for the year ended September 30, 2010 had non-accruing loans been current in accordance with their original terms totaled \$3.0 million.

Other Real Estate Owned and Other Repossessed Assets. Real estate acquired by the Bank as a result of foreclosure or by deed-in-lieu of foreclosure is classified as other real estate owned ("OREO") until sold. When property is acquired, it is recorded at the estimated fair market value

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less estimated costs to sell. At September 30, 2010, the Bank had \$11.5 million of OREO and other repossessed assets consisting of 27 individual properties and three other repossessed assets, an increase of \$3.3 million from \$8.2 million at September 30, 2009. The OREO properties consisted of two condominium projects totaling \$3.9 million, three land development projects totaling \$3.3 million, eight single family homes totaling \$1.7 million, 11 land parcels totaling \$1.4 million and three commercial real estate properties totaling \$1.1 million.

**Restructured Loans.** Under accounting principles generally accepted in the United States of America, the Bank is required to account for certain loan modifications or restructurings as "troubled debt restructurings." In general, the modification or restructuring of a debt constitutes a troubled debt restructuring if the Bank for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrowers that the Bank would not otherwise consider. Debt restructuring or loan modifications for a borrower does not necessarily always constitute troubled debt restructuring, however, and troubled debt restructurings do not necessarily result in non-accrual loans. The Bank had restructured loans totaling \$16.4 million at September 30, 2010, of which \$7.4 million were on non-accrual status.

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

The categories of non-accrual loans and impaired loans overlap, although they are not coextensive. The Bank considers all circumstances regarding the loan and borrower on an individual basis when determining whether an impaired loan should be placed on non-accrual status, such as the financial strength of the borrower, the collateral value, reasons for delay, payment record, the amount of past due and the number of days past due. At September 30, 2010, the Bank had \$42.2 million in impaired loans. For additional information on impaired loans, see Note 4 of the Notes to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K.

**Other Loans of Concern.** Loans not reflected in the table above, but where known information about possible credit problems of borrowers causes management to have doubts as to the ability of the borrower to comply with present repayment terms and that may result in disclosure of such loans as non-performing assets in the future are commonly referred to as "other loans of concern" or "potential problem loans." The amount included in potential problem loans results from an evaluation, on a loan-by-loan basis, of loans classified as "substandard" and "special mention," as those terms are defined under "Asset Classification" below. The amount of potential problem loans was \$43.7 million at September 30, 2010 and \$54.8 million at September 30, 2009. The vast majority of these loans are collateralized by real estate. See "Asset Classification" below for additional information regarding our problem loans.

**Asset Classification.** Applicable regulations require that each insured institution review and classify its assets on a regular basis. In addition, in connection with examinations of insured institutions, regulatory examiners have authority to identify problem assets and, if appropriate, require them to be classified. There are three classifications for problem assets: substandard, doubtful and loss. Substandard assets have one or more defined weaknesses and are characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not



corrected. Doubtful assets have the weaknesses of substandard assets with the additional characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. An asset classified as loss is considered uncollectible and of such little value that continuance as an asset of the institution is not warranted. When an insured institution classifies problem assets as either substandard or doubtful, it is required to establish allowances for loan losses in an amount deemed prudent by management. These allowances represent loss allowances which have been established to recognize the inherent risk associated with lending activities and the risks associated with particular problem assets. When an insured institution classifies problem assets as loss, it charges off the balance of the asset against the allowance for loan losses. Assets which do not currently expose the insured institution to sufficient risk to warrant classification in one of the aforementioned categories but possess weaknesses are required to be designated as special mention. The Bank's determination of the classification of its assets and the amount of its valuation allowances is subject to review by the FDIC and the Division which can require the establishment of additional loss allowances.

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

|  | At September 30, |          |          |
|--|------------------|----------|----------|
|  | 2010             | 2009     | 2008     |
|  | (In thousands)   |          |          |
| Loss.....  | \$ --            | \$ --    | \$ --    |
| Doubtful.....                                      | --               | --       | --       |
| Substandard(1) (2).....                            | 56,796           | 63,188   | 24,603   |
| Special mention(1).....                            | 13,070           | 21,711   | 18,225   |
| Total classified and special<br>mention loans..... | \$69,866         | \$84,899 | \$42,828 |
| Allowance for loan losses.....                     | \$11,264         | \$14,172 | \$ 8,050 |

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

(2) Includes non-performing loans.

The Bank's classified and special mention loans decreased by \$15.0 million from September 30, 2009 to September 30, 2010, primarily as a result of a \$6.4 million decrease in loans classified as substandard and a \$8.6 million decrease in loans classified as special mention.

Special mention loans are defined as those credits deemed by management to have some potential weakness that deserve management's close attention. If left uncorrected these potential weaknesses may result in the deterioration of the payment prospects of the loan. Assets in this category are not adversely

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classified and currently do not expose the Bank to sufficient risk to warrant a substandard classification. Eight individual loans comprised \$8.9 million, or 68.4%, of the \$13.1 million in loans classified as special mention. They include two commercial real estate loans totaling \$3.3 million, three land loans totaling \$2.6 million, two condominium construction loans totaling \$2.1 million and one condominium construction loan with a balance of \$975,000. At September 30, 2010 these loans were current and paying in accordance with their required terms.

Substandard loans are classified as those loans that are inadequately protected by the current net worth, and paying capacity of the obligor, or of the collateral pledged. Assets classified as substandard have a well-defined weakness, or weaknesses that jeopardize the repayment of the debt. If the weakness, or weaknesses are not corrected there is the distinct possibility that some loss will be sustained. The aggregate amount of loans classified as substandard at September 30, 2010 decreased by \$6.4 million to \$56.8 million from \$63.2 million at September 30, 2009. At September 30, 2010, 146 loans were classified as substandard compared to 121 at September 30, 2009.

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Of the \$56.8 million in loans classified as substandard at September 30, 2010, \$24.9 million were on non-accrual status and \$1.3 million were past due 90 days or more and still accruing. Troubled debt restructured loans totaling \$16.4 million were classified as substandard at September 30, 2010, with \$7.4 million in troubled debt restructured loans on non-accrual status and \$9.0 million in troubled debt restructured loans on accrual status. The largest loan classified as substandard at September 30, 2010 had a balance of \$4.6 million and was secured by a mini-storage facility in Pierce County. This loan was 60 days past due at September 30, 2010. The next largest loan classified as substandard at September 30, 2010 had a balance of \$3.4 million and was secured by an apartment building in King County. This loan was performing according to its loan repayment terms at September 30, 2010.

Allowance for Loan Losses. The allowance for loan losses is maintained to cover estimated losses in the loan portfolio. The Bank has established a comprehensive methodology for the determination of provisions for loan losses that takes into consideration the need for an overall general valuation allowance. The Bank's methodology for assessing the adequacy of its allowance for loan losses is based on its historic loss experience for various loan segments; adjusted for changes in economic conditions, delinquency rates, and other factors. Using these loss estimate factors, management develops a range of probable loss for each loan category. Certain individual loans for which full collectibility may not be assured are evaluated individually with loss exposure based on estimated discounted cash flows or net realizable collateral values. The total estimated range of loss based on these two components of the analysis is compared to the loan loss allowance balance. Based on this review, management will adjust the allowance as necessary to maintain directional consistency with trends in the loan portfolio.

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

The Board of Directors reviews the adequacy of the allowance for loan

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losses at least quarterly based on management's assessment of current economic conditions, past loss and collection experience, and risk characteristics of the loan portfolio.

At September 30, 2010, the Bank's allowance for loan losses totaled \$11.3 million. This represents 2.09% of the total loans receivable and 43.01% of non-performing loans. The Bank's allowance for loan losses as a percentage of total loans receivable has decreased to 2.09% at September 30, 2010 from 2.52% at September 30, 2009 primarily due to a decrease in the level of non-performing loans, a decrease in the level of classified loans and a decrease in Bank's construction and land development loan balances.

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

While the Bank believes it has established its existing allowance for loan losses in accordance with accounting principles generally accepted in the United States of America, there can be no assurance that regulators, in reviewing the Bank's loan portfolio, will not request the Bank to increase significantly its allowance for loan losses. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is adequate or that substantial increases will not be necessary should the quality of any loans deteriorate as a result of the factors discussed above. Any material increase in the allowance for loan losses may adversely affect the Bank's financial condition and results of operations.

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The following table sets forth an analysis of the Bank's allowance for loan losses for the periods indicated.

|                                      | Year Ended September 30, |          |         |         |         |
|--------------------------------------|--------------------------|----------|---------|---------|---------|
|                                      | 2010                     | 2009     | 2008    | 2007    | 2006    |
|                                      | (Dollars in thousands)   |          |         |         |         |
| Allowance at beginning of year.....  | \$14,172                 | \$ 8,050 | \$4,797 | \$4,122 | \$4,099 |
| Provision for loan losses...         | 10,550                   | 10,734   | 3,900   | 686     | --      |
| Allocated to loan commitments.....   | --                       | (169)    | --      | --      | --      |
| Recoveries:                          |                          |          |         |         |         |
| Mortgage loans:                      |                          |          |         |         |         |
| Commercial.....                      | 13                       | --       | --      | --      | --      |
| Construction.....                    | 104                      | --       | --      | --      | --      |
| Land.....                            | 153                      | 83       | --      | --      | --      |
| Consumer loans:                      |                          |          |         |         |         |
| Home equity and second mortgage..... | 86                       | --       | --      | --      | --      |
| Other.....                           | 6                        | 5        | 1       | 1       | 5       |

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|                              |          |          |         |         |           |
|------------------------------|----------|----------|---------|---------|-----------|
| Commercial business loans... | --       | --       | --      | --      | 20        |
|                              | -----    | -----    | -----   | -----   | -----     |
| Total recoveries.....        | 362      | 88       | 1       | 1       | 25        |
| Charge-offs:                 |          |          |         |         |           |
| Mortgage loans:              |          |          |         |         |           |
| One- to four-family.....     | 200      | 46       | --      | --      | --        |
| Construction.....            | 8,012    | 3,108    | 648     | --      | --        |
| Commercial.....              | 1,888    | 235      | --      | --      | --        |
| Land.....                    | 3,285    | 705      | --      | --      | --        |
| Consumer loans:              |          |          |         |         |           |
| Home equity and second       |          |          |         |         |           |
| mortgage.....                | 399      | 162      | --      | --      | --        |
| Other.....                   | 36       | 25       | --      | 12      | 2         |
| Commercial business loans... | --       | 250      | --      | --      | --        |
|                              | -----    | -----    | -----   | -----   | -----     |
| Total charge-offs.....       | 13,820   | 4,531    | 648     | 12      | 2         |
|                              | -----    | -----    | -----   | -----   | -----     |
| Net charge-offs              |          |          |         |         |           |
| (recoveries).....            | 13,458   | 4,443    | 647     | 11      | (23)      |
|                              | -----    | -----    | -----   | -----   | -----     |
| Balance at end of year....   | \$11,264 | \$14,172 | \$8,050 | \$4,797 | \$4,122   |
|                              | =====    | =====    | =====   | =====   | =====     |
| Allowance for loan losses    |          |          |         |         |           |
| as a percentage of total     |          |          |         |         |           |
| loans receivable (net) (1)   |          |          |         |         |           |
| outstanding at the end of    |          |          |         |         |           |
| the year.....                |          |          |         |         |           |
|                              | 2.09%    | 2.52%    | 1.42%   | 0.92%   | 0.96%     |
| Net charge-offs (recoveries) |          |          |         |         |           |
| as a percentage of average   |          |          |         |         |           |
| loans outstanding during     |          |          |         |         |           |
| the year.....                |          |          |         |         |           |
|                              | 2.45%    | 0.79%    | 0.12%   | 0.00%   | (0.01%)   |
| Allowance for loan losses    |          |          |         |         |           |
| as a percentage of non-      |          |          |         |         |           |
| performing loans at end      |          |          |         |         |           |
| of year.....                 |          |          |         |         |           |
|                              | 43.01%   | 47.11%   | 67.14%  | 321.95% | 5,152.50% |

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

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

| At September 30,    |                     |                     |                     |       |
|---------------------|---------------------|---------------------|---------------------|-------|
| -----               | -----               | -----               | -----               | ----- |
| 2010                | 2009                | 2008                | 2007                |       |
| -----               | -----               | -----               | -----               | ----- |
| Percent<br>of Loans | Percent<br>of Loans | Percent<br>of Loans | Percent<br>of Loans |       |

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|                        | Amount   | in<br>Category<br>to Total<br>Loans | Amount   | in<br>Category<br>to Total<br>Loans | Amount  | in<br>Category<br>to Total<br>Loans | Amount  | in<br>Category<br>to Total<br>Loans | Amount  |
|------------------------|----------|-------------------------------------|----------|-------------------------------------|---------|-------------------------------------|---------|-------------------------------------|---------|
|                        | -----    | -----                               | -----    | -----                               | -----   | -----                               | -----   | -----                               | -----   |
| (Dollars in thousands) |          |                                     |          |                                     |         |                                     |         |                                     |         |
| Mortgage loans:        |          |                                     |          |                                     |         |                                     |         |                                     |         |
| One- to four-          |          |                                     |          |                                     |         |                                     |         |                                     |         |
| family.....            | \$ 530   | 21.65%                              | \$ 616   | 18.58%                              | \$ 476  | 18.35%                              | \$ 396  | 17.40%                              | \$ 502  |
| Multi-family..         | 392      | 5.77                                | 431      | 4.31                                | 248     | 4.24                                | 200     | 5.97                                | 112     |
| Commercial....         | 3,173    | 37.21                               | 2,719    | 31.63                               | 1,521   | 23.90                               | 1,368   | 21.72                               | 1,222   |
| Construction..         | 1,626    | 12.39                               | 5,132    | 23.48                               | 3,254   | 30.46                               | 1,047   | 31.64                               | 761     |
| Land.....              | 3,709    | 11.27                               | 3,348    | 11.03                               | 1,435   | 9.92                                | 549     | 10.30                               | 275     |
| Non-mortgage loans:    |          |                                     |          |                                     |         |                                     |         |                                     |         |
| Consumer               |          |                                     |          |                                     |         |                                     |         |                                     |         |
| loans.....             | 461      | 8.49                                | 1,216    | 8.66                                | 457     | 9.69                                | 412     | 9.88                                | 497     |
| Commercial             |          |                                     |          |                                     |         |                                     |         |                                     |         |
| business               |          |                                     |          |                                     |         |                                     |         |                                     |         |
| loans.....             | 1,373    | 3.22                                | 710      | 2.31                                | 659     | 3.44                                | 825     | 3.09                                | 753     |
|                        | -----    | -----                               | -----    | -----                               | -----   | -----                               | -----   | -----                               | -----   |
| Total                  |          |                                     |          |                                     |         |                                     |         |                                     |         |
| allowance              |          |                                     |          |                                     |         |                                     |         |                                     |         |
| for loan               |          |                                     |          |                                     |         |                                     |         |                                     |         |
| losses.....            | \$11,264 | 100.00%                             | \$14,172 | 100.00%                             | \$8,050 | 100.00%                             | \$4,797 | 100.00%                             | \$4,122 |
|                        | =====    | =====                               | =====    | =====                               | =====   | =====                               | =====   | =====                               | =====   |

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Investment Activities

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

At September 30, 2010, the Company's investment portfolio totaled \$16.2 million, primarily consisting of \$10.1 million of mortgage-backed securities available-for-sale, \$988,000 of mutual funds available-for-sale, and \$5.0 million of mortgaged-backed securities held-to-maturity. The Company does not maintain a trading account for any investments. This compares with a total investment portfolio of \$20.6 million at September 30, 2009, primarily consisting of \$968,000 of mutual funds available-for-sale, \$12.5 million of mortgage-backed securities available-for-sale, and \$7.1 million of mortgage-backed securities held-to-maturity. The composition of the portfolios by type of security, at each respective date is presented in the following table.

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At September 30,

|  | 2010           |                  | 2009           |                  | 2008           |                  |
|--|----------------|------------------|----------------|------------------|----------------|------------------|
|  | Recorded Value | Percent of Total | Recorded Value | Percent of Total | Recorded Value | Percent of Total |
| (Dollars in thousands)                 |                |                  |                |                  |                |                  |
| Held-to-Maturity:                      |                |                  |                |                  |                |                  |
| U.S. agency securities.....            | \$ 28          | 0.17%            | \$ 27          | 0.13%            | \$ 28          | 0.09%            |
| Mortgage-backed securities.....        | 5,038          | 31.13            | 7,060          | 34.34            | 14,205         | 45.34            |
| Available-for-Sale<br>(at fair value): |                |                  |                |                  |                |                  |
| Mortgage-backed securities.....        | 10,131         | 62.59            | 12,503         | 60.82            | 16,162         | 51.58            |
| Mutual funds.....                      | 988            | 6.11             | 968            | 4.71             | 936            | 2.99             |
| Total portfolio.....                   | \$16,185       | 100.00%          | \$20,558       | 100.00%          | \$31,331       | 100.00%          |

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The following table sets forth the maturities and weighted average yields of the investment and mortgage-backed securities in the Company's investment securities portfolio at September 30, 2010. Mutual funds, which by their nature do not have maturities, are classified in the one year or less category.

|                            | One Year or Less |       | After One to Five Years |       | After Five to Ten Years |       | After Year |
|----------------------------|------------------|-------|-------------------------|-------|-------------------------|-------|------------|
|                            | Amount           | Yield | Amount                  | Yield | Amount                  | Yield | Amount     |
| (Dollars in thousands)     |                  |       |                         |       |                         |       |            |
| Held-to-Maturity:          |                  |       |                         |       |                         |       |            |
| U.S. agency securities     | \$ --            | --%   | \$ 14                   | 3.25% | \$ 14                   | 3.98% | \$ --      |
| Mortgage-backed securities | --               | --    | 5                       | 4.90  | 26                      | 4.73  | 5,007      |
| Available-for-Sale:        |                  |       |                         |       |                         |       |            |
| Mortgage-backed securities | 271              | 0.88  | 9                       | 5.53  | 141                     | 5.92  | 9,710      |
| Mutual funds               | 988              | 3.30  | --                      | --    | --                      | --    | --         |
| Total portfolio            | \$1,259          | 2.78% | \$ 28                   | 4.27% | \$181                   | 5.58% | \$14,717   |

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There were no securities which had an aggregate book value in excess of 10% of the Company's total equity at September 30, 2010. At September 30, 2010, the Company had \$5.0 million of private label mortgage backed securities of which \$3.4 million was on non-accrual status. The private label mortgage backed securities were acquired from the in-kind redemption of the Company's investment in the AMF family of mutual funds in June 2008. For additional information regarding investment securities, see "Item 1A, Risk Factors Other-than-temporary impairment charges in our investment securities portfolio could result in additional losses" and Note 3 of the Notes to the Consolidated Financial Statements included in Item 8 of this Annual Report on Form 10-K.

Deposit Activities and Other Sources of Funds

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

Deposit Accounts. Substantially all of the Bank's depositors are residents of Washington. Deposits are attracted from within the Bank's market area through the offering of a broad selection of deposit instruments, including money market deposit accounts, checking accounts, regular savings accounts and certificates of deposit. Deposit account terms vary, according to the minimum balance required, the time periods the funds must remain on deposit and the interest rate, among other factors. In determining the terms of its deposit accounts, the Bank considers current market interest rates, profitability to the Bank, matching deposit and loan products and its customer preferences and concerns. The Bank actively seeks consumer and commercial checking accounts through a checking account acquisition marketing program that was implemented in 2000. At September 30, 2010, the Bank had 36.6% of total deposits in non-interest bearing accounts and NOW checking accounts.

At September 30, 2010 the Bank had \$93.0 million of jumbo certificates of deposit of \$100,000 or more. The Bank had no brokered certificates of deposits at September 30, 2010. The Bank believes that its jumbo certificates of deposit, which represented 16.1% of total deposits at September 30, 2010, present similar interest rate risk compared to its other deposits.

The following table sets forth information concerning the Bank's deposits at September 30, 2010.

| Category                  | Weighted<br>Average<br>Interest Rate | Amount         | Percentage<br>of Total<br>Deposits |
|---------------------------|--------------------------------------|----------------|------------------------------------|
|                           |                                      | (In thousands) |                                    |
| Non-interest bearing..... | --%                                  | \$ 58,755      | 10.15%                             |

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|   |       |           |         |
|---|-------|-----------|---------|
| Negotiable order of withdrawal ("NOW")            |       |           |         |
| checking.....                                     | 1.24  | 153,304   | 26.48   |
| Savings.....                                      | 0.71  | 67,448    | 11.65   |
| Money market.....                                 | 1.13  | 55,723    | 9.63    |
|   |       | -----     | -----   |
| Subtotal.....                                     | 1.09% | \$335,230 | 57.91%  |
| Certificates of Deposit(1)                        |       |           |         |
| -----   |       |           |         |
| Maturing within 1 year                            | 1.63% | \$177,911 | 30.73%  |
| Maturing after 1 year but within 2<br>years.....  | 1.91  | 43,032    | 7.43    |
| Maturing after 2 years but within 5<br>years..... | 3.03  | 22,386    | 3.87    |
| Maturing after 5 years.....                       | 2.53  | 310       | 0.05    |
|   |       | -----     | -----   |
| Total certificates of deposit.....                | 1.81  | 243,639   | 42.09   |
|   |       | -----     | -----   |
| Total deposits.....                               | 1.39% | \$578,869 | 100.00% |
|   |       | =====     | =====   |

(1) Based on remaining maturity of certificates.

The following table indicates the amount of the Bank's jumbo certificates of deposit by time remaining until maturity as of September 30, 2010. Jumbo certificates of deposit have principal balances of \$100,000 or more and the rates paid on these accounts are generally negotiable.

| Maturity Period                   | Amount         |
|-----------------------------------|----------------|
| -----                             | -----          |
|                                   | (In thousands) |
| Three months or less.....         | \$23,157       |
| Over three through six months.... | 20,549         |
| Over six through twelve months... | 26,715         |
| Over twelve months.....           | 22,585         |
|                                   | -----          |
| Total.....                        | \$93,006       |
|                                   | =====          |

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

| At September 30, |                        |                        |        |                        |                        |        |
|------------------|------------------------|------------------------|--------|------------------------|------------------------|--------|
| 2010             |                        |                        | 2009   |                        |                        | 2      |
| -----            | -----                  | -----                  | -----  | -----                  | -----                  | -----  |
| Amount           | Percent<br>of<br>Total | Increase<br>(Decrease) | Amount | Percent<br>of<br>Total | Increase<br>(Decrease) | Amount |
| -----            | -----                  | -----                  | -----  | -----                  | -----                  | -----  |



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(Dollars in thousands)

|   |           |         |          |           |         |            |         |
|---|-----------|---------|----------|-----------|---------|------------|---------|
| Non-interest-bearing....                  | \$ 58,755 | 10.15%  | \$ 8,460 | \$ 50,295 | 9.95%   | \$ (1,660) | \$ 51,9 |
| NOW checking.....                         | 153,304   | 26.48   | 35,947   | 117,357   | 23.21   | 26,889     | 90,4    |
| Savings.....                              | 67,448    | 11.65   | 8,839    | 58,609    | 11.59   | 2,218      | 56,3    |
| Money market.....                         | 55,723    | 9.63    | (6,755)  | 62,478    | 12.36   | (7,901)    | 70,3    |
| Certificates of deposit<br>which mature:  |           |         |          |           |         |            |         |
| Within 1 year.....                        | 177,911   | 30.74   | (4,374)  | 182,285   | 36.04   | 6,468      | 175,8   |
| After 1 year, but<br>within 2 years.....  | 43,032    | 7.43    | 20,445   | 22,587    | 4.47    | (23,820)   | 46,4    |
| After 2 years, but<br>within 5 years..... | 22,386    | 3.87    | 10,652   | 11,734    | 2.32    | 4,975      | 6,7     |
| Certificates maturing<br>thereafter.....  | 310       | 0.05    | (6)      | 316       | 0.06    | (80)       | 3       |
|   | -----     | -----   | -----    | -----     | -----   | -----      | -----   |
| Total.....                                | \$578,869 | 100.00% | \$73,208 | \$505,661 | 100.00% | \$7,089    | \$498,5 |
|   | =====     | =====   | =====    | =====     | =====   | =====      | =====   |

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

| At September 30,      |                |           |           |
|-----------------------|----------------|-----------|-----------|
|                       | 2010           | 2009      | 2008      |
|                       | -----          | -----     | -----     |
|                       | (In thousands) |           |           |
| 0.00 - 1.99%.....     | \$194,142      | \$ 59,466 | \$ 866    |
| 2.00 - 3.99%.....     | 48,059         | 146,513   | 203,859   |
| 4.00 - 5.99%.....     | 1,374          | 10,569    | 24,274    |
| 6.00% - and over..... | 64             | 374       | 380       |
|                       | -----          | -----     | -----     |
| Total.....            | \$243,639      | \$216,922 | \$229,379 |
|                       | =====          | =====     | =====     |

Certificates of Deposit by Maturities. The following table sets forth the amount and maturities of certificates of deposit at September 30, 2010.

| Amount Due          |                       |                        |                                  |                     |           |
|---------------------|-----------------------|------------------------|----------------------------------|---------------------|-----------|
|                     | Less Than<br>One Year | One to<br>Two<br>Years | After<br>Two to<br>Five<br>Years | After<br>Five Years | Total     |
|                     | -----                 | -----                  | -----                            | -----               | -----     |
|                     | (In thousands)        |                        |                                  |                     |           |
| 0.00 - 1.99%.....   | \$152,796             | \$39,880               | \$ 1,466                         | \$ --               | \$194,142 |
| 2.00 - 3.99%.....   | 24,741                | 2,509                  | 20,499                           | 310                 | 48,059    |
| 4.00 - 5.99%.....   | 310                   | 643                    | 421                              | --                  | 1,374     |
| 6.00% and over..... | 64                    | --                     | --                               | --                  | 64        |
|                     | -----                 | -----                  | -----                            | -----               | -----     |
| Total.....          | \$177,911             | \$43,032               | \$22,386                         | \$ 310              | \$243,639 |

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

|  | Year Ended September 30, |           |           |
|--|--------------------------|-----------|-----------|
|  | 2010                     | 2009      | 2008      |
|  | (In thousands)           |           |           |
| Beginning balance.....                                   | \$505,661                | \$498,572 | \$466,735 |
| Net deposits (withdrawals) before interest credited..... | 65,401                   | (2,383)   | 20,075    |
| Interest credited.....                                   | 7,807                    | 9,472     | 11,762    |
| Net increase in deposits.....                            | 73,208                   | 7,089     | 31,837    |
| Ending balance.....                                      | \$578,869                | \$505,661 | \$498,572 |

Borrowings. Deposits and loan repayments are generally the primary source of funds for the Bank's lending and investment activities and for general business purposes. The Bank has the ability to use advances from the FHLB-Seattle to supplement its supply of lendable funds and to meet deposit withdrawal requirements. The FHLB-Seattle functions as a central reserve bank providing credit for member financial institutions. As a member of the FHLB-Seattle, the Bank is required to own capital stock in the FHLB-Seattle and is authorized to apply for advances on the security of such stock and certain mortgage loans and other assets (principally securities which are obligations of, or guaranteed by, the United States government) provided certain creditworthiness standards have been met. Advances are made pursuant to several different credit programs. Each credit program has its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based on the financial condition of the member institution and the adequacy of collateral pledged to secure the credit. At September 30, 2010, the Bank maintained an uncommitted credit facility with the FHLB-Seattle that provided for immediately available advances up to an aggregate amount of 30% of the Bank's total assets, limited by available collateral, under which \$75.0 million was outstanding.

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The Bank also utilizes overnight repurchase agreements with customers. These overnight repurchase agreements are classified as other borrowings and totaled \$622,000 at September 30, 2010. The Bank also maintains a short-term borrowing line with the FRB with total credit based on eligible collateral. At September 30, 2010, the Bank had no outstanding balance and \$41.4 million in unused borrowing capacity on this borrowing line.

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

|  | At or For the<br>Year Ended September 30, |      |      |
|--|---|------|------|
|  | 2010                                      | 2009 | 2008 |
|  |   |      |      |

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|   | -----                  | -----     | -----     |
|---|------------------------|-----------|-----------|
|   | (Dollars in thousands) |           |           |
| Average total borrowings.....                       | \$ 75,408              | \$ 97,393 | \$108,858 |
| Weighted average rate paid on total borrowings..... | 4.03%                  | 4.14%     | 4.27%     |
| Total borrowings outstanding at end of period.....  | \$ 75,622              | \$105,777 | \$105,386 |

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

|  | At or For the<br>Year Ended September 30, |        |          |
|--|---|--------|----------|
|  | -----                                     | -----  | -----    |
|  | 2010                                      | 2009   | 2008     |
|  | (Dollars in thousands)                    |        |          |
| Maximum amount outstanding at any month end:         |   |        |          |
| FHLB advances.....                                   | \$ --                                     | \$ --  | \$42,600 |
| Repurchase agreements.....                           | 750                                       | 844    | 1,884    |
| Pacific Coast Bankers' Bank ("PCBB") borrowings..... | --  | --     | --       |
| FRB borrowings.....                                  | 10,000                                    | 10,000 | --       |
| Average outstanding during period:                   |   |        |          |
| FHLB advances.....                                   | \$ --                                     | \$ 15  | \$13,366 |
| Repurchase agreements.....                           | 539                                       | 624    | 943      |
| PCBB borrowings.....                                 | --  | 6      | 12       |
| FRB borrowings.....                                  | 384                                       | 27     | --       |
| Total average outstanding during period.....         | \$ 923                                    | \$ 672 | \$14,321 |
| Weighted average rate paid during period:            |   |        |          |
| FHLB advances.....                                   | --%                                       | 0.71%  | 4.44%    |
| Repurchase agreements.....                           | 0.05                                      | 0.08   | 2.12     |
| PCBB borrowings.....                                 | --  | 1.48   | 5.27     |
| FRB borrowings.....                                  | 0.66                                      | 0.50   | --       |
| Total weighted average rate paid during period.....  | 0.30                                      | 0.12   | 4.29     |

(table continued on following page)

|  | At or For the<br>Year Ended September 30, |       |       |
|--|---|-------|-------|
|  | -----                                     | ----- | ----- |
|  | 2010                                      | 2009  | 2008  |
|  | (Dollars in thousands)                    |       |       |

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Outstanding at end of period:

|   |        |          |        |
|---|--------|----------|--------|
| FHLB advances.....                      | \$ --  | \$ --    | \$ --  |
| Repurchase agreements.....              | 622    | 777      | 758    |
| PCBB borrowings.....                    | --     | --       | --     |
| FRB borrowings.....                     | --     | 10,000   | --     |
|   | -----  | -----    | -----  |
| Total outstanding at end of period..... | \$ 622 | \$10,777 | \$ 758 |
|   | =====  | =====    | =====  |

Weighted average rate at end of period:

|  |      |      |      |
|--|------|------|------|
| FHLB advances.....                             | --%  | %    | --%  |
| Repurchase agreements.....                     | 0.05 | 0.05 | 1.05 |
| PCBB borrowings.....                           | --   | --   | --   |
| FRB borrowings.....                            | --   | 0.50 | --   |
| Total weighted average rate at end of period.. | 0.05 | 0.50 | 1.05 |

### Bank Owned Life Insurance

The Bank has purchased life insurance policies covering certain officers. These policies are recorded at their cash surrender value, net of any cash surrender charges. Increases in cash surrender value, net of policy premiums, and proceeds from death benefits are recorded in non-interest income. At September 30, 2010, the Bank had \$13.4 million in bank owned life insurance.

### Regulation of the Bank

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

In December 2009, the FDIC and the Division agreed to terms on an informal supervisory agreement the Bank MOU. The terms of the Bank MOU restrict the Bank from certain activities, and require that the Bank obtain the prior written approval, or non-objection, of the FDIC and/or the DFI to engage in certain activities. In addition, on February 1, 2010, the FRB determined that the Company required additional supervisory attention and entered into the Company MOU. Under the Company MOU, the Company must among other things obtain prior written approval, or non-objection, from the FRB to declare or pay any dividends, or make any other capital distributions; issue any trust preferred securities; or purchase or redeem any of its stock. The FRB has denied the Company's requests to pay dividends on its Series A Preferred Stock issued under the CPP for the payments due May 15, 2010, August 15, 2010 and November 15, 2010. There can be no assurances that the FRB will approve such payments or dividends in the future. For additional information regarding the Bank MOU and the Company MOU, see "Item 1A, Risk Factors - The Company and the Bank are required to comply with the terms of separate memorandums of understanding issued by their respective regulators and lack of compliance could result in additional regulatory actions."

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Recent Legislative and Regulatory Initiatives to Address Financial and Economic Crises. Legislation is introduced from time to time in the United States Congress that may affect the Company's and the Bank's operations. In addition, the regulations governing the Company and the Bank may be amended from time to time by the FDIC. Any such legislation or regulatory changes could adversely affect the Company and the Bank and no prediction can be made as to whether any such changes may occur.

On July 21, 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act implements far-reaching changes across the financial regulatory landscape, including provisions that, among other things, will:

- \* Centralize responsibility for consumer financial protection by creating a new agency within the Federal Reserve Board, the Bureau of Consumer Financial Protection, with broad rulemaking, supervision and enforcement authority for a wide range of consumer protection laws that would apply to all banks and thrifts. Smaller financial institutions, including the Bank, will be subject to the supervision and enforcement of their primary federal banking regulator with respect to the federal consumer financial protection laws.
- \* Require the federal banking regulators to promulgate new capital regulations and seek to make their capital requirements countercyclical, so that capital requirements increase in times of economic expansion and decrease in times of economic contraction.
- \* Provide for new disclosure and other requirements relating to executive compensation and corporate governance.
- \* Change the assessment base for federal deposit insurance from deposits to average total assets minus tangible equity.
- \* Make permanent the \$250,000 limit for federal deposit insurance and provide unlimited federal deposit insurance until January 1, 2013 for non interest-bearing demand transaction accounts at all insured depository institutions.
- \* Effective July 21, 2011, repeal the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.
- \* Require all depository institution holding companies to serve as a source of financial strength to their depository institution subsidiaries in the event such subsidiaries suffer from financial distress.

Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on the Company and the financial services industry more generally. The elimination of the prohibition on the payment of interest on demand deposits could materially increase our interest expense, depending on our competitors' responses. Provisions in the legislation that require revisions to the capital requirements of the Company and the Bank could require the Company and the Bank to seek additional sources of capital in the future.

Temporary Liquidity Guaranty Program. Following a systemic risk determination, the FDIC established a Temporary Liquidity Guarantee Program ("TLGP") on October 14, 2008. The TLGP includes the Transaction Account Guarantee Program, which provides unlimited deposit insurance coverage through December 31, 2010 for noninterest-bearing transaction accounts (typically

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business checking accounts) and certain funds swept into noninterest-bearing savings accounts ("TAGP"). Institutions participating in the TAGP pay a 10 basis point fee (annualized) on the balance of each covered account in excess of \$250,000, while the extra deposit insurance is in place. The TLGP also includes the Debt Guarantee Program ("DGP"), under which the FDIC guarantees certain senior unsecured debt of FDIC-insured institutions and their holding companies. The TAGP and DGP are in effect for all eligible entities, unless the entity opted out on or before December 5, 2008. The Company did not opt out of the program. At September 30, 2010, the DGP

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coverage limit is equal to 2% of the Bank's liabilities; however, the Bank did not have any senior unsecured debt which was being guaranteed under the DGP at that time.

Insurance of Accounts and Regulation by the FDIC. The Bank's deposits are insured up to applicable limits by the Deposit Insurance Fund ("DIF") of the FDIC. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of and to require reporting by FDIC insured institutions. It also may prohibit any FDIC insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious risk to the insurance fund.

The FDIC currently assesses deposit insurance premiums on each FDIC-insured institution quarterly based on annualized rates for one of four risk categories applied to its deposits subject to certain adjustments. Each institution is assigned to one of four risk categories based on its capital, supervisory ratings and other factors. Well capitalized institutions that are financially sound with only a few minor weaknesses are assigned to Risk Category I. Risk Categories II, III and IV present progressively greater risks to the DIF. Under FDIC's current risk-based assessment rules, the initial base assessment rates prior to adjustments range from 12 to 16 basis points for Risk Category I, 22 basis points for Risk Category II, 32 basis points for Risk Category III, and 45 basis points for Risk Category IV. Initial base assessment rates are subject to adjustments based on an institution's unsecured debt, secured liabilities and brokered deposits, such that the total base assessment rates after adjustments range from 7 to 24 basis points for Risk Category I, 17 to 43 basis points for Risk Category II, 27 to 58 basis points for Risk Category III, and 40 to 77.5 basis points for Risk Category IV. The FDIC's regulations include authority for the FDIC to increase or decrease total base assessment rates in the future by as much as three basis points without a formal rulemaking proceeding. No institution may pay a dividend if in default of the FDIC assessment.

The Dodd-Frank Act requires the FDIC to amend its regulations to define the assessment base against which deposit insurance premiums are calculated as a depository institution's average total consolidated assets minus the institution's average tangible equity. In November 2009, the FDIC issued a proposed rule under which, effective in the second calendar quarter of 2011, the assessment base would be average consolidated assets minus Tier 1 capital. The FDIC has stated that it set rates using the new assessment base such that the revenues it receives will be approximately the same as under the current assessment base. Under the proposal, initial base assessment rates for institutions with less than \$10 billion in assets would be from 5-9 basis points for Risk Category I, 14 basis points for Risk Category II, 23 basis points for Risk Category III and 35 basis points for Risk Category IV. After a downward adjustment for certain long-term, unsecured debt issued by an

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institution and an upward adjustment for brokered deposits (except in Risk Category I), total assessments rates would range from 2.5-9 basis points for Risk Category I, 9-24 basis points for Risk Category II, 18-33 basis points for Risk Category III, and 30-45 basis points for Risk Category IV, subject to further increase in the case of an institution that holds unsecured debt issued by another FDIC-insured institution. The Bank is currently classified as a Risk Category II institution.

The Dodd-Frank Act increased the minimum designated reserve ratio or DRR (the ratio of the net worth of the DIF to estimated insured deposits) from 1.15% of estimated deposits to 1.35% of estimated deposits (or a comparable percentage of the asset-based assessment base described above). The Dodd-Frank Act requires the FDIC to offset the effect of the increase in the DRR when setting assessments for insured depository institutions with less than \$10 billion in total consolidated assets, including the Bank. The FDIC has until September 30, 2020 to achieve the new DRR of 1.35%.

A significant increase in insurance premiums would likely have an adverse effect on the operating expenses and results of operations of the Bank. There can be no prediction as to what insurance assessment rates will be in the future. Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. Management of the Bank is not aware of any practice, condition or violation that might lead to termination of the Bank's deposit insurance.

On November 12, 2009, the FDIC required insured depository institutions to prepay their quarterly risk-based assessments for the quarter ended December 31, 2009 and for all of calendar 2010, 2011, and 2012, on December 30,

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2009, along with each institution's risk-based assessment for the third quarter of 2009. In December 2009, the Bank paid the prepaid assessment of \$4.4 million; and as of September 30, 2010, the remaining prepaid balance was \$3.3 million.

Prompt Corrective Action. Federal statutes establish a supervisory framework based on five capital categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. An institution's category depends upon where its capital levels are in relation to relevant capital measures, which include a risk-based capital measure, a leverage ratio capital measure and certain other factors. The federal banking agencies have adopted regulations that implement this statutory framework. Under these regulations, an institution is deemed to be well capitalized if its ratio of total capital to risk-weighted assets is 10% or more, its ratio of core capital to risk-weighted assets is 6% or more, its ratio of core capital to adjusted total assets (leverage ratio) is 5% or more, and it is not subject to any federal supervisory order or directive to meet a specific capital level. In order to be adequately capitalized, an institution must have a total risk-based capital ratio of not less than 8%, a Tier 1 risk-based capital ratio of not less than 4%, and a leverage ratio of not less than 4%. Any institution which is neither wellcapitalized nor adequately capitalized is considered undercapitalized.

Undercapitalized institutions are subject to certain prompt corrective

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action requirements, regulatory controls and restrictions which become more extensive as an institution becomes more severely undercapitalized. Failure by institutions to comply with applicable capital requirements would, if unremedied, result in progressively more severe restrictions on their respective activities and lead to enforcement actions, including, but not limited to, the issuance of a capital directive to ensure the maintenance of required capital levels and, ultimately, the appointment of the FDIC as receiver or conservator. Banking regulators will take prompt corrective action with respect to depository institutions that do not meet minimum capital requirements. Additionally, approval of any regulatory application filed for their review may be dependent on compliance with capital requirements.

At September 30, 2010, the Bank was categorized as "well capitalized" under the prompt corrective action regulations of the FDIC. For additional information on capital requirements, see Note 19 of the Notes to the Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplemental Data."

Standards for Safety and Soundness. The federal banking regulatory agencies have prescribed, by regulation, guidelines for all insured depository institutions relating to: internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, asset quality, earnings, and compensation, fees and benefits. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. Each insured depository institution must implement a comprehensive written information security program that includes administrative, technical, and physical safeguards appropriate to the institution's size and complexity and the nature and scope of its activities. The information security program also must be designed to ensure the security and confidentiality of customer information, protect against any unanticipated threats or hazards to the security or integrity of such information, protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer, and ensure the proper disposal of customer and consumer information. Each insured depository institution must also develop and implement a risk-based response program to address incidents of unauthorized access to customer information in customer information systems. If the FDIC determines that the Bank fails to meet any standard prescribed by the guidelines, the agency may require the Bank to submit to the agency an acceptable plan to achieve compliance with the standard. FDIC regulations establish deadlines for the submission and review of such safety and soundness compliance plans. Management of the Bank is not aware of any conditions relating to these safety and soundness standards which would require submission of a plan of compliance.

Capital Requirements. Federally insured savings institutions, such as the Bank, are required to maintain a minimum level of regulatory capital. FDIC regulations recognize two types, or tiers, of capital: core ("Tier 1") capital and supplementary ("Tier 2") capital. Tier 1 capital generally includes common shareholders' equity and noncumulative perpetual preferred stock, less most intangible assets. Tier 2 capital, which is limited to 100% of Tier 1 capital, includes such items as qualifying general loan loss reserves, cumulative perpetual preferred stock, mandatory convertible debt, term subordinated debt and limited life preferred stock; however, the amount of term subordinated debt and intermediate



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term preferred stock (original maturity of at least five years but less than 20 years) that may be included in Tier 2 capital is limited to 50% of Tier 1 capital.

The FDIC currently measures an institution's capital using a leverage limit together with certain risk-based ratios. The FDIC's minimum leverage capital requirement specifies a minimum ratio of Tier 1 capital to average total assets. Most banks are required to maintain a minimum leverage ratio of at least 4% to 5% of total assets. At September 30, 2010, the Bank had a Tier 1 leverage capital ratio of 10.0%. The FDIC retains the right to require a particular institution to maintain a higher capital level based on the its particular risk profile.

FDIC regulations also establish a measure of capital adequacy based on ratios of qualifying capital to risk-weighted assets. Assets are placed in one of four categories and given a percentage weight based on the relative risk of that category. In addition, certain off-balance-sheet items are converted to balance-sheet credit equivalent amounts, and each amount is then assigned to one of the four categories. Under the guidelines, the ratio of total capital (Tier 1 capital plus Tier 2 capital) to risk-weighted assets must be at least 8%, and the ratio of Tier 1 capital to risk-weighted assets must be at least 4%. In evaluating the adequacy of a bank's capital, the FDIC may also consider other factors that may affect a bank's financial condition. Such factors may include interest rate risk exposure, liquidity, funding and market risks, the quality and level of earnings, concentration of credit risk, risks arising from nontraditional activities, loan and investment quality, the effectiveness of loan and investment policies, and management's ability to monitor and control financial operating risks. At September 30, 2010, the Bank's ratio of total capital to risk-weighted assets was 14.9% and the ratio of Tier 1 capital to risk-weighted assets was 13.6%.

The Division requires that net worth equal at least 5% of total assets. Intangible assets must be deducted from net worth and assets when computing compliance with this requirement. At September 30, 2010, the Bank had a net worth of 9.7% of total assets.

The table below sets forth the Bank's capital position relative to its FDIC capital requirements at September 30, 2010. The definitions of the terms used in the table are those provided in the capital regulations issued by the FDIC and reflect the higher Tier 1 leverage capital ratio that the Bank is required to comply with in connection with the Bank MOU. For additional information regarding the MOU, see "Item 1A, Risk Factors The Company and the Bank are required to comply with the terms of separate memoranda of understanding issued by their respective regulators and lack of compliance could result in additional regulatory actions."

|  | At September 30, 2010  |   |
|--|------------------------|---|
|  | Amount                 | Percent of Adjusted<br>Total Assets (1) |
|  | (Dollars in thousands) |   |
| Tier 1 (leverage) capital.....               | \$72,784               | 10.0%                                   |
| Tier 1 (leverage) capital requirement (2)... | 72,809                 | 10.0                                    |
|  | -----                  | ----                                    |
| Deficit.....                                 | \$ (25)                | --%                                     |
|  | =====                  | =====                                   |
| Tier 1 risk adjusted capital.....            | \$72,784               | 13.6%                                   |

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|  |          |       |
|--|----------|-------|
| Tier 1 risk adjusted capital requirement.... | 32,036   | 6.0   |
|  | -----    | ----  |
| Excess.....                                  | \$40,748 | 7.6%  |
|  | =====    | ===== |
| <br>   |          |       |
| Total risk-based capital.....                | \$79,515 | 14.9% |
| Total risk-based capital requirement.....    | 53,393   | 10.0  |
|  | -----    | ----  |
| Excess.....                                  | \$26,122 | 4.9%  |
|  | =====    | ===== |

(Footnotes on following page)

- 
- (1) For the Tier 1 (leverage) capital and Washington regulatory capital calculations, percent of total average assets of \$728.1 million. For the Tier 1 risk-based capital and total risk-based capital calculations, percent of total risk-weighted assets of \$533.9 million.
  - (2) As a Washington-chartered savings bank, the Bank is subject to the capital requirements of the FDIC and the Division. The FDIC requires state-chartered savings banks, including the Bank, to have a minimum leverage ratio of Tier 1 capital to total assets of at least 3%, provided, however, that all institutions, other than those (i) receiving the highest rating during the examination process and (ii) not anticipating any significant growth, are required to maintain a ratio of 1% to 2% above the stated minimum, with an absolute total capital to risk-weighted assets of at least 8%. Under the MOU, the Bank is required to maintain at least a 10.0% Tier 1 leverage capital ratio.

Events beyond the control of the Bank, such as a downturn in the economy in areas where the Bank has most of its loans, could adversely affect future earnings and, consequently, the ability of the Bank to meet its capital requirements under the MOU. See "Item 1A, Risk Factors The Company and the Bank are required to comply with the terms of separate memoranda of understanding issued by their respective regulators and lack of compliance could result in additional regulatory actions."

Real Estate Lending Standards. FDIC regulations require the Bank to adopt and maintain written policies that establish appropriate limits and standards for real estate loans. These standards, which must be consistent with safe and sound banking practices, must establish loan portfolio diversification standards, prudent underwriting standards (including loan-to-value ratio limits) that are clear and measurable, loan administration procedures, and documentation, approval and reporting requirements. The Bank is obligated to monitor conditions in its real estate markets to ensure that its standards continue to be appropriate for current market conditions. The Bank's Board of Directors is required to review and approve the Bank's standards at least annually. The FDIC has published guidelines for compliance with these regulations, including supervisory limitations on loan-to-value ratios for different categories of real estate loans. Under the guidelines, the aggregate amount of all loans in excess of the supervisory loan-to-value ratios should not exceed 100% of total capital, and the total of all loans for commercial, agricultural, multifamily or other non-one- to four-family residential properties should not exceed 30% of total capital. Loans in excess of the supervisory loan-to-value ratio limitations must be identified

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in the Bank's records and reported at least quarterly to the Bank's Board of Directors. The Bank is in compliance with the record and reporting requirements. As of September 30, 2010, the Bank's aggregate loans in excess of the supervisory loan-to-value ratios were 2.0% of total capital and the Bank's loans on commercial, agricultural, multifamily or other non-one- to four-family residential properties in excess of the supervisory loan-to-value ratios were 15% of total capital.

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

Washington state has enacted a law regarding financial institution parity. Primarily, the law affords Washington-chartered commercial banks the same powers as Washington-chartered savings banks. In order for a bank to exercise these powers, it must provide 30 days notice to the Director of the Washington Division of Financial Institutions and the Director must authorize the requested activity. In addition, the law provides that Washington-chartered commercial banks may exercise any of the powers that the Federal Reserve has determined to be closely related to the business of banking and the powers of national banks, subject to the approval of the Director in certain situations. The law also provides that Washington-chartered savings banks may exercise any of the powers of Washington-chartered commercial banks, national banks and federally-chartered savings banks, subject to the approval of the Director in certain situations. Finally, the law provides additional flexibility for Washington-chartered commercial and savings banks with

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respect to interest rates on loans and other extensions of credit. Specifically, they may charge the maximum interest rate allowable for loans and other extensions of credit by federally-chartered financial institutions to Washington residents.

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

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

**Federal Reserve System.** The Federal Reserve Board requires that all depository institutions maintain reserves on transaction accounts or non-personal time deposits. These reserves may be in the form of cash or non-interest-bearing deposits with the regional Federal Reserve Bank. Negotiable order of withdrawal accounts and other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are subject to reserve requirements, as are any non-personal time deposits at a savings bank. As of September 30, 2010, the Bank's deposit with the Federal Reserve and vault cash exceeded its Regulation D reserve requirements.

**Affiliate Transactions.** The Company and the Bank are separate and distinct legal entities. Federal laws strictly limit the ability of banks to engage in certain transactions with their affiliates, including their bank holding companies. Transactions deemed to be a "covered transaction" under Section 23A of the Federal Reserve Act and between a subsidiary bank and its parent company or the nonbank subsidiaries of the bank holding company are limited to 10% of the bank subsidiary's capital and surplus and, with respect to the parent company and all such nonbank subsidiaries, to an aggregate of 20% of the bank subsidiary's capital and surplus. Further, covered transactions that are loans and extensions of credit generally are required to be secured by eligible collateral in specified amounts. Federal law also requires that covered transactions and certain other transactions listed in Section 23B of the Federal Reserve Act between a bank and its affiliates be on terms as favorable to the bank as transactions with non-affiliates.

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

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

The amount of dividends actually paid during any one period will be strongly affected by the Bank's management policy of maintaining a strong capital position. Federal law further provides that no insured depository institution may pay a cash dividend if it would cause the institution to be "undercapitalized," as defined in the prompt corrective action regulations. Moreover, the federal bank regulatory agencies also have the general authority

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to limit the dividends paid by insured banks if such payments should be deemed to constitute an unsafe and unsound practice.

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**Privacy Standards.** The Gramm-Leach-Bliley Financial Services Modernization Act of 1999 ("GLBA") modernized the financial services industry by establishing a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms and other financial service providers. The Bank is subject to FDIC regulations implementing the privacy protection provisions of the GLBA. These regulations require the Bank to disclose its privacy policy, including informing consumers of its information sharing practices and informing consumers of their rights to opt out of certain practices.

**Other Consumer Protection Laws and Regulations.** The Bank is subject to a broad array of federal and state consumer protection laws and regulations that govern almost every aspect of its business relationships with consumers. While the list set forth below is not exhaustive, these include the Truth-in-Lending Act, the Truth in Savings Act, the Electronic Fund Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Real Estate Settlement Procedures Act, the Home Mortgage Disclosure Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, the Right to Financial Privacy Act, the Home Ownership and Equity Protection Act, the Consumer Leasing Act, the Fair Credit Billing Act, the Homeowners Protection Act, the Check Clearing for the 21st Century Act, laws governing flood insurance, laws governing consumer protections in connection with the sale of insurance, federal and state laws prohibiting unfair and deceptive business practices, and various regulations that implement some or all of the foregoing. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits, making loans, collecting loans, and providing other services. Failure to comply with these laws and regulations can subject the Bank to various penalties, including but not limited to, enforcement actions, injunctions, fines, civil liability, criminal penalties, punitive damages, and the loss of certain contractual rights.

The Americans with Disabilities Act requires employers with 15 or more employees and all businesses operating "commercial facilities" or "public accommodations" to accommodate disabled employees and customers. The Americans with Disabilities Act has two major objectives: (i) to prevent discrimination against disabled job applicants, job candidates and employees, and (ii) to provide disabled persons with ready access to commercial facilities and public accommodations. Commercial facilities, such as the Bank, must ensure that all new facilities are accessible to disabled persons, and in some instances may be required to adapt existing facilities to make them accessible.

### Regulation of the Company

**General.** The Company, as the sole shareholder of the Bank, is a bank holding company and is registered as such with the Federal Reserve. Bank holding companies are subject to comprehensive regulation by the Federal Reserve under the Bank Holding Company Act of 1956, as amended ("BHCA"), and the regulations of the Federal Reserve. As a bank holding company, the Company is required to file with the Federal Reserve annual reports and such additional information as the Federal Reserve may require and will be subject

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

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

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

The Company and any subsidiaries that it may control are considered "affiliates" within the meaning of the Federal Reserve Act, and transactions between our bank subsidiary and affiliates are subject to numerous restrictions. With some exceptions, the Company and its subsidiaries, are prohibited from tying the provision of various services, such as extensions of credit, to other services offered by the Company, or its affiliates.

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

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Interstate Banking. The Federal Reserve may approve an application of a bank holding company to acquire control of, or acquire all or substantially all of the assets of, a bank located in a state other than such holding company's home state, without regard to whether the transaction is prohibited by the laws of any state except with respect to the acquisition of a bank that has not been in existence for the minimum time period, not exceeding five years, specified by the law of the host state. The Federal Reserve may not approve an application if the applicant controls or would control more than 10% of the insured deposits in the United States or 30% or more of the deposits in the target bank's home state or in any state in which the target bank maintains a branch. Federal law does not affect the authority of states to limit the percentage of total insured deposits in the state that may be held or controlled by a bank holding company to the extent such limitation does not discriminate against out-of-state banks or bank holding companies. Individual states may also waive the 30% state-wide concentration limit contained in the federal law.

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

Dividends. The Federal Reserve has issued a policy statement on the payment of cash dividends by bank holding companies, which expresses the Federal Reserve's view that a bank holding company should pay cash dividends only to the extent that the company's net income for the past year is sufficient to cover both the cash dividends and a rate of earning retention that is consistent with the company's capital needs, asset quality and overall financial condition, and that it is inappropriate for a company experiencing serious financial problems to borrow funds to pay dividends. Under the terms of the Bank MOU, the Bank may not pay dividends to the Company without the prior consent of the FDIC and the Division. In addition, in May and August 2010, the FRB denied the Company's request to pay cash dividends on its common stock. The Company's ability to pay dividends with respect to common stock is subject to obtaining approval from the FRB and the Treasury and is further restricted until the dividend obligations under the Series A Preferred Stock are brought current.

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

Capital Requirements. The Federal Reserve has established capital

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adequacy guidelines for bank holding companies that generally parallel the capital requirements of the FDIC for the Bank. The Federal Reserve regulations provide that capital standards will be applied on a consolidated basis in the case of a bank holding company with \$500 million or more in total consolidated assets.

The Company's total risk based capital must equal 8% of risk-weighted assets and one half of the 8%, or 4%, must consist of Tier 1 (core) capital and its Tier 1 (core) capital must equal 4% of total assets. As of September 30, 2010, the Company's total risk based capital was 16.3% of risk-weighted assets, its risk based capital of Tier 1 (core) capital was 15.0% of risk-weighted assets and its Tier 1 (core) capital was 11.0% of average assets.

Sarbanes-Oxley Act of 2002. As a public company, the Company is subject to the Sarbanes-Oxley Act of 2002, which implements a broad range of corporate governance and accounting measures for public companies designed to promote honesty and transparency in corporate America and better protect investors from corporate wrongdoing. The Sarbanes-Oxley Act of 2002 was signed into law on July 30, 2002 in response to public concerns regarding corporate accountability in connection with several accounting scandals. The stated goals of the Sarbanes-Oxley Act are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws.

The Sarbanes-Oxley Act includes very specific additional disclosure requirements and new corporate governance rules, requires the Securities and Exchange Commission and securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules and mandates further studies of certain issues by the SEC and the Comptroller General.

### Taxation

#### Federal Taxation

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

Allowance for Loan Losses. Historically, savings institutions such as the Bank which met certain definitional tests primarily related to their assets and the nature of their business ("qualifying thrift") were permitted to establish an allowance for loan losses and to make annual additions thereto, which may have been deducted in arriving at their taxable income.

The provisions repealing the current thrift bad debt rules were passed by Congress as part of "The Small Business Job Protection Act of 1996." These rules required that all institutions recapture all or a portion of their allowance for loan losses added since the base year (last taxable year beginning before January 1, 1988). The Bank had previously recorded deferred taxes equal to the bad debt recapture and as such the new rules had no effect on the net income or federal income tax expense. For taxable years beginning after December 31, 1995, the Bank's bad debt deduction is determined under the experience method using a formula based on actual bad debt experience over a period



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of years or, if the Bank is a "large" association (assets in excess of \$500 million) on the basis of net charge-offs during the taxable year. The unrecaptured base year reserves will not be subject to recapture as long as the institution continues to carry on the business of banking. In addition, the balance of the pre-1988 bad debt reserves continue to be subject to provisions of present law referred to below that require recapture in the case of certain excess distributions to shareholders. The Bank has recaptured all federal tax bad debt reserves that had been accumulated since October 1, 1988.

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

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

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

**Audits.** The Company is no longer subject to United States federal tax examination by tax authorities for years ended on or before September 30, 2006.

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

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### Competition

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

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### Subsidiary Activities

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

### Personnel

As of September 30, 2010, the Bank had 250 full-time employees and 33 part-time and on-call employees. The employees are not represented by a collective bargaining unit and the Bank believes its relationship with its employees is good.

### Executive Officers of the Registrant

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

Executive Officers of the Company and Bank

| Name             | Age at<br>September<br>30, 2010 | Position  |  |
|------------------|---------------------------------|---|--|
|                  |                                 | Company   | Bank   |
| Michael R. Sand  | 56                              | President and Chief<br>Executive Officer                              | President and Chief<br>Executive Officer                                 |
| Dean J. Brydon   | 43                              | Executive Vice President,<br>Chief Financial Officer<br>and Secretary | Executive Vice<br>President, Chief<br>Financial Officer and<br>Secretary |
| Robert A. Drugge | 59                              | Executive Vice President  | Executive Vice<br>President and<br>Business Banking<br>Division Manager  |
| John P. Norawong | 45                              | Executive Vice President  | Executive Vice<br>President and<br>Community Banking                     |

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|                  |    |  |  |
|------------------|----|--|--|
|                  |    |  | Division Manager   |
| Marci A. Basich  | 41 | Senior Vice President<br>and Treasurer | Senior Vice President<br>and Treasurer                     |
| Kathie M. Bailey | 59 | Senior Vice President                  | Senior Vice President<br>and Chief Operations<br>Officer   |
| Michael J. Scott | 64 |  | Senior Vice President<br>and Chief Credit<br>Administrator |

Biographical Information.

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

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

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

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

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

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

Michael J. Scott has been affiliated with the Bank since January 2008 and has served as Senior Vice President and Chief Credit Administrator. Prior to joining Timberland, Mr. Scott was employed by Bank of America where he was a Senior Vice President and Senior Credit Products Officer for the past several years in both Seattle and Tacoma. He began his banking career at Seafirst in 1973, which was acquired by Bank America Corp. and became known as Bank of America.

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### Item 1A. Risk Factors

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We assume and manage a certain degree of risk in order to conduct our business strategy. In addition to the risk factors described below, other risks and uncertainties not specifically mentioned, or that are currently known to, or deemed to be immaterial by management, also may materially and adversely affect our financial position, results of operations and/or cash flows. Before making an investment decision, you should carefully consider the risks described below together with all of the other information included in this Form 10-K. If any of the circumstances described in the following risk factors actually occur to a significant degree, the value of our common stock could decline, and you could lose all or part of your investment.

The Company and the Bank are required to comply with the terms of separate memoranda of understanding issued by their respective regulators and lack of compliance could result in additional regulatory actions.

In December 2009, the FDIC and the Division determined that the Bank required additional supervisory attention and on December 29, 2009 entered into the Bank MOU. Under the terms of the Bank MOU, the Bank, without the prior written approval, or nonobjection, of the FDIC and/or the DFI, may not:

- \* appoint any new director or senior executive officer or change the responsibilities of any current senior executive officers;
- \* pay cash dividends to its holding company, Timberland Bancorp, Inc.; or
- \* engage in any transactions that would materially change the balance sheet composition including growth in total assets of five percent or more or significant changes in funding sources, such as by increasing brokered deposits.

Other material provisions of the Bank MOU require the Bank to:

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- \* maintain Tier 1 Capital of not less than 10.0% of the Bank's adjusted total assets pursuant to Part 325 of the FDIC Rules and Regulations, and maintain capital ratios above "well capitalized" thresholds as defined under Section 325.103 of the FDIC Rules and Regulations;
- \* maintain a fully funded allowance for loan and lease losses, the adequacy of which shall be deemed to be satisfactory to the FDIC and the DFI;
- \* formulate and implement a written profit plan acceptable to the FDIC and the DFI;
- \* eliminate from its books all assets classified "Loss" that have not been previously collected or charged-off;
- \* reduce the dollar volume by 50% the assets classified "Substandard" and "Doubtful" at April 30, 2009;
- \* develop a written plan for reducing the aggregate amount of its acquisition, development and construction loans; and
- \* revise, adopt and fully implement a written liquidity and funds management policy.

In addition on February 1, 2010, the FRB determined that the Company required additional supervisory attention and entered into the Company MOU.

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Under the terms of the Company MOU, the Company, without prior written approval, or non-objection, of the FRB, may not:

- \* appoint any new director or senior executive officer or change the responsibilities of any current senior executive officers;
- \* receive dividends or any other form of payment or distribution representing a reduction in capital from the Bank;
- \* declare or pay any dividends, or make any other capital distributions; incur, renew, increase, or guarantee any debt;
- \* issue any trust preferred securities; or
- \* purchase or redeem any of its stock.

The Bank MOU and the Company MOU will remain in effect until stayed, modified, terminated or suspended by the FDIC and the Division or FRB, as the case may be. If either the Company or the Bank is found not in compliance with their respective MOU, it could be subject to various remedies, including among others, the power to enjoin "unsafe or unsound" practices, to require affirmative action to correct any conditions resulting from any violation or practice, to direct an increase in capital, to restrict growth, to remove officers and / or directors, and to assess civil monetary penalties. Management of the Company and the Bank have been taking action and implementing programs to comply with the requirements of the Company MOU and the Bank MOU, respectively. Compliance will be determined by the FDIC, Division and FRB. Any of these regulators may determine in their sole discretion that the issues raised by the Company MOU or the Bank MOU have not been addressed satisfactorily, or that any current or past actions, violations or deficiencies could be the subject of further regulatory enforcement actions. Such enforcement actions could involve penalties or further limitations on the Company's business and negatively affect its ability to implement its business plan, pay dividends on its common stock or the value of its common stock, as well as its financial condition and result of operations.

As of September 30, 2010, the FRB has denied the Company's requests to pay dividends on its Series A Preferred Stock (issued under TARP) for the payments due May 15, 2010 and August 15, 2010. There can be no assurance that our regulators will approve such payments or dividends in the future. The Company may not declare or pay dividends on its common stock or, with certain exceptions, repurchase common stock without first having paid all cumulative preferred dividends that are due. If dividends on the Series A Preferred Stock are not paid for six quarters, whether or not consecutive, the Treasury has the right to appoint two members to the Board of Directors of the Company. See " Risks specific to our participation in TARP."

Financial reform legislation recently enacted by Congress will, among other things, tighten capital standards, create a new Consumer Financial Protection Bureau and result in new laws and regulations that are expected to increase our costs of operations.

Congress recently enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). This new law will significantly change the current bank regulatory structure and affect the lending, deposit,

investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to

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prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting the implementing rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years.

Certain provisions of the Dodd-Frank Act are expected to have a near term impact on the Company. For example, one year after the date of enactment a provision of the Dodd-Frank Act eliminates the federal prohibitions on paying interest on demand deposits, thus allowing businesses to have interest bearing checking accounts. Depending on competitive responses, this significant change to existing law could have an adverse impact on the Company's interest expense and deposit balances.

It is difficult to predict at this time what specific impact the Dodd-Frank Act and the yet to be written implementing rules and regulations will have on community banks. However, it is expected that at a minimum they will increase our operating and compliance costs and could increase our interest expense.

The current economic recession in the market areas we serve may continue to adversely impact our earnings and could increase the credit risk associated with our loan portfolio.

Substantially all of our loans are to businesses and individuals in the state of Washington. A continuing decline in the economies of our local market areas of Grays Harbor, Pierce, Thurston, King, Kitsap and Lewis counties in which we operate, and which we consider to be our primary market areas, could have a material adverse effect on our business, financial condition, results of operations and prospects. In particular, Washington has experienced substantial home price declines and increased foreclosures and has experienced above average unemployment rates.

A further deterioration in economic conditions in the market areas we serve could result in the following consequences, any of which could have a materially adverse impact on our business, financial condition and results of operations:

- \* loan delinquencies, problem assets and foreclosures may increase; demand for our products and services may decline;
- \* collateral for loans made may decline further in value, in turn reducing customers' borrowing power, reducing the value of assets and collateral associated with existing loans;
- \* the amount of our low-cost or non-interest bearing deposits may decrease; and
- \* the price of our common stock may decrease.

Our real estate construction and land development loans are based upon estimates of costs and the value of the completed project.

We make real estate construction loans to individuals and builders, primarily for the construction of residential properties. We originate these loans whether or not the collateral property underlying the loan is under contract for sale. At September 30, 2010, construction and land development loans totaled \$69.3 million, or 12.4% of our total loan portfolio, of which \$39.3 million were for residential real estate projects. Approximately \$30.9 million of our residential construction loans were made to finance the construction of owner-occupied homes and are structured to be converted to permanent loans at the end of the construction phase. Land development loans, which are loans made with land as security, totaled \$6.4 million, or 1.2%, of

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our total loan portfolio at September 30, 2010. In general, construction and land development lending involves additional risks because of the inherent difficulty in estimating a property's value both before and at completion of the project as well as the estimated cost of the project. Construction costs may exceed original estimates as a result of increased materials, labor or other costs. In addition, because of current uncertainties in the residential real estate market, property values have become more difficult to determine than they have historically

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been. Construction loans and land development loans often involve the disbursement of funds with repayment dependent, in part, on the success of the project and the ability of the borrower to sell or lease the property or refinance the indebtedness, rather than the ability of the borrower or guarantor to repay principal and interest. These loans are also generally more difficult to monitor. In addition, speculative construction loans to a builder are often associated with homes that are not pre-sold, and thus pose a greater potential risk than construction loans to individuals on their personal residences. At September 30, 2010, \$4.8 million of our construction portfolio was comprised of speculative one- to four-family construction loans. Approximately \$7.6 million, or 11.0%, of our total real estate construction and land development loans were non-performing at September 30, 2010. A material increase in our non-performing construction and loan development loans could have a material adverse effect on our financial condition and results of operation.

Our emphasis on commercial real estate lending may expose us to increased lending risks.

Our current business strategy includes the expansion of commercial real estate lending. This type of lending activity, while potentially more profitable than single-family residential lending, is generally more sensitive to regional and local economic conditions, making loss levels more difficult to predict. Collateral evaluation and financial statement analysis in these types of loans requires a more detailed analysis at the time of loan underwriting and on an ongoing basis. In our primary market of southwest Washington, a further downturn in the real estate market, could increase loan delinquencies, defaults and foreclosures, and significantly impair the value of our collateral and our ability to sell the collateral upon foreclosure. Many of our commercial borrowers have more than one loan outstanding with us. Consequently, an adverse development with respect to one loan or one credit relationship can expose us to a significantly greater risk of loss.

At September 30, 2010, we had \$208.0 million commercial real estate mortgage loans, representing 37.2% of our total loan portfolio. 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. For example, if the cash flow from the borrower's project is reduced as a result of leases not being obtained or renewed, the borrower's ability to repay the loan may be impaired. Commercial real estate 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. In addition, many of our commercial real estate loans are not fully amortizing and contain large balloon payments upon maturity. Such balloon payments may require the

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borrower to either sell or refinance the underlying property in order to make the payment, which may increase the risk of default or non-payment.

A secondary market for most types of commercial real estate loans is not readily liquid, so we have less opportunity to mitigate credit risk by selling part or all of our interest in these loans. As a result of these characteristics, if we foreclose on a commercial real estate loan, our holding period for the collateral typically is longer than for one- to four-family residential mortgage loans because there are fewer potential purchasers of the collateral. Accordingly, charge-offs on commercial real estate loans may be larger as a percentage of the total principal outstanding than those incurred with our residential or consumer loan portfolios.

The level of our commercial real estate loan portfolio may subject us to additional regulatory scrutiny.

The FDIC, the Federal Reserve and the Office of Thrift Supervision have promulgated joint guidance on sound risk management practices for financial institutions with concentrations in commercial real estate lending. Under this guidance, a financial institution that, like us, is actively involved in commercial real estate lending should perform a risk assessment to identify concentrations. A financial institution may have a concentration in commercial real estate lending if, among other factors (i) total reported loans for construction, land development, and other land represent 100% or more of total capital, or (ii) total reported loans secured by multifamily and non-farm residential properties, loans for construction, land development and other land, and loans otherwise sensitive to the general commercial real estate market, including loans to commercial real estate related entities, represent 300% or more of total capital. The particular focus of the guidance is on exposure to commercial real estate loans that are dependent on the cash flow from the real estate held as collateral and that are likely to be at greater risk to conditions in the commercial real estate market (as

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opposed to real estate collateral held as a secondary source of repayment or as an abundance of caution). The purpose of the guidance is to guide banks in developing risk management practices and capital levels commensurate with the level and nature of real estate concentrations. The guidance states that management should employ heightened risk management practices including board and management oversight and strategic planning, development of underwriting standards, risk assessment and monitoring through market analysis and stress testing. We have concluded that we have a concentration in commercial real estate lending under the foregoing standards because our balance in commercial real estate loans at September 30, 2010 represents more than 300% of total capital. While we believe we have implemented policies and procedures with respect to our commercial real estate loan portfolio consistent with this guidance, bank regulators could require us to implement additional policies and procedures consistent with their interpretation of the guidance that may result in additional costs to us and an adjustment to our growth strategies.

Repayment of our commercial loans is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value.

At September 30, 2010, we had \$18.0 million or 3.2% of total loans in commercial loans. Commercial lending involves risks that are different from those associated with residential and commercial real estate lending. Real



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estate lending is generally considered to be collateral based lending with loan amounts based on predetermined loan to collateral values and liquidation of the underlying real estate collateral being viewed as the primary source of repayment in the event of borrower default. Our commercial 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. Although commercial loans are often collateralized by equipment, inventory, accounts receivable, or other business assets, the liquidation of collateral in the event of default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories may be obsolete or of limited use, among other things. Accordingly, the repayment of commercial loans depends primarily on the cash flow and credit worthiness of the borrower and secondarily on the underlying collateral provided by the borrower.

Our business may be adversely affected by credit risk associated with residential property.

At September 30, 2010, \$159.4 million, or 28.5% of our total loan portfolio, was secured by one- to four-family mortgage loans and home equity loans. This type of lending is generally sensitive to regional and local economic conditions that significantly impact the ability of borrowers to meet their loan payment obligations, making loss levels difficult to predict. The decline in residential real estate values as a result of the downturn in the Washington housing market has reduced the value of the real estate collateral securing these types of loans and increased the risk that we would incur losses if borrowers default on their loans. Continued declines in both the volume of real estate sales and the sales prices coupled with the current recession and the associated increases in unemployment may result in higher than expected loan delinquencies or problem assets, a decline in demand for our products and services, or lack of growth or a decrease in deposits. These potential negative events may cause us to incur losses, adversely affect our capital and liquidity, and damage our financial condition and business operations.

High loan-to-value ratios on a portion of our residential mortgage loan portfolio exposes us to greater risk of loss.

Many of our residential mortgage loans are secured by liens on mortgage properties in which the borrowers have reduced equity or no equity because either we originated upon purchase a first mortgage with an 80% loan-to-value ratio, have originated a home equity loan with a combined loan-to-value ratio of up to 90%, or because of the decline in home values in our market areas. Residential loans with high loan-to-value ratios will be more sensitive to declining property values than those with lower combined loan-to-value ratios and, therefore, may experience a higher incidence of default and severity of losses. In addition, if the borrowers sell their homes, such borrowers may be unable to repay their loans in full from the sale. As a result, these loans may experience higher rates of delinquencies, defaults and losses.

Our provision for loan losses has increased substantially in the years ended September 30, 2010 and 2009, and we may be required to make further increases in our provision for loan losses and to charge-off additional loans in the future, which could adversely affect our results of operations.

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provision for loan losses of \$10.6 million and \$10.7 million, respectively. We also recorded net loan charge-offs of \$13.5 million and \$4.4 million for the fiscal years ended September 30, 2010 and 2009, respectively. During these last two fiscal years, we experienced higher loan delinquencies and credit losses. Our non-performing loans and assets have historically reflected unique operating difficulties for individual borrowers rather than weakness in the overall economy of the Pacific Northwest; however, more recently the deterioration in the general economy has become a significant contributing factor to the increased levels of delinquencies and non-performing loans. Slower sales and excess inventory in the housing market have been the primary causes of the increase in delinquencies and foreclosures for construction and land development loans, which represent 30.6% of our non-performing assets at September 30, 2010. Further, our portfolio is concentrated in construction and land loans and commercial and commercial real estate loans, all of which have a higher risk of loss than residential mortgage loans.

If current trends in the housing and real estate markets continue, and until general economic conditions improve, we expect that we will continue to experience significantly higher than normal delinquencies and credit losses. As a result, we could be required to make further increases in our provision for loan losses and to charge off additional loans in the future, which could have a material adverse effect on our financial condition and results of operations.

We may have continuing losses.

We reported net losses of \$(2.3 million) and \$(242,000) for the fiscal years ended September 30, 2010 and 2009, respectively. These losses primarily resulted from our high level of non-performing assets and the resultant increased provision for loan losses and OREO related expenses and write-downs. We may continue to suffer further losses which could materially adversely affect our financial condition and require us to raise additional capital.

Our allowance for loan losses may prove to be insufficient to absorb losses in our loan portfolio.

Lending money is a substantial part of our business and each loan carries a certain risk that it will not be repaid in accordance with its terms or that any underlying collateral will not be sufficient to assure repayment. This risk is affected by, among other things:

- \* the cash flow of the borrower and/or the project being financed;
- \* changes and uncertainties as to the future value of the collateral, in the case of a collateralized loan;
- \* the duration of the loan;
- \* the credit history of a particular borrower; and
- \* changes in economic and industry conditions.

We maintain an allowance for loan losses, which is a reserve established through a provision for loan losses charged to expense, which we believe is appropriate to provide for probable losses in our loan portfolio. The amount of this allowance is determined by our management through periodic reviews and consideration of several factors, including, but not limited to:

- \* our general reserve, based on our historical default and loss experience and certain macroeconomic factors based on management's expectations of future events; and

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- \* our specific reserve, based on our evaluation of impaired loans and their underlying collateral and cash flows.

The determination of the appropriate level of the allowance for loan losses inherently involves a high degree of subjectivity and requires us to make various assumptions and judgments about the collectability of our loan portfolio,

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including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we review our loans and the loss and delinquency experience, and evaluate economic conditions and make significant estimates of current credit risks and future trends, all of which may undergo material changes. If our estimates are incorrect, the allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, resulting in the need for additions to our allowance through an increase in the provision for loan losses. Continuing deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans and other factors, both within and outside of our control, may require an increase in the allowance for loan losses. Our allowance for loan losses was \$11.3 million or 2.1% of gross loans held for investment and 45.3% of non-performing loans at September 30, 2010. In addition, bank regulatory agencies periodically review our allowance for loan losses and may require an increase in the provision for possible loan losses or the recognition of further loan charge-offs, based on judgments different than those of management. If charge-offs in future periods exceed the allowance for loan losses, we may need additional provisions to increase the allowance for loan losses. Any increases in the provision for loan losses will result in a decrease in net income and may have a material adverse effect on our financial condition, results of operations and our capital.

If our investments in real estate are not properly valued or sufficiently reserved to cover actual losses, or if we are required to increase our valuation reserves, our earnings could be reduced.

We obtain updated valuations in the form of appraisals and broker price opinions when a loan has been foreclosed and the property is taken in as OREO, and at certain other times during the assets holding period. Our net book value ("NBV") in the loan at the time of foreclosure and thereafter is compared to the updated estimated market value of the foreclosed property less estimated selling costs (fair value). A charge-off is recorded for any excess in the asset's NBV over its fair value. If our valuation process is incorrect or if the property declines in value after foreclosure, the fair value of our OREO may not be sufficient to recover our NBV in such assets, resulting in the need for additional charge-offs. Additional material charge-offs to our OREO could have a material adverse effect on our financial condition and results of operations.

In addition, bank regulators periodically review our OREO and may require us to recognize further charge-offs. Any increase in our charge-offs, as required by such regulators, may have a material adverse effect on our financial condition and results of operations.

Other-than-temporary impairment charges in our investment securities portfolio could result in additional losses.

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During the year ended September 30, 2010, we recognized a \$2.2 million other than temporary impairment ("OTTI") charge on private label mortgage backed securities we hold for investment. Management concluded that the decline of the estimated fair value below the cost of these securities was other than temporary and recorded a credit loss through non-interest income. At September 30, 2010 our remaining private label mortgage backed securities portfolio totaled \$5.0 million

We closely monitor our investment securities for changes in credit risk. The valuation of our investment securities also is influenced by external market and other factors, including implementation of Securities and Exchange Commission and Financial Accounting Standards Board guidance on fair value accounting, default rates on residential mortgage securities, rating agency actions, and the prices at which observable market transactions occur. The current market environment significantly limits our ability to mitigate our exposure to valuation changes in our investment securities by selling them. Accordingly, if market conditions deteriorate further and we determine our holdings of our private label mortgage backed securities or other investment securities are other than temporarily impaired, our results of operations could be adversely affected.

An increase in interest rates, change in the programs offered by the FHLMC or our ability to qualify for their programs may reduce our mortgage revenues, which would negatively impact our non-interest income.

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The sale of residential mortgage loans to the FHLMC provides a significant portion of our non-interest income. Any future changes in their program, our eligibility to participate in such program, the criteria for loans to be accepted or laws that significantly affect the activity of the FHLMC could, in turn, materially adversely affect our results of operations if we could not find other purchasers. Further, in a rising or higher interest rate environment, our originations of mortgage loans may decrease, resulting in fewer loans that are available to be sold. This would result in a decrease in mortgage revenues and a corresponding decrease in non-interest income. In addition, our results of operations are affected by the amount of non-interest expense associated with our loan sale activities, such as salaries and employee benefits, occupancy, equipment and data processing expense and other operating costs. During periods of reduced loan demand, our results of operations may be adversely affected to the extent that we are unable to reduce expenses commensurate with the decline in loan originations.

Our real estate lending also exposes us to the risk of environmental liabilities.

In the course of our business, we may foreclose and take title to real estate, and we could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third persons for property damage, personal injury, investigation, and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, as the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we

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ever become subject to significant environmental liabilities, our business, financial condition and results of operations could be materially and adversely affected.

Fluctuating interest rates can adversely affect our profitability.

Our profitability is dependent to a large extent upon net interest income, which is the difference, or spread, between the interest earned on loans, securities and other interest-earning assets and the interest paid on deposits, borrowings, and other interest-bearing liabilities. Because of the differences in maturities and repricing characteristics of our interest-earning assets and interest-bearing liabilities, changes in interest rates do not produce equivalent changes in interest income earned on interest-earning assets and interest paid on interest-bearing liabilities. We principally manage interest rate risk by managing our volume and mix of our earning assets and funding liabilities. In a changing interest rate environment, we may not be able to manage this risk effectively. Changes in interest rates also can affect: (1) our ability to originate and/or sell loans; (2) the value of our interest-earning assets, which would negatively impact shareholders' equity, and our ability to realize gains from the sale of such assets; (3) our ability to obtain and retain deposits in competition with other available investment alternatives; and (4) the ability of our borrowers to repay adjustable or variable rate loans. Interest rates are highly sensitive to many factors, including government monetary policies, domestic and international economic and political conditions and other factors beyond our control. If we are unable to manage interest rate risk effectively, our business, financial condition and results of operations could be materially harmed.

Our loan portfolio possesses increased risk due to our level of adjustable rate loans.

A substantial majority of our real estate secured loans held are adjustable-rate loans. Any rise in prevailing market interest rates may result in increased payments for borrowers who have adjustable rate mortgage loans, increasing the possibility of defaults that may adversely affect our profitability.

Increases in deposit insurance premiums and special FDIC assessments will hurt our earnings.

Beginning in late 2008, the economic environment caused higher levels of bank failures, which dramatically increased FDIC resolution costs and led to a significant reduction in the Deposit Insurance Fund. As a result, the FDIC has significantly increased the initial base assessment rates paid by financial institutions for deposit insurance. The base assessment rate was increased by seven basis points (seven cents for every \$100 of deposits) for the first quarter of 2009. Effective April 1, 2009, initial base assessment rates were changed to range from 12 basis points to 45 basis points across

all risk categories with possible adjustments to these rates based on certain debt-related components. These increases in the base assessment rate have increased our deposit insurance costs and negatively impacted our earnings. In addition, in May 2009, the FDIC imposed a special assessment on all insured institutions due to recent bank and savings association failures. The emergency assessment amounts to five basis points on each institution's assets

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minus Tier 1 capital as of June 30, 2009, subject to a maximum equal to 10 basis points times the institution's assessment base. Our FDIC deposit insurance expense for the years ended September 30, 2010 and 2009 was \$1.7 million and \$778,000, respectively.

Additionally, in November 2009, the FDIC announced that financial institutions are required to prepay their estimated quarterly risk-based assessment for the fourth quarter of 2009 and for all of 2010, 2011 and 2012. In December 2009, we prepaid \$4.4 million, which will be expensed over this three-year period. This prepayment did not immediately impact our earnings as the payment will be expensed over time, however, any additional emergency special assessment imposed by the FDIC will adversely affect our earnings.

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

Liquidity is essential to our business. An inability to raise funds through deposits, borrowings, the sale of loans and other sources could have a substantial negative effect on our liquidity. We rely on customer deposits and advances from the FHLB of Seattle, borrowings from the Federal Reserve Bank of San Francisco and other borrowings to fund our operations. Although we have historically been able to replace maturing deposits and advances if desired, we may not be able to replace such funds in the future if, among other things, our financial condition, the financial condition of the FHLB or FRB, or market conditions change. Our access to funding sources in amounts adequate to finance our activities or the terms of which are acceptable could be impaired by factors that affect us specifically or the financial services industry or economy in general - 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. 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 Washington markets where our loans are concentrated or adverse regulatory action against us.

Our financial flexibility will be severely constrained if we are unable to maintain our access to funding or if adequate financing is not available to accommodate future growth at acceptable interest rates. Although we consider our sources of funds adequate for our liquidity needs, we may seek additional debt in the future to achieve our long-term business objectives. Additional borrowings, if sought, may not be available to us or, if available, may not be available on reasonable terms. If additional financing sources are unavailable, or are not available on reasonable terms, our financial condition, results of operations, growth and future prospects could be materially adversely affected. Finally, if we are required to rely more heavily on more expensive funding sources to support future growth, our revenues may not increase proportionately to cover our costs.

Our growth or future losses may require us to raise additional capital in the future, but that capital may not be available when it is needed or the cost of that capital may be very high.

We are required by federal regulatory authorities to maintain adequate levels of capital to support our operations. At some point, we may need to raise additional capital to support continued growth. Our ability to raise additional capital, if needed, will depend on conditions in the capital markets at that time, which are outside our control, and on our financial condition and performance. If we are able to raise capital it may not be on terms that are acceptable to us. Accordingly, we cannot make assurances that we will be able to raise additional capital. If we cannot raise additional capital when needed, our operations could be materially impaired and our financial condition and liquidity could be materially and adversely affected.

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As a result, we may have to raise additional capital on terms that may be dilutive to our shareholders. In addition, if we are unable to raise additional capital when required by the FDIC, we may be subject to adverse regulatory action. See " The Company and the Bank are required to comply with the terms of separate memoranda of understanding issued by their respective regulators and lack of compliance could result in additional regulatory actions."

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We operate in a highly regulated environment and may be adversely affected by changes in federal and state laws and regulations, including changes that may restrict our ability to foreclose on single-family home loans and offer overdraft protection.

We are subject to extensive examination, supervision and comprehensive regulation by the FDIC and the Washington Department of Financial Institutions. Banking regulations are primarily intended to protect depositors' funds, federal deposit insurance funds, and the banking system as a whole, and not holders of our common stock. These regulations affect our lending practices, capital structure, investment practices, dividend policy, and growth, among other things. Congress and federal and state regulatory agencies continually review banking laws, regulations, and policies for possible changes. Changes to statutes, regulations, or regulatory policies, including changes in interpretation or implementation of statutes, regulations, or policies, could affect us in substantial and unpredictable ways. Such changes could subject us to additional costs, limit the types of financial services and products we may offer, restrict mergers and acquisitions, investments, access to capital, the location of banking offices, and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputational damage, which could have a material adverse effect on our business, financial condition and results of operations. While we have policies and procedures designed to prevent any such violations, there can be no assurance that such violations will not occur.

Further, our regulators have significant discretion and authority to prevent or remedy unsafe or unsound practices or violations of laws by financial institutions and holding companies in the performance of their supervisory and enforcement duties. Congress and federal regulatory agencies continually review banking laws, regulations and policies for possible changes. Changes to statutes, regulations or regulatory policies, including changes in interpretation or implementation of statutes, regulations or policies, could affect us in substantial and unpredictable ways. Such changes could subject us to additional costs, limit the types of financial services and products we may offer and/or increase the ability of non banks to offer competing financial services and products, among other things.

We may experience future goodwill impairment, which could reduce our earnings.

We performed our test for goodwill impairment for fiscal year 2010, but no impairment was identified. Our assessment of the fair value of goodwill is based on an evaluation of current purchase transactions, discounted cash flows from forecasted earnings, our current market capitalization, and a valuation of our assets and liabilities. Our evaluation of the fair value of goodwill involves a substantial amount of judgment. If our judgment was incorrect and an impairment of goodwill was deemed to exist, we would be required to write

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down our goodwill resulting in a charge to earnings, which would adversely affect our results of operations, perhaps materially; however, it would have no impact on our liquidity, operations or regulatory capital.

Our investment in Federal Home Loan Bank of Seattle stock may become impaired.

At September 30, 2010, we owned \$5.7 million in FHLB stock. As a condition of membership at the FHLB, we are required to purchase and hold a certain amount of FHLB stock. Our stock purchase requirement is based, in part, upon the outstanding principal balance of advances from the FHLB and is calculated in accordance with the Capital Plan of the FHLB. Our FHLB stock has a par value of \$100, is carried at cost, and it is subject to recoverability testing per accounting guidance for the impairment of long lived assets. The FHLB has announced that it had a risk-based capital deficiency under the regulations of the Federal Housing Finance Agency (the "FHFA"), its primary regulator, as of December 31, 2008, and that it would suspend future dividends and the repurchase and redemption of outstanding common stock. As a result, the FHLB has not paid a dividend since the fourth quarter of 2008. The FHLB has communicated that it believes the calculation of risk-based capital under the current rules of the FHFA significantly overstates the market risk of the FHLB's private-label mortgage-backed securities in the current market environment and that it has enough capital to cover the risks reflected in its balance sheet. As a result, we have not recorded an other-than-temporary impairment on our investment in FHLB stock. However, continued deterioration in the FHLB's financial position may result in impairment in the value of those securities. On October 26, 2010, the FHLB announced that it had entered into a Consent Agreement with the FHFA, which requires the FHLB to take certain specified actions related to

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its business and operations. We will continue to monitor the financial condition of the FHLB as it relates to, among other things, the recoverability of our investment.

We may experience further decreases in the fair value of our mortgage servicing rights, which could reduce our earnings.

Mortgage servicing rights (MSRs) are capitalized at estimated fair value when acquired through the origination of loans that are subsequently sold with servicing rights retained. MSRs are amortized to servicing income on loans sold over the period of estimated net servicing income. The estimated fair 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. We periodically evaluate the fair value of MSRs 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. Our methodology for estimated the fair value of MSRs is highly sensitive to changes in assumptions, such as prepayment speeds. The effect of changes in market interest rates on estimated rates of loan prepayments represents the predominant risk characteristic underlying the MSRs portfolio. For example, a decrease in mortgage interest rates typically increases the prepayment speeds of MSRs and therefore decreases the fair value of the MSRs. We recorded an \$890,000 valuation allowance to our MSRs during the year ended September 30, 2010, which reduced our earnings. Future decreases in mortgage interest rates could further decrease the fair value of our MSRs, which would decrease our earnings.



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Our assets as of September 30, 2010 include a deferred tax asset and we may not be able to realize the full amount of such asset.

We recognize deferred tax assets and liabilities based on differences between the financial statement recorded amounts and the tax bases of assets and liabilities. At September 30, 2010, the net deferred tax asset was approximately \$3.4 million, a decrease from a balance of approximately \$4.5 million at September 30, 2009. The net deferred tax asset results primarily from our provisions for loan losses recorded for financial reporting purposes, which have been larger than net loan charge-offs deducted for tax reporting purposes.

We regularly review our net deferred tax assets for recoverability based on history of earnings expectations for future earnings and expected timing of reversals of temporary differences. Realization of deferred tax assets ultimately depends on the existence of sufficient taxable income, including taxable income in prior carryback years, as well as future taxable income. We believe the recorded net deferred tax asset at September 30, 2010 is fully realizable; however, if we determine that we will be unable to realize all or part of the net deferred tax asset, we would adjust this net deferred tax asset, which would negatively impact our financial condition and results of operations.

Risks specific to our participation in TARP.

Because of our participation in the TARP CPP we are subject to restrictions on compensation paid to our executives. Pursuant to the terms of the TARP CPP we adopted certain standards for executive compensation and corporate governance for the period during which the Treasury holds an investment in us. These standards generally apply to our Chief Executive Officer, Chief Financial Officer and the three next most highly compensated senior executive officers. The standards include (1) ensuring that incentive compensation for senior executives does not encourage unnecessary and excessive risks that threaten the value of the financial institution; (2) required clawback of any bonus or incentive compensation paid to a senior executive based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate; (3) prohibition on making golden parachute payments to senior executives; and (4) agreement not to deduct for tax purposes executive compensation in excess of \$500,000 for each senior executive. Pursuant to the American Recovery and Reinvestment Act and its implementing regulations, further compensation restrictions have been imposed on us with respect to our senior executive officers and other most highly compensated employees, including significant limitations on our ability to pay incentive compensation and make severance payments. Such restrictions and any future limitations on compensation that may be adopted could adversely affect our ability to hire and retain the most qualified management and other personnel.

The securities purchase agreement between us and Treasury limits our ability to pay dividends on and repurchase our common stock. The securities purchase agreement between us and Treasury provides that prior to the earlier of (i) December 23, 2011 and (ii) the date on which all of the shares of the Series A Preferred Stock have been redeemed by us or transferred by Treasury to third parties, we may not, without the consent of Treasury, (a) increase the cash dividend on our common stock or (b) subject to limited exceptions,

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redeem, repurchase or otherwise acquire shares of our common stock or preferred stock other than the Series A Preferred Stock or any trust preferred securities. In addition, we are unable to pay any dividends on our common stock unless we are current in our dividend payments on the Series A Preferred Stock. As of September 30, 2010, the FRB has denied the Company's request to pay dividends on its Series A Preferred Stock (issued under TARP) for the payments due May 15, 2010 and August 15, 2010. The foregoing, together with the potentially dilutive impact of the warrant described in the next risk factor, could have a negative effect on the value of our common stock. Moreover, holders of our common stock are entitled to receive dividends only when, as and if declared by our Board of Directors. Although we have historically paid cash dividends on our common stock, we are not required to do so and our Board of Directors could reduce or eliminate our common stock dividend in the future.

The Series A Preferred Stock impacts net income (loss) to our common shareholders and net income (loss) per common share and the warrant we issued to Treasury may be dilutive to holders of our common stock. The dividends declared or accrued on the Series A Preferred Stock reduce the net income (increase the net loss) to common shareholders and our net income (loss) per common share. The Series A Preferred Stock will also receive preferential treatment in the event of liquidation, dissolution or winding up of the Company. Additionally, the ownership interest of the existing holders of our common stock will be diluted to the extent the warrant we issued to Treasury in conjunction with the sale of the Series A Preferred Stock is exercised. The shares of common stock underlying the warrant represent approximately 5.0% of the shares of our common stock outstanding as of September 30, 2010 (including the shares issuable upon exercise of the warrant in total shares outstanding). Although Treasury has agreed not to vote any of the shares of common stock it receives upon exercise of the warrant, a transferee of any portion of the warrant or of any shares of common stock acquired upon exercise of the warrant is not bound by this restriction.

We rely heavily on the proper functioning of our technology.

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

We rely on third-party service providers for much of our communications, information, operating and financial control systems technology. If any of our third-party service providers experience financial, operational or technological difficulties, or if there is any other disruption in our relationships with them, we may be required to locate alternative sources of such services, and we cannot assure that we could negotiate terms that are as favorable to us, or could obtain services with similar functionality, as found in our existing systems, without the need to expend substantial resources, if at all. Any of these circumstances could have an adverse effect on our business.

Changes in accounting standards may affect our performance.

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

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We are dependent on key personnel and the loss of one or more of those key personnel may materially and adversely affect our prospects.

Competition for qualified employees and personnel in the banking industry is intense and there are a limited number of qualified persons with knowledge of, and experience in, the community banking industry where the Bank conducts its business. The process of recruiting personnel with the combination of skills and attributes required to carry out our strategies is often lengthy. Our success depends to a significant degree upon our ability to attract and retain qualified management, loan origination, finance, administrative, marketing and technical personnel and upon the continued contributions of our management and personnel. In particular, our success has been and continues to be highly dependent upon the abilities of key executives, including our President, and certain other employees. In addition, our success has been and continues to be highly dependent upon the services of our directors, and we may not be able to identify and attract suitable candidates to replace such directors.

### Item 1B. Unresolved Staff Comments

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Not applicable.

### Item 2. Properties

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At September 30, 2010 the Bank operated 22 full service facilities. The following table sets forth certain information regarding the Bank's offices, all of which are owned, except for the Tacoma office, the Gig Harbor office and the Lacey office at 1751 Circle Lane SE, which are leased.

| Location   | Year Opened | Approximate<br>Square Footage | Deposits at<br>September 30, 2010 |
|--|-------------|-------------------------------|-----------------------------------|
|  |             |                               | (In thousands)                    |
| Main Office:   |             |                               |                                   |
| 624 Simpson Avenue<br>Hoquiam, Washington 98550      | 1966        | 7,700                         | \$82,308                          |
| Branch Offices:                                      |             |                               |                                   |
| 300 N. Boone Street<br>Aberdeen, Washington 98520    | 1974        | 3,400                         | 33,316                            |
| 201 Main Street South<br>Montesano, Washington 98563 | 2004        | 3200                          | 31,472                            |

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|  |      |       |        |
|--|------|-------|--------|
| 361 Damon Road<br>Ocean Shores, Washington 98569               | 1977 | 2,100 | 23,210 |
| 2418 Meridian East<br>Edgewood, Washington 98371               | 1980 | 2400  | 39,581 |
| 202 Auburn Way South<br>Auburn, Washington 98002               | 1994 | 4,200 | 28,345 |
| 12814 Meridian East (South Hill)<br>Puyallup, Washington 98373 | 1996 | 4,200 | 31,014 |
| 1201 Marvin Road, N.E.<br>Lacey, Washington 98516              | 1997 | 4,400 | 18,673 |
| 101 Yelm Avenue W.<br>Yelm, Washington 98597                   | 1999 | 1,800 | 17,704 |

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| Location   | Year Opened | Approximate<br>Square Footage | Deposits at<br>September 30, 2010 |
|--|-------------|-------------------------------|-----------------------------------|
| -----  | -----       | -----                         | -----                             |
|  |             |                               | (In thousands)                    |
| 20464 Viking Way NW<br>Poulsbo, Washington 98370       | 1999        | 3,400                         | 12,738                            |
| 2419 224th Street E.<br>Spanaway, Washington 98387     | 1999        | 3,900                         | 26,534                            |
| 801 Trosper Road SW<br>Tumwater, Washington 98512      | 2001        | 3,300                         | 28,032                            |
| 7805 South Hosmer Street<br>Tacoma, Washington 98408   | 2001        | 5,000                         | 25,886                            |
| 2401 Bucklin Hill Road<br>Silverdale, Washington 98383 | 2003        | 4,000                         | 37,140                            |
| 423 Washington Street SE<br>Olympia, Washington 98501  | 2003        | 3,000                         | 16,439                            |
| 3105 Judson St<br>Gig Harbor, Washington 98335         | 2004        | 2,700                         | 22,904                            |
| 117 N. Broadway<br>Aberdeen, Washington 98520          | 2004        | 3,700                         | 19,260                            |
| 313 West Waldrip<br>Elma, Washington 98541             | 2004        | 5,900                         | 21,422                            |
| 1751 Circle Lane SE<br>Lacey, Washington 98503         | 2004        | 900                           | 15,306                            |
| 101 2nd Street   | 2004        | 1,800                         | 20,617                            |

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Toledo, Washington 98591

|  |      |       |        |
|--|------|-------|--------|
| 209 NE 1st Street<br>Winlock, Washington 98586 | 2004 | 3,400 | 15,622 |
|--|------|-------|--------|

|  |      |       |        |
|--|------|-------|--------|
| 714 W. Main Street<br>Chehalis, Washington 98532 | 2009 | 4,600 | 11,346 |
|--|------|-------|--------|

Loan Center/Data Center:

|   |      |       |    |
|---|------|-------|----|
| 120 Lincoln Street<br>Hoquiam, Washington 98550 | 2003 | 6,000 | -- |
|---|------|-------|----|

Other Properties:

|   |      |       |    |
|---|------|-------|----|
| 305 8th Street (1)<br>Hoquiam, Washington 98550 | 2004 | 4,100 | -- |
|---|------|-------|----|

-----  
(1) Office at 305 8th Street, Hoquiam, Washington was consolidated into the office at 624 Simpson Avenue, Hoquiam, Washington on November 15, 2004. The building is currently being used for storage and other administrative purposes.

Management believes that all facilities are appropriately insured and are adequately equipped for carrying on the business of the Bank.

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At September 30, 2010 the Bank operated 23 proprietary ATMs that are part of a nationwide cash exchange network.

Item 3. Legal Proceedings  
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Periodically, there have been various claims and lawsuits involving the Bank, such as claims to enforce liens, condemnation proceedings on properties in which the Bank holds security interests, claims involving the making and servicing of real property loans and other issues incident to the Bank's business. The Bank is not a party to any pending legal proceedings that it believes would have a material adverse effect on the financial condition or operations of the Bank.

Item 4. [Removed and Reserved]  
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PART II

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

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The Company's common stock is traded on the Nasdaq Global Market under the symbol "TSBK." As of November 30, 2010, there were 7,045,036 shares of common stock issued and approximately 605 shareholders of record. The following table sets forth the high and low sales prices of, and dividends paid on, the Company's common stock for each quarter during the years ended September 30, 2010 and 2009. The high and low price information was provided by the Nasdaq Stock Market.

|                      | High<br>----- | Low<br>----- | Dividends<br>----- |
|----------------------|---------------|--------------|--------------------|
| Fiscal 2010<br>----- |               |              |                    |
| First Quarter.....   | \$ 4.75       | \$ 3.95      | \$ 0.03            |
| Second Quarter.....  | 4.42          | 3.59         | 0.01               |
| Third Quarter.....   | 5.28          | 3.30         | --                 |
| Fourth Quarter.....  | 4.25          | 2.98         | --                 |

|                      | High<br>----- | Low<br>----- | Dividends<br>----- |
|----------------------|---------------|--------------|--------------------|
| Fiscal 2009<br>----- |               |              |                    |
| First Quarter.....   | \$7.99        | \$5.10       | \$0.11             |
| Second Quarter.....  | 7.93          | 1.94         | 0.11               |
| Third Quarter.....   | 6.00          | 3.57         | 0.11               |
| Fourth Quarter.....  | 5.63          | 3.90         | 0.06               |

### Dividends

Dividend payments by the Company are dependent primarily on dividends received by the Company from the Bank. Under federal regulations, the dollar amount of dividends the Bank may pay is dependent upon its capital position and recent net income. Generally, if the Bank satisfies its regulatory capital requirements, it may make dividend payments up to the limits prescribed in the FDIC regulations. However, an institution that has converted to a stock form of ownership may not declare or pay a dividend on, or repurchase any of, its common stock if the effect thereof would cause the regulatory capital of the institution to be reduced below the amount required for the liquidation account which was established in connection with the mutual to stock conversion. In addition, the Bank is subject to restrictions on its ability to pay dividends to the Company under the terms of the Bank MOU. The Company is also subject to restrictions on its ability to pay dividends to stockholders under the terms of the Company MOU. Further, the Company also is subject to restrictions on its ability to pay dividends pursuant to the terms of the securities purchase agreement between the Company and the U.S. Treasury. As of September 30, 2010, the FRB has denied the Company's request to pay dividends on its Series A Preferred Stock issued under the CPP for the payments due on May 15, 2010 and August 15, 2010. For additional information regarding the Company's and the Bank's restrictions on the payment of dividends, see "Item 1A, Risk Factors The Company and the Bank are required to comply with the terms of separate memoranda of understanding issued by their respective regulators and lack of compliance could result in additional regulatory actions." and " Risks specific to our participation in TARP."

### Equity Compensation Plan Information

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

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Stock Repurchases

The Company is subject to restrictions on its ability to repurchase its common stock pursuant to the terms of the securities purchase agreement between the Company and the U.S. Treasury, and pursuant to the terms of the Company MOU. For additional information, see Item 1A, "Risk Factors - The Company and the Bank are required to

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comply with the terms of separate memoranda of understanding issued by their respective regulators and lack of compliance could result in additional regulatory actions." and " Risks specific to our participation in TARP."

The following graph compares the cumulative total shareholder return on our common stock with the cumulative total return on the Nasdaq U.S. Companies Index and with the SNL \$250 to \$500 Million Asset Thrift Index and the SNL \$500 million to \$1 Billion Asset Thrift Index, peer group indices. Total return assumes the reinvestment of all dividends and that the value of the Company's Common Stock and each index was \$100 on September 30, 2005.

[GRAPH APPEARS HERE]

| Index                                   | Period Ending |          |          |          |          |          |
|---|---------------|----------|----------|----------|----------|----------|
|   | 09-30-05      | 09-30-06 | 09-30-07 | 09-30-08 | 09-30-09 | 09-30-10 |
| Timberland Bancorp,<br>Inc.....         | \$100.00      | 154.92   | 141.08   | 70.87    | 46.78    | 41.12    |
| NASDAQ Composite...                     | 100.00        | 104.96   | 125.55   | 97.22    | 98.64    | 110.08   |
| SNL \$250M-\$500 M<br>Thrift Index..... | 100.00        | 108.82   | 100.55   | 85.50    | 80.16    | 81.83    |
| SNL \$500M-\$1 B<br>Thrift Index.....   | 100.00        | 116.17   | 111.96   | 83.83    | 70.18    | 67.32    |

\* Source: SNL Financial LC, Charlottesville, VA

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Item 6. Selected Financial Data

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

|  | At September 30, |           |           |           |           |
|--|------------------|-----------|-----------|-----------|-----------|
|  | 2010             | 2009      | 2008      | 2007      | 2006      |
|  | (In thousands)   |           |           |           |           |
| SELECTED FINANCIAL CONDITION DATA:   |                  |           |           |           |           |
| Total assets.....  | \$742,687        | \$701,676 | \$681,883 | \$644,848 | \$577,087 |
| Loans receivable and loans held for sale, net.....   | 527,591          | 547,208   | 557,687   | 515,341   | 424,645   |
| Investment securities available-for-sale.....  | --               | --        | --        | 50,851    | 63,805    |
| Investment securities held-to-maturity.....  | 28               | 27        | 28        | --        | --        |
| Mortgage-backed securities held-to-maturity.....   | 5,038            | 7,060     | 14,205    | 71        | 75        |
| Mortgage-backed securities and mutual funds available-for-sale.....                                  | 11,119           | 13,471    | 17,098    | 13,047    | 17,603    |
| FHLB Stock.....  | 5,705            | 5,705     | 5,705     | 5,705     | 5,705     |
| Cash and due from financial institutions, interest-bearing deposits in banks and fed funds sold..... | 111,786          | 66,462    | 42,874    | 16,670    | 22,789    |
| Certificates of deposit held for investment.....   | 18,047           | 3,251     | --        | --        | 100       |
| Deposits.....  | 578,869          | 505,661   | 498,572   | 466,735   | 431,061   |
| FHLB advances.....   | 75,000           | 95,000    | 104,628   | 99,697    | 62,761    |
| Federal Reserve Bank advances.....   | --               | 10,000    | --        | --        | --        |
| Shareholders' equity.....  | 85,408           | 87,199    | 74,841    | 74,547    | 79,365    |

|   | Year Ended September 30,              |          |          |          |          |
|---|---------------------------------------|----------|----------|----------|----------|
|   | 2010                                  | 2009     | 2008     | 2007     | 2006     |
|   | (In thousands, except per share data) |          |          |          |          |
| SELECTED OPERATING DATA:                              |                                       |          |          |          |          |
| Interest and dividend income.....                     | \$ 36,596                             | \$38,801 | \$43,338 | \$41,944 | \$35,452 |
| Interest expense.....                                 | 10,961                                | 13,504   | 16,413   | 15,778   | 10,814   |
| Net interest income.....                              | 25,635                                | 25,297   | 26,295   | 26,166   | 24,638   |
| Provision for loan losses...                          | 10,550                                | 10,734   | 3,900    | 686      | --       |
| Net interest income after provision for loan losses.. | 15,085                                | 14,563   | 23,025   | 25,480   | 24,638   |
| Non-interest income.....                              | 5,696                                 | 6,949    | 4,178    | 5,962    | 6,244    |
| Non-interest expense.....                             | 24,641                                | 22,739   | 20,349   | 19,451   | 18,896   |



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|   |            |            |          |          |          |
|---|------------|------------|----------|----------|----------|
| Income (loss) before income taxes.....                      | (3,860)    | (1,227)    | 6,854    | 11,991   | 11,986   |
| Provision (benefit) for federal and state income taxes..... | (1,569)    | (985)      | 2,849    | 3,828    | 3,829    |
| Net income (loss).....                                      | \$ (2,291) | \$ (242)   | \$ 4,005 | \$ 8,163 | \$ 8,157 |
| Preferred stock dividends...                                | \$ (832)   | \$ (643)   | \$ --    | \$ --    | \$ --    |
| Preferred stock accretion...                                | (210)      | (129)      | --       | --       |          |
| Net income (loss) to common shareholders.....               | \$ (3,333) | \$ (1,014) | \$ 4,005 | \$ 8,163 | \$ 8,157 |
| Net income (loss) per common share (1):                     |            |            |          |          |          |
| Basic.....  | \$ (0.50)  | \$ (0.15)  | \$ 0.62  | \$ 1.20  | \$ 1.16  |
| Diluted.....  | \$ (0.50)  | \$ (0.15)  | \$ 0.61  | \$ 1.17  | \$ 1.12  |
| Dividends per common share (1).....                         | \$ 0.04    | \$ 0.39    | \$ 0.43  | \$ 0.37  | \$ 0.33  |
| Dividend payout ratio (2)...                                | N/A        | N/A        | 74.33%   | 32.86%   | 30.55%   |

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- (1) Has been restated to reflect the two-for-one split of common stock, in the form of a 100% stock dividend paid on June 5, 2007.
- (2) Cash dividends to common shareholders divided by net income (loss) to common shareholders.

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At September 30,

|  | 2010   | 2009   | 2008   | 2007   | 2006   |
|--|--------|--------|--------|--------|--------|
| OTHER DATA:                                  |        |        |        |        |        |
| Number of real estate loans outstanding..... | 2,919  | 3,062  | 3,261  | 3,295  | 3,005  |
| Deposit accounts.....                        | 55,598 | 53,941 | 53,501 | 53,166 | 51,392 |
| Full-service offices.....                    | 22     | 22     | 21     | 21     | 21     |

At or For the Year Ended September 30,

|  | 2010    | 2009    | 2008  | 2007  | 2006  |
|--|---------|---------|-------|-------|-------|
| KEY FINANCIAL RATIOS:                    |         |         |       |       |       |
| Performance Ratios:                      |         |         |       |       |       |
| Return (loss) on average assets (1)..... | (0.32)% | (0.04)% | 0.61% | 1.34% | 1.47% |
| Return (loss) on average equity (2)..... | (2.65)  | (0.28)  | 5.35  | 10.67 | 10.59 |

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|   |         |        |         |         |          |
|---|---------|--------|---------|---------|----------|
| Interest rate spread (3)...   | 3.63    | 3.64   | 3.98    | 4.18    | 4.49     |
| Net interest margin (4)....   | 3.87    | 4.01   | 4.41    | 4.69    | 4.91     |
| Average interest-earning assets to average interest-bearing liabilities.....                    | 114.51  | 117.42 | 115.70  | 118.01  | 119.20   |
| Noninterest expense as a percent of average total assets.....                                   | 3.43    | 3.35   | 3.10    | 3.20    | 3.41     |
| Efficiency ratio (5).....   | 78.65   | 70.52  | 65.42   | 60.54   | 61.19    |
| Book value per common share.....  | \$ 9.89 | 10.17  | \$10.74 | \$10.72 | \$10.56  |
| Tangible book value per common share (6).....   | 9.00    | 9.26   | 9.79    | 9.73    | 9.61     |
| Asset Quality Ratios:   |         |        |         |         |          |
| Non-accrual and 90 days or more past due loans as a percent of total loans receivable, net..... | 4.86%   | 5.36%  | 2.12%   | 0.29%   | 0.02%    |
| Non-performing assets as a percent of total assets (7).....                                     | 5.53    | 5.52   | 1.83    | 0.23    | 0.02     |
| Allowance for loan losses as a percent of total loans receivable, net (8).....                  | 2.09    | 2.59   | 1.44    | 0.92    | 0.96     |
| Allowance for losses as a percent of non-performing loans (9).....                              | 43.01   | 47.11  | 67.14   | 321.95  | 5,152.50 |
| Net charge-offs (recoveries) to average outstanding loans.....                                  | 2.45    | 0.79   | 0.12    | --      | (0.01)   |
| Capital Ratios:   |         |        |         |         |          |
| Total equity-to-assets ratio (6).....   | 11.50%  | 12.43% | 10.98%  | 11.56%  | 13.75%   |
| Tangible equity-to-assets ratio.....  | 10.66   | 11.51  | 10.00   | 10.49   | 12.51    |
| Average equity to average assets.....   | 12.05   | 12.72  | 11.47   | 12.58   | 13.90    |

- 
- (1) Net income (loss) divided by average total assets.
  - (2) Net income (loss) divided by average total equity.
  - (3) Difference between weighted average yield on interest-earning assets and weighted average cost of interest-bearing liabilities.
  - (4) Net interest income (before provision for loan losses) as a percentage of average interest-earning assets.
  - (5) Non-interest expenses divided by the sum of net interest income and non-interest income.
  - (6) Calculation subtracts goodwill and core deposit intangible from the equity component.
  - (7) Non-performing assets include non-accrual loans, loans past due 90 days or more and still accruing, non-accrual investment securities, other real estate owned and other repossessed assets.
  - (8) Loans receivable includes loans held for sale and is before the allowance for loan losses.
  - (9) Non-performing loans include non-accrual loans and loans past due 90 days or more and still accruing. Troubled debt restructured loans that are on accrual status are not included.

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

### Results of Operations

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

##### General

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

##### Special Note Regarding Forward-Looking Statements

These forward-looking statements are intended to be covered by the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995. Forward-looking statements are not statements of historical fact and often include the words "believes," "expects," "anticipates," "estimates," "forecasts," "intends," "plans," "targets," "potentially," "probably," "projects," "outlook" or similar expressions or future or conditional verbs such as "may," "will," "should," "would" and "could." Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, assumptions and statements about future performance. These forward-looking statements are subject to known and unknown risks, uncertainties and other factors that could cause our actual results to differ materially from the results anticipated, including, but not limited to: the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets and may lead to increased losses and nonperforming assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses, and require us to materially increase our reserves; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes, land and other properties and fluctuations in real estate values in our market areas; secondary market conditions for loans and our ability to sell loans in the secondary market; results of examinations of us by the Federal Reserve and our bank subsidiary by the Federal Deposit Insurance Corporation, the Washington State Department of Financial Institutions, Division of Banks or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our reserve for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits, which could adversely affect our liquidity and earnings; our compliance with regulatory enforcement actions, including regulatory memoranda of understandings ("MOUs") to which we are subject; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules; our ability to attract and retain deposits; further

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increases in premiums for deposit insurance; our ability to control operating costs and expenses; the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risks associated with the loans on our balance sheet; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our workforce and potential associated charges; computer systems on which we depend could fail or experience a security breach; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; our ability to manage loan delinquency rates; increased competitive pressures among financial services companies; changes in consumer spending, borrowing and savings habits; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, the interpretation of regulatory capital or other rules and any changes in the rules applicable to institutions participating in the TARP Capital Purchase Program; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; 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 issued by the financial institution

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regulatory agencies or the Financial Accounting Standards Board, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; the economic impact of war or any terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations; pricing, products and services; and other risks described elsewhere in this Form 10-K.

Any of the forward-looking statements that we make in this Form 10-K and in the other public statements we make are based upon management's beliefs and assumptions at the time they are made. We undertake no obligation to publicly update or revise any forward-looking statements included in this annual report or to update the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise. We caution readers not to place undue reliance on any forward-looking statements. We do not undertake and specifically disclaim any obligation to revise any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements. These risks could cause our actual results for fiscal 2011 and beyond to differ materially from those expressed in any forward-looking statements by, or on behalf of, us, and could negatively affect the Company's results of operations and stock price.

### Critical Accounting Policies and Estimates

The Company has established various accounting policies that govern the application of accounting principles generally accepted in the United States of America ("GAAP") in the preparation of the Company's Consolidated Financial Statements. The Company has identified five policies, that as a result of judgments, estimates and assumptions inherent in those policies, are critical to an understanding of the Company's Consolidated Financial Statements. These

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policies relate to the methodology for the determination of the allowance for loan losses, the valuation of mortgage servicing rights ("MSRs"), the determination of other than temporary impairments in the market value of investment securities, the determination of goodwill impairment and the determination of the recorded value of other real estate owned. These policies and the judgments, estimates and assumptions are described in greater detail in subsequent sections of Management's Discussion and Analysis contained herein and in the notes to the Consolidated Financial Statements contained in Item 8 of this Form 10-K. In particular, Note 1 of the Notes to Consolidated Financial Statements, "Summary of Significant Accounting Policies," generally describes the Company's accounting policies. Management believes that the judgments, estimates and assumptions used in the preparation of the Company's Consolidated Financial Statements are appropriate given the factual circumstances at the time. However, given the sensitivity of the Company's Consolidated Financial Statements to these critical policies, the use of other judgments, estimates and assumptions could result in material differences in the Company's results of operations or financial condition.

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

While the Company believes it has established its existing allowance for loan losses in accordance with GAAP, 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 level of the allowance as of September 30, 2010 was adequate to absorb probable losses inherent in the loan portfolio, a decline in local economic conditions, results of examinations by the Company's or the Bank's regulators or other factors, could result in a material increase in the allowance for loan losses and may adversely affect the Company's financial condition and results of operations.

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

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

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firm for impairment by comparing actual cash flows and estimated cash flows from the servicing assets to those estimated at the time servicing assets were originated. The effect of changes in market interest rates on estimated rates of loan prepayments represents the predominant risk characteristic underlying the MSR's 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.

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

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

One of the circumstances evaluated when determining if an impairment test of goodwill is needed more frequently than annually is the extent and duration that the Company's market capitalization (total common shares outstanding multiplied by current stock price) is less than the total equity applicable to common shareholders. During the quarter ended June 30, 2010, the Company engaged a third party firm to perform the annual test for goodwill impairment. The test concluded that recorded goodwill was not impaired. As of September 30, 2010, there have been no events or changes in the circumstances that would indicate a potential impairment. No assurance can be given, however, that the Company will not record an impairment loss on goodwill in the future.

Other Real Estate Owned and Other Repossessed Assets. Other real estate

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owned and other repossessed assets consist of properties or assets acquired through or in lieu of foreclosure, and are recorded initially at the estimated fair value of the properties less estimated costs of disposal. Costs relating to development and improvement of the properties or assets are capitalized while costs relating to holding the properties or assets are expensed. Valuations are periodically performed by management, and a charge to earnings is recorded if the recorded value of a property exceeds its estimated net realizable value.

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### New Accounting Pronouncements

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

### Operating Strategy

The Company is a bank holding company which operates primarily through its subsidiary, the Bank. The Bank is a community-oriented bank which has traditionally offered a wide variety of savings products to its retail customers while concentrating its lending activities on real estate loans. Since the latter half of 2008, depressed economic conditions have prevailed in portions of the United States, including Washington State where we hold substantially all of our loans and conduct all of our operations. The majority of our loans are secured by collateral and made to borrowers located in Washington State. Western Washington, which includes our primary market areas, has experienced home price declines, increased foreclosures, and has experienced above average unemployment rates. In response to the financial challenges in our market areas we have taken actions to manage our capital, reduce our exposure to speculative construction and land development loans and maintain higher levels of on balance sheet liquidity. We have continued in this low interest environment to originate residential fixed rate mortgage loans primarily for sale in the secondary market. We continue to manage the growth of our commercial and multi-family real estate loan portfolios in a disciplined fashion while continuing to dispose of other real estate owned properties and grow retail deposits.

We believe the resolution of problem financial institutions and continued bank consolidation in Western Washington will provide opportunities for the Company to increase market share within the communities it serves. We are currently pursuing the following strategies:

**Improve Asset Quality.** We are focused on monitoring existing performing loans, resolving non-performing assets and selling foreclosed assets. We have sought to reduce the level of non-performing assets through collections, write-downs, modifications and sales of other real estate owned properties. We have taken proactive steps to resolve our non-performing loans, including negotiating payment plans, forbearances, loan modifications and loan extensions and accepting short payoffs on delinquent loans when such actions have been deemed appropriate.

**Expand our presence within our existing market areas by capturing opportunities resulting from changes in the competitive environment.** We currently conduct our business primarily in Western Washington. We have a community bank strategy that emphasizes responsive and personalized service to our customers. As a result of FDIC bank resolutions and anticipated

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consolidation of banks in our market areas, we believe there is an opportunity for a community and customer focused bank to expand its customer base. By offering timely decision making, delivering appropriate banking products and services, and providing customer access to our senior managers we believe community banks, such as Timberland Bank, can distinguish themselves from larger banks operating in our market areas. We believe we have a significant opportunity to attract additional borrowers and depositors and expand our market presence and market share within our extensive branch footprint.

Continue generating revenues through mortgage banking operations. The substantial majority of the fixed rate residential mortgage loans we originate are sold into the secondary market with servicing retained. This strategy produces gains on the sale of such loans and reduces the interest rate and credit risk associated with fixed rate residential lending. We will continue to originate custom construction and owner builder loans for sale into the secondary market upon the completion of construction.

Portfolio Diversification. We have strictly limited the origination of speculative construction, land development and land loans in favor of loans that possess credit profiles representing less risk to the Bank. We will continue originating owner/builder and custom construction loans, multi-family loans, commercial business loans and certain commercial real estate loans which offer higher risk adjusted returns, shorter maturities and more sensitivity to interest rate fluctuations. We anticipate capturing more of each customer's banking relationship by cross selling our loan and deposit products and additional services to our customers.

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Increase Core Deposits and other Retail Deposit Products. We focus on establishing a total banking relationship with our customers with the intent of internally funding our loan portfolio. We anticipate that the continued focus on customer relationships will help increase our level of core deposits and locally-based retail certificates of deposit. In addition to our retail branches we maintain technology based products such as business cash management and a business remote deposit product that enables us to compete effectively with banks of all sizes.

Limit Exposure to Increasing Interest Rates. For many years the majority of the loans the Bank has retained in its portfolio have generally possessed periodic interest rate adjustment features or have been relatively short term in nature. Loans originated for portfolio retention have included ARM loans, short term construction loans, and to a lesser extent commercial business loans with interest rates tied to a market index such as the prime rate. Longer term fixed-rate mortgage loans have generally been originated for sale into the secondary market.

### Market Risk and Asset and Liability Management

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



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

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

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

Sharp increases or decreases in interest rates may adversely affect the Bank's earnings. Management of the Bank monitors the Bank's interest rate sensitivity through the use of a model provided for the Bank by FIMAC Solutions, LLC ("FIMAC"), a company that specializes in providing the financial services industry interest rate risk and balance sheet management services. Based on a rate shock analysis prepared by FIMAC based on data at September 30, 2010, an immediate increase in interest rates of 200 basis points would increase the Bank's projected net interest income by approximately 7.0%, primarily because a larger portion of the Bank's interest rate sensitive assets than interest rate sensitive liabilities would reprice within a one year period. Similarly, an immediate 200 basis point decrease in interest rates would negatively affect net interest income by approximately 4.4%, as repricing would have the opposite effect. See "- Quantitative Aspects of Market Risk" below for additional information. Management has sought to sustain the match between asset and liability maturities and rates, while maintaining an acceptable interest rate spread. Pursuant to this strategy, the Bank actively originates adjustable-rate loans for retention in its loan portfolio. Fixed-rate mortgage loans with maturities greater than seven years generally are originated for the immediate or future resale in the secondary mortgage market. At September 30, 2010, adjustable-rate mortgage loans constituted \$165.8 million or 37.6%, of the Bank's total mortgage loan portfolio due after one year. Although the Bank has sought to originate ARM loans, the

ability to originate such loans depends to a great extent on market interest rates and borrowers' preferences. Particularly in lower interest rate

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environments, borrowers often prefer fixed-rate loans.

Consumer loans and construction and land development loans typically have shorter terms and higher yields than permanent residential mortgage loans, and accordingly reduce the Bank's exposure to fluctuations in interest rates. At September 30, 2010, the construction and land development, and consumer loan portfolios amounted to \$69.3 million and \$47.5 million, or 12.4% and 8.5% of total loans receivable (including loans held for sale), respectively.

**Quantitative Aspects of Market Risk.** The model provided for the Bank by FIMAC estimates the changes in net portfolio value ("NPV") and net interest income in response to a range of assumed changes in market interest rates. The model first estimates the level of the Bank's NPV (market value of assets, less market value of liabilities, plus or minus the market value of any off-balance sheet items) under the current rate environment. In general, market values are estimated by discounting the estimated cash flows of each instrument by appropriate discount rates. The model then recalculates the Bank's NPV under different interest rate scenarios. The change in NPV under the different interest rate scenarios provides a measure of the Bank's exposure to interest rate risk. The following table is provided by FIMAC based on data at September 30, 2010.

| Hypothetical<br>Interest Rate<br>Scenario<br>-----<br>(Basis Points) | Net Interest Income(1) (2)      |                        |                       | Current Market Value |                        |                       |
|--|---------------------------------|------------------------|-----------------------|----------------------|------------------------|-----------------------|
|  | Estimated<br>Value              | \$ Change<br>from Base | % Change<br>from Base | Estimated<br>Value   | \$ Change<br>from Base | % Change<br>from Base |
|  | -----<br>(Dollars in thousands) |                        |                       |                      |                        |                       |
| +300   | \$26,520                        | \$ 2,307               | 9.53%                 | \$ 97,859            | \$ (113)               | (0.12)%               |
| +200   | 25,909                          | 1,696                  | 7.00                  | 98,786               | 814                    | 0.83                  |
| +100   | 25,070                          | 857                    | 3.54                  | 98,681               | 709                    | 0.72                  |
| BASE   | 24,213                          | --                     | --                    | 97,972               | --                     | --                    |
| -100   | 24,015                          | (198)                  | (0.81)                | 96,961               | (1,011)                | (1.03)                |
| -200   | 23,141                          | (1,072)                | (4.43)                | 100,879              | 2,907                  | 2.97                  |
| -300   | 22,030                          | (2,183)                | (9.02)                | 112,618              | 14,646                 | 14.95                 |

(1) Does not include loan fees.

(2) Includes BOLI income, which is included in non-interest income on the Consolidated Financial Statements.

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

In the event of a 200 basis point decrease in interest rates, the Bank would be expected to experience a 3.0% increase in NPV and a 4.4% decrease in net interest income. In the event of a 200 basis point increase in interest rates, a 0.8% increase in NPV and a 7.0% increase in net interest income would be expected. Based upon the modeling described above, the Bank's asset and liability structure generally results in decreases in net interest income in a declining interest rate scenario and increases in net interest income in a rising rate scenario. This structure also generally results in increases in NPV when rates increase by 200 basis points or less and a decrease in NPV when rates decrease by 100 basis points or less.

As with any method of measuring interest rate risk, certain shortcomings are inherent in the method of analysis presented in the foregoing table. For

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example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets have features which restrict changes in interest rates on a short-term basis and over the life of the asset. Further, in the event of a change in interest rates,

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

Comparison of Financial Condition at September 30, 2010 and September 30, 2009

The Company's total assets increased by \$41.0 million, or 5.8%, to \$742.7 million at September 30, 2010 from \$701.7 million at September 30, 2009. The increase was primarily attributable to an increase in cash and cash equivalents and short-term certificates of deposit ("CDs") held for investment. These increases were partially offset by a decrease in net loans receivable.

Net loans receivable decreased by \$19.6 million, or 3.6%, to \$527.6 million at September 30, 2010 from \$547.2 million at September 30, 2009. The reduction in the loan portfolio was primarily due to a significant decrease in construction and land development loan balances during the year ended September 30, 2010, which was partially offset by increases in commercial real estate loan balances, one- to four-family loan balances, multi-family loan balances and commercial business loan balances.

Total deposits increased by \$73.2 million, or 14.5%, to \$578.9 million at September 30, 2010 from \$505.7 million at September 30, 2009, primarily as a result of increases in N.O.W. checking account balances and CD account balances.

Shareholders' equity decreased by \$1.8 million, or 2.1%, to \$85.4 million at September 30, 2010 from \$87.2 million at September 30, 2009. The decrease was primarily due to a net loss for the year ended September 30, 2010, which was partially offset by a reduction in the accumulated other comprehensive loss equity component, due to a reduction in unrealized losses on investment securities. The Company remains well capitalized with a total risk based capital ratio of 16.3% at September 30, 2010.

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

**Cash and Cash Equivalents and CDs Held for Investment:** Cash and cash equivalents and CDs held for investment increased by \$60.1 million, or 86.2%, to \$129.8 million at September 30, 2010 from \$69.7 million at September 30, 2009. The increase in cash equivalents and short-term CDs was primarily due to the Company's decision to increase its liquidity position for regulatory and asset-liability management purposes.

**Mortgage-backed Securities and Other Investments:** Mortgage-backed securities and other investments decreased by \$4.4 million, or 21.3%, to \$16.2 million at September 30, 2010 from \$20.6 million at September 30, 2009. The

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decrease was primarily as a result of regular amortization and prepayments on mortgage-backed securities and OTTI charges recorded on private label residential mortgage-backed securities. The securities on which the OTTI charges were recognized were acquired from the in-kind redemption of the Company's investment in the AMF family of mutual funds in June 2008. For additional details on investments and mortgage-backed securities, see "Item 1, Business - Investment Activities" and Note 3 of the Notes to the Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplemental Data."

Loans Receivable and Loans Held for Sale, Net of Allowance for Loan Losses: Net loans receivable, including loans held for sale, decreased by \$19.6 million or 3.6% to \$527.6 million at September 30, 2010 from \$547.2 million at September 30, 2009. The decrease in the portfolio was primarily a result of a \$57.1 million decrease in construction and land development loan balances (net of the undisbursed portion of construction loans in process), a \$4.1 million decrease in consumer loan balances and a \$2.6 million decrease in land loan balances. These decreases to net loans receivable were partially offset by a \$19.8 million increase in commercial real estate loan balances, a \$10.5 million increase in one- to four-family loan balances, a \$6.6 million increase multi-family loan balances and a \$4.2 million increase in commercial business loan balances. The decreases in the construction and land development loan balances were primarily due to loan payoffs, construction projects being completed and converted to permanent financing, loan charge-offs and changes in the Company's underwriting standards for these types of loans, which has decreased the level of construction and land development loan originations.

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Loan originations decreased by 38.2% to \$182.5 million for the year ended September 30, 2010 from \$295.3 million for the year ended September 30, 2009, primarily due to a decrease in the demand for single family home loan refinances. The Company continued to sell longer-term fixed rate loans for asset-liability management purposes and to generate non-interest income. The Bank sold \$68.3 million in fixed rate one- to four-family mortgage loans during the year ended September 30, 2010 compared to \$162.9 million for the fiscal year ended September 30, 2009. For additional information on loans, see "Item 1, Business - Lending Activities" and Note 4 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

Premises and Equipment: Premises and equipment decreased by \$663,000, or 3.7%, to \$17.4 million at September 30, 2010 from \$18.0 million at September 30, 2009. The decrease was primarily as a result of depreciation. For additional information on premises and equipment, see "Item 2, Properties" and Note 6 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

OREO: OREO and other repossessed assets increased by \$3.3 million, or 40.7% to \$11.5 million at September 30, 2010 from \$8.2 million at September 30, 2009 as a result of additional properties being acquired through the loan foreclosure process. At September 30, 2010, the balance was comprised of 27 individual properties and three other repossessed assets. The OREO properties consisted of two condominium projects totaling \$3.9 million, three land development projects totaling \$3.3 million, eight single family homes totaling \$1.7 million, 11 land parcels totaling \$1.4 million and three commercial real estate properties totaling \$1.1 million. The largest OREO property was a

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condominium project with a balance of \$3.0 million. For additional information on OREO, see "Item 1, Business Lending Activities Nonperforming Assets" and Note 7 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

**Goodwill and Core Deposit Intangible ("CDI"):** The recorded value of goodwill at \$5.7 million at September 30, 2010 remained unchanged from September 30, 2009. The amortized value of CDI decreased by \$191,000 to \$564,000 at September 30, 2010 from \$755,000 at September 30, 2009 due to scheduled amortization. The Company recorded goodwill and CDI in connection with an acquisition of seven branches and related deposits in October 2004. The Company performed its annual review of goodwill during the quarter ended June 30, 2010 and determined that there was no impairment to goodwill. For additional information of Goodwill and CDI, see Note 1 and Note 8 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplemental Data."

**Mortgage Servicing Rights ("MSRs"):** MSRs decreased \$689,000, or 26.3%, to \$1.9 million at September 30, 2010 from \$2.6 million at September 30, 2009, primarily due to an \$890,000 MSR valuation allowance established during the year ended September 30, 2010. The establishment of a valuation allowance was primarily a result of lower mortgage interest rates at September 30, 2010 which reduced the expected duration of the cash flows associated with the MSR portfolio, and therefore reduced the estimated fair value of the MSRs.

**Prepaid FDIC Insurance Assessment:** The prepaid FDIC insurance assessment increased to \$3.27 million at September 30, 2010 due to the FDIC's new requirement to prepay three year's worth of estimated insurance fees on December 31, 2009.

**Deposits:** Deposits increased by \$73.2 million, or 14.5%, to \$578.9 million at September 30, 2010 from \$505.7 million at September 30, 2009. The increase was primarily a result of a \$35.9 million increase in N.O.W. checking account balances, a \$26.7 million increase in CD account balances, an \$8.8 million increase in savings account balances and an \$8.5 million increase in non-interest bearing account balances. These increases were partially offset by a \$6.8 million decrease in money market account balances. The increase in N.O.W. account balances was primarily a result of the Company's checking account promotions. The increase in CD account balances was primarily a result of increased demand for CD accounts by customers in the Company's market areas. The Company also experienced deposit inflows due to a number of customers transferring funds from other financial institutions during the year ended September 30, 2010. For additional information on deposits, see "Item 1, Business - Deposit Activities and Other Sources of Funds" and Note 9 of the Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

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**FHLB Advances and FRB Borrowings:** FHLB advances and FRB borrowings decreased by \$30.0 million, or 27.3%, to \$75.0 million at September 30, 2010 from \$110.0 million at September 30, 2009 as the Company used a portion of its liquid assets to repay maturing FHLB advances and FRB borrowings. For additional information on borrowings, see "Item 1, Business - Deposit Activities and Other Sources of Funds Borrowings" and Notes 10 of the Notes to Consolidated Financial Statements contained in "Item 8, Financial Statements and Supplementary Data."

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Shareholders' Equity: Total shareholders' equity decreased by \$1.8 million, or 2.1%, to \$85.4 million at September 30, 2010 from \$87.2 million at September 30, 2009. The decrease was primarily due to a net loss of \$(2.3 million) and the payment and accrual of \$1.1 million in dividends to preferred and common shareholders and was partially offset by a \$1.3 million reduction in the accumulated other comprehensive loss equity component, due to a reduction in unrealized losses on investment securities.

The FRB has denied the Company's request to pay cash dividends on its outstanding Series A Preferred Stock held by the Treasury for the payments due May 15, 2010 and August 15, 2010. Cash dividends on the Series A Preferred Stock are cumulative and accrue and compound on each subsequent date. Accordingly, during the deferral period, the Company will continue to accrue, and reflect in the consolidated financial statements, the deferred dividends on the outstanding Series A Preferred Stock. As a result of not receiving permission from the FRB, the Company had not made the May 15, 2010 or the August 15, 2010 dividend payment as of September 30, 2010. At September 30, 2010, the Company had unpaid preferred stock dividends in arrears of \$416,000.

If the Company does not make six quarterly dividend payments on the Series A Preferred Stock, whether or not consecutive, the Treasury will have the right to appoint two directors to the Company's board of directors until all accrued but unpaid dividends have been paid. In addition, the Company's ability to pay dividends with respect to common stock is restricted until the dividend obligations under the Series A Preferred Stock are brought current.

For additional information on shareholders' equity, see the Consolidated Statements of Shareholders' Equity contained in "Item 8, Financial Statements and Supplementary Data."

### Comparison of Operating Results for the Years Ended September 30, 2010 and 2009

The Company reported a net loss of \$(2.29 million) for the year ended September 30, 2010 compared to a net loss of \$(242,000) for the year ended September 30, 2009. Net loss to common shareholders after adjusting for preferred stock dividends and preferred stock discount accretion was \$(3.33 million) for the year ended September 30, 2010 compared to a net loss to common shareholders of \$(1.01 million) for the year ended September 30, 2009. The increased loss was primarily due to increased non-interest expenses and decreased non-interest income, which were partially offset by increased net interest income, a decreased provision for loan losses and an increased benefit for federal income taxes. Loss per diluted common share was \$(0.50) for the year ended September 30, 2010, compared to a loss per diluted common share of \$(0.15) for the year ended September 30, 2009.

The increased non-interest expense was primarily attributable to an increase in FDIC insurance expense, an increase in salaries and employee benefits expense, an increase in OREO related expenses, an increase in the Company's general liability insurance expense and increases in premises and equipment expenses.

The decrease in non-interest income was primarily a result of a decrease in gain on sale of loans, a decrease in BOLI net earnings and an MSR valuation allowance. These decreases to non-interest income were partially offset by a decrease in the OTTI loss on mortgage-backed securities.

A more detailed explanation of the Statement of Operations categories is presented below.

Net Loss: The net loss for the year ended September 30, 2010 increased by \$2.05 million to \$(2.29 million) from \$(242,000) for the year ended September 30, 2009. Net loss to common shareholders after adjusting for

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preferred stock dividends and preferred stock discount accretion was \$(3.33 million) or \$(0.50) per diluted common share for the year ended September 30, 2010, compared to a net loss to common shareholders of \$(1.01 million) or \$(0.15) per diluted common share for the year ended September 30, 2009.

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The \$0.35 increase in loss per diluted common share for the year ended September 30, 2010 was primarily the result of a \$1.90 million (\$1.26 million net of income tax - \$0.19 per diluted common share) increase in non-interest expense, a \$1.25 million (\$826,000 net of income tax - \$0.13 per diluted common share) decrease in non-interest income and a \$270,000 increase in preferred stock dividends and preferred stock discount accretion which increased the net loss to common shareholders by approximately \$0.04 per diluted common share. Changes to the benefit for income taxes due to a decrease in the amount of dividend deductions and adjustments to the Company's deferred tax valuation allowance also increased the loss per diluted common share by approximately \$0.04 per diluted common share. These increases to the loss per diluted common share were partially offset by a \$338,000 (\$223,000 net of income tax - \$0.03 per diluted common share) increase in net interest income and a \$184,000 (\$121,000 net of income tax - \$0.02 per diluted common share) decrease in the provision for loan losses.

**Net Interest Income:** Net interest income increased by \$338,000, or 1.3%, to \$25.64 million for the year ended September 30, 2010 from \$25.30 million for the year ended September 30, 2009. The increase in net interest income was primarily attributable to an increased average level of interest earning assets which was partially offset by margin compression due to an increased level of relatively low yielding cash equivalents and other liquid assets.

Total interest and dividend income decreased by \$2.21 million, or 5.7%, to \$36.60 million for the year ended September 30, 2010 from \$38.80 million for the year ended September 30, 2009 as the yield on interest earning assets decreased to 5.53% from 6.15%. The decrease in the weighted average yield on interest earning assets was primarily a result of an increase in the amount of lower yielding cash equivalents and other liquid assets and a change in the composition of the loan portfolio as the level of higher yielding construction and land development loans decreased.

Total interest expense decreased by \$2.54 million to \$10.96 million for the year ended September 30, 2010 from \$13.50 million for the year ended September 30, 2009 as the average rate paid on interest-bearing liabilities decreased to 1.90% for the year ended September 30, 2010 from 2.51% for the year ended September 30, 2009. The decrease in funding costs was primarily a result of a decrease in overall market rates and a decrease in the level of average FHLB advances.

The net interest margin decreased 14 basis points to 3.87% for the year ended September 30, 2010 from 4.01% for the year ended September 30, 2009 as the yield on interest earning assets decreased at a greater rate than the funding costs decreased. The margin compression was primarily due to an increased level of liquid assets with lower yields and the reversal of interest income on loans placed on non-accrual status during the year ended September 30, 2010. The reversal of interest income on loans placed on non-accrual status during the year ended September 30, 2010 reduced the net interest margin by approximately 12 basis points.

**Provision for Loan Losses:** The provision for loan losses decreased by

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\$184,000, or 1.7%, to \$10.55 million for the year ended September 30, 2010 from \$10.73 million for the year ended September 30, 2009. The small decrease in the provision for loan losses was primarily a result of a decrease in the level of non-performing loans and a decrease in the Bank's construction and land development loan balances. The Company had net charge-offs of \$13.46 million for the year ended September 30, 2010 compared to net charge-offs of \$4.44 million for the year ended September 30, 2009. The net charge-off total for the year ended September 30, 2010 included \$3.36 million in impairments that were identified and specifically provisioned for in the previous fiscal year. The net charge-offs to average outstanding loans ratio was 2.45% for the year ended September 30, 2010 and 0.79% for the year ended September 30, 2009.

The Company has established a comprehensive methodology for determining the provision for loan losses. On a quarterly basis the Company performs an analysis that considers pertinent factors underlying the quality of the loan portfolio. These factors include changes in the amount and composition of the loan portfolio, historic loss experience for various loan segments, changes in economic conditions, delinquency rates, a detailed analysis of impaired loans, and other factors to determine an appropriate level of allowance for loan losses. Management's analysis for the years ended September 30, 2010 and 2009, placed a greater emphasis on the Company's construction and land development portfolio and the effect of various factors such as geographic and loan type concentrations.

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Based on the comprehensive methodology, management deemed the allowance for loan losses of \$11.26 million at September 30, 2010 (2.09% of loans receivable and loans held for sale and 45.3% of non-performing loans) adequate to provide for probable losses based on an evaluation of known and inherent risks in the loan portfolio at that date. Impaired loans are subject to an impairment analysis to determine an appropriate reserve amount to be held against each loan. The aggregate principal impairment amount determined at September 30, 2010 was \$862,000. While the Company believes it has established its existing allowance for loan losses in accordance with GAAP, there can be no assurance that regulators, in reviewing the Company's loan portfolio, will not request the Company to increase significantly its allowance for loan losses. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is adequate or that substantial increases will not be necessary should the quality of any loans deteriorate. Any material increase in the allowance for loan losses would adversely affect the Company's financial condition and results of operations. For additional information, see "Item 1, Business Lending Activities Allowance for Loan Losses."

Non-interest Income: Total non-interest income decreased by \$1.25 million, or 18.0%, to \$5.70 million for the year ended September 30, 2010 from \$6.95 million for the year ended September 30, 2009. This decrease was primarily a result of a \$1.28 million decrease in gain on sale of loans, an \$890,000 valuation allowance on mortgage servicing rights, and a \$474,000 decrease in BOLI net earnings. Also impacting the comparison between the years was \$139,000 in non-recurring income recorded during the year ended September 30, 2009 for property easements sold. These decreases to non-interest income were partially offset by a \$1.37 million decrease in net OTTI losses recorded and a \$358,000 increase in ATM transaction fees.



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The decreased income from loan sales was primarily a result of a decrease in the amount of residential mortgage loans sold in the secondary market for the year ended September 30, 2010. The sale of one-to four-family mortgage loans totaled \$68.3 million for the year ended September 30, 2010 compared to \$162.6 million for the year ended September 30, 2009. The higher loan sales during the year ended September 30, 2009 was primarily due to increased refinance activity that was attributable to decreased interest rates for fixed rate mortgage loans. The \$890,000 valuation allowance on the Company's mortgage servicing rights was primarily the result of lower mortgage interest rates at September 30, 2010 relative to September 30, 2009. The lower interest rates reduced the market value of the Company's mortgage servicing rights by reducing the expected duration of the cash flows associated with the asset. The higher BOLI income for the year ended September 30, 2009 was primarily due to a \$377,000 gain on a BOLI death claim benefit and a \$134,000 non-recurring gain associated with transferring a portion of the BOLI portfolio to a new insurance company during the year ended September 30, 2009.

The Company's net OTTI loss on mortgage-backed securities decreased by \$1.37 million to \$2.18 million for the year ended September 30, 2010 from \$3.55 million for the year ended September 30, 2009. The OTTI charges for both years were on private label mortgage-backed securities that were acquired from an in-kind redemption from the AMF family of mutual funds in June 2008. At September 30, 2010, the Company's remaining private label mortgage-backed securities had been reduced to \$4.95 million from an original acquired balance of \$15.30 million.

**Non-interest Expense:** Total non-interest expense increased by \$1.90 million, or 8.4%, to \$24.64 million for the year ended September 30, 2010 from \$22.74 million for the year ended September 30, 2009. The increase was primarily attributable to an \$881,000 increase in FDIC insurance expense, a \$354,000 increase in the Company's general liability insurance expense (which is included in the other non-interest expense category), a \$265,000 increase in salaries and employee benefit expense, a \$239,000 increase in OREO related expenses and a \$194,000 increase in premises and equipment expense.

The increase in FDIC insurance expense was primarily due to increased assessments rates and a non-recurring accrual adjustment which increased the expense by \$400,000 for the year ended September 30, 2010. The increase in general liability insurance expense was primarily due to increased insurance costs for financial institutions in this economic cycle.

The increase in salaries and employee benefit expense was primarily a result of a decreased level of loan originations. Under GAAP, the portion of a loan origination fee that is attributable to the estimated employee costs to

generate the loan is recorded as a reduction of salaries and employee benefit expense. With the decrease in loan originations, the loan origination fees that reduced salaries and employee benefit expense decreased by \$381,000 during the year ended September 30, 2010 compared to the year ended September 30, 2009.

The increase in OREO related expenses was primarily a result of valuation write-downs based on updated appraisals received for several properties. The increase in premises and equipment expense for the current fiscal year was primarily the result of a capital gain on the sale of Company owned property that reduced premises and equipment expenses by \$235,000 for the year ended

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September 30, 2009.

The Company's efficiency ratio increased to 78.65% for the year ended September 30, 2010 from 70.52% for the year ended September 30, 2009.

**Benefit for Federal Income Taxes:** The benefit for federal income taxes increased by \$582,000 to \$1.57 million for the year ended September 30, 2010 from \$982,000 for the year ended September 30, 2009 primarily as a result of an increased loss before income taxes. The Company's effective federal income tax (benefit) rate was (40.5%) for the year ended September 30, 2010 compared to (80.0%) for the year ended September 30, 2009. The change in the effective tax (benefit) rate is primarily due to changes in the percentage of non-taxable income and changes to the Company's deferred tax valuation allowance. The benefit for federal income taxes for the year ended September 30, 2009 was increased by a higher level of non-taxable income, primarily due to an increase in BOLI net earnings. The benefit for income taxes for the year ended September 30, 2009 was also increased by approximately \$180,000 due to adjustments made to the Company's deferred tax valuation allowance for a previous non-deductible capital loss carry forward. In periods with a loss before income taxes, the effective benefit rate is increased by non-taxable income items and other adjustments that increase the tax benefit.

### Comparison of Operating Results for the Years Ended September 30, 2009 and 2008

The Company's net income decreased by \$4.25 million, or 106.0%, to a net loss of \$(242,000) for the year ended September 30, 2009 from net income of \$4.01 million for the year ended September 30, 2008. Income available to common shareholders after adjusting for the preferred stock dividend and the preferred stock discount accretion was a loss of \$(1.01 million) for the year ended September 30, 2009 compared to income of \$4.01 million available to common shareholders for the year ended September 30, 2008. The decrease was primarily as a result of increased provision for loan losses, decreased net interest income, and increased non-interest expenses, which were partially offset by increased non-interest income. Diluted earnings per common share decreased by 124.6% to a loss of \$(0.15) for the year ended September 30, 2009 from \$0.61 for the year ended September 30, 2008.

The increased provision for loan losses was primarily a result of an increase in net charge-offs, an increase in impaired loans, an increase in the level of performing loans classified as substandard under the Bank's loan grading system, and uncertainties in real estate values in the Pacific Northwest. Net charge-offs totaled \$4.44 million during the year ended September 30, 2009, which was equivalent to 0.79% of the average outstanding loans.

The decreased net interest income was primarily attributable to an increase in non-accrual loans and lower overall market interest rates, which compressed the Company's net interest margin. The net interest margin decreased 40 basis points to 4.01% for the year ended September 30, 2009 from 4.41% for the year ended September 30, 2008.

The increased non-interest expense was primarily attributable to an increase in FDIC insurance expense, an increase in OREO related expenses, an increase in loan monitoring and foreclosure related expenses and increases in premises and equipment expenses.

The increased non-interest income was primarily a result of increased gains on sale of loans, increased service charges on deposit accounts and increased BOLI net earnings partially offset by net OTTI losses on private label mortgage backed securities. The increased income from loan sales was primarily a result of an increase in the dollar amount of residential mortgage

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loans sold in the secondary market for the year ended September 30, 2009. The increase

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in loan sales was primarily attributable to lower interest rates for 30-year fixed rate loans which increased refinancing activity.

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

**Net Income:** Net income for the year ended September 30, 2009 decreased by \$4.25 million, or 106.0%, to a net loss of \$(242,000) from net income of \$4.01 million for the year ended September 30, 2008. Income available to common shareholders after adjusting for preferred stock dividends and preferred stock discount accretion was a loss of \$(1.01 million), or \$(0.15) per diluted common share for the year ended September 30, 2009 compared to net income of \$4.01 million, or \$0.61 per diluted common share for the year ended September 30, 2008.

The \$0.76 decrease in diluted earnings per common share for the year ended September 30, 2009 was primarily the result of a \$6.83 million (\$4.51 million net of income tax - \$0.69 per diluted common share) increase in the provision for loan losses, a \$2.39 million (\$1.58 million net of income tax - \$0.24 per diluted common share) increase in non-interest expense, a \$1.63 million (\$1.07 million net of income tax - \$0.16 per diluted common share) decrease in net interest income and a \$772,000 increase in preferred stock dividends and preferred stock accretion which decreased earnings by approximately \$0.12 per diluted common share. These items were partially offset by a \$2.77 million increase in non-interest income which increased diluted earnings per common share by approximately \$0.45.

**Net Interest Income:** Net interest income decreased by \$1.63 million, or 6.0%, to \$25.30 million for the year ended September 30, 2009 from \$26.93 million for the year ended September 30, 2008. The decrease in net interest income was primarily attributable to an increase in non-accrual loans and lower overall market interest rates.

Total interest and dividend income decreased by \$4.54 million to \$38.80 million for the year ended September 30, 2009 from \$43.34 million for the year ended September 30, 2008 as the yield on interest earning assets decreased to 6.15% from 7.09%. Total average interest earning assets (including non-accrual loans) increased by \$20.11 million to \$631.25 million for the year ended September 30, 2009 from \$611.14 million for the year ended September 30, 2008. Non-accrual loans increased by \$17.30 million to \$29.29 million at September 30, 2009 from \$11.99 million at September 30, 2008.

Total interest expense decreased by \$2.91 million to \$13.50 million for the year ended September 30, 2009 from \$16.41 million for the year ended September 30, 2008 as the average rate paid on interest-bearing liabilities decreased to 2.51% for the year ended September 30, 2009 from 3.11% for the year ended September 30, 2008. Total interest bearing liabilities increased by \$9.34 million to \$537.54 million for the year ended September 30, 2009 from \$528.20 million for the year ended September 30, 2008.

The net interest margin decreased 40 basis points to 4.01% for the year ended September 30, 2009 from 4.41% for the year ended September 30, 2008 as the yield on interest earnings assets decreased at a greater rate than funding

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costs decreased. This was primarily a result of the decreasing interest rate environment which reduced yields on loans at a faster pace than the Bank was able to reduce deposit and borrowing costs. The reversal of interest income on loans placed on non-accrual status contributed to the margin compression and reduced the net interest margin by approximately 18 basis points for the year ended September 30, 2009.

**Provision for Loan Losses:** The provision for loan losses increased by \$6.83 million, or 175.2%, to \$10.73 million for the year ended September 30, 2009 from \$3.90 million for the year ended September 30, 2008. The increased provision for loan losses was primarily a result of an increase in net charge-offs, an increase in impaired loans, an increase in the level of performing loans classified as substandard under the Company's loan grading system, and uncertainties in the housing market in certain markets of the Pacific Northwest. The Company had net charge-offs of \$4.44 million for the year ended September 30, 2009 compared to net charge-offs of \$647,000 for the year ended September 30, 2008. The net charge-offs to average outstanding loans ratio was 0.79% for the year ended September 30, 2009 and 0.12% for the year ended September 30, 2008.

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**Non-interest Income:** Total non-interest income increased by \$2.77 million, or 66.3%, to \$6.95 million for the year ended September 30, 2009 from \$4.18 million for the year ended September 30, 2008. This increase was primarily a result of a \$2.82 million decrease in loss on the redemption of mutual funds, \$1.82 million increase in gain on sale of loans, an \$819,000 increase in service charges on deposit accounts, a \$479,000 increase in BOLI net earnings and \$139,000 in income recorded for property easements sold. These increases to non-interest income were partially offset by a \$3.62 million increase in net OTTI losses recorded during the year ended September 30, 2009.

The \$2.82 million loss on mutual funds recorded during the year ended September 30, 2008 was a result of the redemption of investments in the AMF family of mutual funds for the underlying securities and cash. The net OTTI charges of \$3.62 million recorded during the year ended September 30, 2009 were on private label mortgage backed securities that were acquired from the in-kind redemption from the AMF family of mutual funds in 2008.

The increased income from loan sales was primarily a result of an increase in the dollar amount of residential mortgage loans sold in the secondary market for the year ended September 30, 2009. The sale of one- to four-family mortgage loans totaled \$162.6 million for the year ended September 30, 2009 compared to \$45.3 million for the year ended September 30, 2008. 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 deposit accounts was primarily a result of implementing a new automated overdraft decision system in May 2008 and increasing the fee charged for overdrafts. The increase in BOLI income was attributable to a \$337,000 death claim benefit and a \$134,000 gain from moving a number of the Company's BOLI policies to a new insurance carrier.

**Non-interest Expense:** Total non-interest expense increased by \$2.39 million, or 11.7%, to \$22.74 million for the year ended September 30, 2009 from \$20.35 million for the year ended September 30, 2008. The increase was primarily attributable to a \$648,000 increase in FDIC insurance expense (including a special FDIC assessment of \$391,000), a \$646,000 increase in OREO

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related expenses, a \$204,000 increase in loan monitoring and foreclosure related expenses (which are included in the other non-interest expense category), a \$267,000 increase in premises and equipment expense, a \$232,000 increase in salary and benefit expenses, and a \$143,000 increase in deposit related expenses (which are included in the other non-interest expense category).

The increase in OREO related expenses and foreclosure expenses were primarily a result of an increase in the number of OREO properties held and an increase in foreclosure activity. The increase in premises and equipment expenses was partially attributable to the addition of a full service branch facility in Chehalis, Washington. Also contributing to the change in premises and equipment expense was an insurance settlement and the sale of a building in the prior fiscal year which reduced premises and equipments expenses by a combined \$295,000 for the year ended September 30, 2008. The Company also recorded a capital gain on the sale of Company owned property which reduced premises and equipment expenses by \$235,000 for the year ended September 30, 2009. The increased salary and benefit expenses were primarily a result of annual salary adjustments and increased insurance expenses. The increased deposit related expenses were primarily a result of the expenses associated with several new deposit related programs.

The Company's efficiency ratio increased to 70.52% for the year ended September 30, 2009 from 65.42% for the year ended September 30, 2008.

Provision (Benefit) for Federal Income Taxes: The provision for federal income taxes decreased by \$3.81 million to a net benefit of \$982,000 for the year ended September 30, 2009 from \$2.82 million for the year ended September 30, 2008 primarily as a result of lower income before taxes. The benefit for federal income taxes for the year ended September 30, 2009 was impacted by an increased level of non-taxable income, primarily attributable to the increase in BOLI net earnings. The income tax benefit for the year ended September 30, 2009 was also increased by approximately \$180,000 due to adjustments made to the Company's deferred tax valuation allowance for a previous non-deductible capital loss carry forward.

The provision for federal income taxes for the year ended September 30, 2008 was impacted by the \$2.82 million loss on the redemption of mutual funds. The redemption of the mutual funds resulted in a capital loss which can only be deducted for tax purposes to the extent that capital gains are realized within a three year carry back period and a five year carry forward period. The Company estimated that it would have \$679,000 in capital gains during the allowable tax period to offset the capital loss. Therefore \$2.14 million of the \$2.82 million loss was treated as non-

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deductible for tax purposes for the year ended September 30, 2008. The Company's effective tax rate was 41.35% (or 31.65% exclusive of the mutual fund redemption loss and associated tax impact) for the year ended September 30, 2008.

Average Balances, Interest and Average Yields/Cost

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

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

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|  | Year Ended September 30, |                        |             |                  |                        |             |                  |                        |
|--|--------------------------|------------------------|-------------|------------------|------------------------|-------------|------------------|------------------------|
|  | 2010                     |                        |             | 2009             |                        |             | 2008             |                        |
|  | Average Balance          | Interest and Dividends | Yield/ Cost | Average Balance  | Interest and Dividends | Yield/ Cost | Average Balance  | Interest and Dividends |
|  | (Dollars in thousands)   |                        |             |                  |                        |             |                  |                        |
| <b>Interest-earning assets:</b>                      |                          |                        |             |                  |                        |             |                  |                        |
| Loans receivable (1) (2)...                          | \$555,050                | \$35,344               | 6.43%       | \$564,741        | \$37,249               | 6.60%       | \$552,318        | \$40,000               |
| Mortgage-backed securities and other investments.... | 17,513                   | 910                    | 5.20        | 25,762           | 1,379                  | 5.35        | 19,799           | 1,000                  |
| FHLB stock and equity securities.....                | 6,679                    | 35                     | 0.52        | 6,655            | 38                     | 0.57        | 29,201           | 1,000                  |
| Federal funds sold                                   | --                       | --                     | --          | 9,032            | 36                     | 0.40        | 8,318            | --                     |
| Interest-bearing deposits.....                       | 82,455                   | 307                    | 0.37        | 24,964           | 99                     | 0.40        | 1,499            | --                     |
| <b>Total interest-earning assets.....</b>            | <b>661,697</b>           | <b>36,596</b>          | <b>5.53</b> | <b>631,154</b>   | <b>38,801</b>          | <b>6.15</b> | <b>611,135</b>   | <b>43,000</b>          |
| <b>Non-interest-earning assets.....</b>              | <b>56,482</b>            |                        |             | <b>47,851</b>    |                        |             | <b>47,086</b>    |                        |
| <b>Total assets.....</b>                             | <b>\$718,179</b>         |                        |             | <b>\$679,005</b> |                        |             | <b>\$658,221</b> |                        |
| <b>Interest-bearing liabilities:</b>                 |                          |                        |             |                  |                        |             |                  |                        |
| Savings accounts.....                                | \$ 63,695                | 454                    | 0.71%       | \$ 55,814        | 394                    | 0.71        | \$ 56,461        | 1,000                  |
| Money market accounts....                            | 59,988                   | 677                    | 1.13        | 61,777           | 1,036                  | 1.68        | 51,943           | 1,000                  |
| NOW accounts.....                                    | 141,240                  | 1,749                  | 1.24        | 97,879           | 1,031                  | 1.05        | 86,441           | 1,000                  |
| Certificates of deposit...                           | 234,550                  | 4,927                  | 2.10        | 224,673          | 7,011                  | 3.12        | 224,493          | 9,000                  |
| Short-term borrowings(3)...                          | 923                      | 3                      | 0.33        | 672              | 1                      | 0.12        | 14,321           | 1,000                  |
| Long-term borrowings (4)...                          | 77,479                   | 3,151                  | 4.07        | 96,721           | 4,031                  | 4.17        | 94,537           | 4,000                  |
| <b>Total interest bearing liabilities.....</b>       | <b>577,875</b>           | <b>10,961</b>          | <b>1.90</b> | <b>537,536</b>   | <b>13,504</b>          | <b>2.51</b> | <b>528,196</b>   | <b>16,000</b>          |
| <b>Non-interest bearing liabilities.....</b>         | <b>53,734</b>            |                        |             | <b>55,086</b>    |                        |             | <b>55,150</b>    |                        |
| <b>Total liabilities.....</b>                        | <b>631,609</b>           |                        |             | <b>592,622</b>   |                        |             | <b>583,346</b>   |                        |
| Shareholders' equity.....                            | 86,570                   |                        |             | 86,383           |                        |             | 74,875           |                        |

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|   |           |         |           |           |
|---|-----------|---------|-----------|-----------|
|   | -----     | -----   | -----     | -----     |
| Total liabilities and<br>shareholders' equity...  | \$718,179 |         | \$679,005 | \$658,221 |
|   | =====     |         | =====     | =====     |
| Net interest income.....  | \$25,635  |         | \$25,297  | \$26,000  |
|   | =====     |         | =====     | =====     |
| Interest rate spread.....   |           | 3.63%   |           | 3.64%     |
|   |           | =====   |           | =====     |
| Net interest margin (5)....   |           | 3.87%   |           | 4.01%     |
|   |           | =====   |           | =====     |
| Ratio of average interest-<br>earning assets to<br>average interest-bearing<br>liabilities..... |           | 114.51% |           | 117.42%   |
|   |           | =====   |           | =====     |

-----

- (1) Does not include interest on loans on non-accrual status. Includes loans originated for sale net deferred loan fees, late fees, extension fees and prepayment penalties (2010, \$829; 2009, and 2008, \$1,804) included with interest and dividends.
- (2) Average balance includes nonaccrual loans.
- (3) Includes FHLB, FRB and PCBB advances with original maturities of less than one year and other borrowings-repurchase agreements.
- (4) Includes FHLB advances with original maturities of one year or greater.
- (5) Net interest income divided by total average interest earning assets.

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Rate/Volume Analysis

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

|                          | Year Ended September 30,<br>2010 Compared to Year<br>Ended September 30, 2009 |         |                | Year Ended September 30,<br>2009 Compared to Year<br>Ended September 30, 2008 |        |               |
|--------------------------|---|---------|----------------|---|--------|---------------|
|                          | Increase (Decrease)<br>Due to   |         |                | Increase (Decrease)<br>Due to   |        |               |
|                          | Rate  | Volume  | Net<br>Change  | Rate  | Volume | Net<br>Change |
|                          | -----   | -----   | -----          | -----   | -----  | -----         |
|                          |   |         | (In thousands) |   |        |               |
| Interest-earning assets: |   |         |                |   |        |               |
| Loans receivable (1).... | \$(1,273)   | \$(632) | \$(1,905)      | \$(4,579)   | \$ 903 | \$(3,676)     |
| Mortgage-backed          |   |         |                |   |        |               |

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|   |          |          |         |            |        |            |
|---|----------|----------|---------|------------|--------|------------|
| securities and other investments.....                           | (38)     | (431)    | (469)   | (4)        | 319    | 315        |
| FHLB stock and equity securities.....                           | (3)      | --       | (3)     | (569)      | (516)  | (1,085)    |
| Federal funds sold.....   | --       | (36)     | (36)    | (170)      | 15     | (155)      |
| Interest-bearing deposits                                       | (5)      | 213      | 208     | (54)       | 117    | 63         |
| Total net change in income on interest-earning assets.....      | (1,319)  | (886)    | (2,205) | (5,376)    | 838    | (4,538)    |
| Interest-bearing liabilities:                                   |          |          |         |            |        |            |
| Savings accounts.....   | 3        | 57       | 60      | 1          | (5)    | (4)        |
| NOW accounts.....   | 204      | 514      | 718     | 147        | 110    | 257        |
| Money market accounts..   | (330)    | (29)     | (359)   | (422)      | 209    | (213)      |
| Certificate accounts...   | (2,408)  | 324      | (2,084) | (2,339)    | 8      | (2,331)    |
| Short-term borrowings..   | 1        | --       | 1       | (310)      | (304)  | (614)      |
| Long-term borrowings...   | (94)     | (785)    | (879)   | (96)       | 92     | (4)        |
|   | -----    | -----    | -----   | -----      | -----  | -----      |
| Total net change in expense on interest-bearing liabilities.... | (2,624)  | 81       | (2,543) | (3,019)    | 110    | (2,909)    |
|   | -----    | -----    | -----   | -----      | -----  | -----      |
| Net change in net interest income.....                          | \$ 1,305 | \$ (967) | \$ 338  | \$ (2,357) | \$ 728 | \$ (1,629) |
|   | =====    | =====    | =====   | =====      | =====  | =====      |

-----  
 (1) Excludes interest on loans on non-accrual status. Includes loans originated for sale.

Liquidity and Capital Resources

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

The Bank must maintain an adequate level of liquidity to ensure the availability of sufficient funds to fund loan originations and deposit withdrawals, to satisfy other financial commitments and to take advantage of investment opportunities. The Bank generally maintains sufficient cash and short-term investments to meet short-term liquidity needs. At September 30, 2010, the Bank's regulatory liquidity ratio (net cash, and short-term and marketable assets, as a percentage of net deposits and short-term liabilities) was 22.49%. At September 30, 2010, the Bank maintained an uncommitted credit facility with the FHLB that provided for immediately available advances up to an aggregate amount

equal to 30% of total assets, limited by available collateral, under which \$75.0 million was outstanding. The Bank also maintains a short-term borrowing line with the Federal Reserve Bank with total credit based on eligible collateral. At September 30, 2010 the Bank had no outstanding balance on this borrowing line.



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

The Bank's primary investing activity is the origination of mortgage loans. During the years ended September 30, 2010, 2009 and 2008, the Bank originated \$154.1 million, \$273.6 million and \$223.9 million of mortgage loans, respectively. At September 30, 2010, the Bank had loan commitments totaling \$34.4 million and undisbursed loans in process totaling \$18.0 million. The Bank anticipates that it will have sufficient funds available to meet current loan commitments. Certificates of deposit that are scheduled to mature in less than one year from September 30, 2010 totaled \$177.9 million. Historically, the Bank has been able to retain a significant amount of its deposits as they mature.

The Bank's liquidity is also affected by the volume of loans sold and loan principal payments. During the years ended September 30, 2010, 2009 and 2008, the Bank sold \$68.3 million, \$162.9 million and \$45.3 million in fixed rate, one- to four-family mortgage loans, respectively. During the years ended September 30, 2010, 2009 and 2008, the Bank received \$150.3 million, \$150.7 million and \$176.1 million in principal repayments, respectively.

The Bank's liquidity has been impacted by increases in deposit levels. During the years ended September 30, 2010, 2009 and 2008, deposits increased by \$73.2 million, \$7.1 million and \$31.8 million, respectively.

Cash and cash equivalents, certificate of deposits held for investment and mortgage-backed securities and other investments increased to \$146.0 million at September 30, 2010 from \$90.3 million at September 30, 2009.

Federally-insured state-chartered banks are required to maintain minimum levels of regulatory capital. Under current FDIC regulations, insured state-chartered banks generally must maintain (i) a ratio of Tier 1 leverage capital to total assets of at least 3.0% (4.0% to 5.0% for all but the most highly rated banks), (ii) a ratio of Tier 1 capital to risk weighted assets of at least 4.0% and (iii) a ratio of total capital to risk weighted assets of at least 8.0%. The Bank is required to maintain at least a 10.0% Tier 1 leverage capital ratio pursuant to the Bank MOU. At September 30, 2010, the Bank was in compliance with all applicable capital requirements, including the higher Tier 1 leverage capital ratio required by the Bank MOU. For additional details see Note 19 of the Notes to Consolidated Financial Statements contained in "Item 8. Financial Statements and Supplementary Data" and "Item 1. Business - Regulation of the Bank - Capital Requirements."

Contractual obligations. The following table presents, as of September 30, 2010, the Company's significant fixed and determinable contractual obligations, within the categories described below, by payment date or contractual maturity. These contractual obligations, except for the operating

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lease obligations are included in the Consolidated Balance Sheet. The payment amounts represent those amounts contractually due at September 30, 2010.

| Contractual obligations            | Payments due by period |                              |  |                  | Total    |
|------------------------------------|------------------------|------------------------------|--|------------------|----------|
|                                    | Less<br>than<br>1 year | 1 year<br>through<br>3 years | After<br>3 years<br>through<br>5 years | After<br>5 years |          |
|                                    | (In thousands)         |                              |  |                  |          |
| Short-term debt obligations...     | \$ 622                 | \$ --                        | \$ --                                  | \$ --            | \$ 622   |
| Long-term debt obligations....     | 20,000                 | 10,000                       | --                                     | 45,000           | 75,000   |
| Operating lease obligations...     | 198                    | 422                          | 288                                    | --               | 908      |
| Total contractual obligations..... | \$20,820               | \$10,422                     | \$ 288                                 | \$45,000         | \$76,530 |
|                                    | =====                  | =====                        | =====                                  | =====            | =====    |

### Effect of Inflation and Changing Prices

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

### Item 7A. Quantitative and Qualitative Disclosures About Market Risk

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

### Item 8. Financial Statements and Supplementary Data

#### Management's Report on Internal Control Over Financial Reporting

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. The Company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and disposition of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or

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disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls

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may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company's management conducted an evaluation of the effectiveness of internal control over financial reporting based on the framework in Internal Control -- Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management concluded that the Company's internal control over financial reporting was effective as of September 30, 2010.

### TIMBERLAND BANCORP, INC. AND SUBSIDIARY

#### Index to Consolidated Financial Statements

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#### Report of Independent Registered Public Accounting Firm

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To the Board of Directors and  
Shareholders of Timberland Bancorp, Inc.

We have audited the accompanying consolidated balance sheet of Timberland Bancorp, Inc. and Subsidiary (collectively, "the Company") as of September 30, 2010, and the related consolidated statements of operations, shareholders' equity, cash flows, and comprehensive income (loss) for the year then ended.

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The Company's management is responsible for these consolidated financial statements. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The consolidated financial statements of the Company as of September 30, 2009, and for the years ended September 30, 2009 and 2008, were audited by other auditors whose report dated December 14, 2009, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2010 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Timberland Bancorp, Inc. and Subsidiary as of September 30, 2010, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

/s/ Delap LLP

Lake Oswego, Oregon  
December 10, 2010

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### Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders  
Timberland Bancorp, Inc.

We have audited the consolidated balance sheet of Timberland Bancorp, Inc. and Subsidiary as of September 30, 2009, and the related consolidated statements of operations, shareholders' equity, cash flows and comprehensive income for each of the two years in the period ended September 30, 2009. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in

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the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Timberland Bancorp, Inc. and Subsidiary as of September 30, 2009, and the results of their operations and their cash flows for each of the two years in the period ended September 30, 2009, in conformity with U.S. generally accepted accounting principles.

/s/McGladrey & Pullen, LLP

Seattle, Washington  
December 14, 2009

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### Consolidated Balance Sheets

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(Dollars in Thousands, Except Per Share Amounts)

Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

|   | 2010<br>----- | 2009<br>----- |
|---|---------------|---------------|
| <b>Assets</b>   |               |               |
| Cash and cash equivalents:  |               |               |
| Cash and due from financial institutions  | \$ 9,466      | \$ 10,205     |
| Interest-bearing deposits in banks  | 102,320       | 56,257        |
|   | -----         | -----         |
| Total cash and cash equivalents   | 111,786       | 66,462        |
|   | -----         | -----         |
| Certificates of deposit ("CDs") held for investment,<br>(at cost which approximates fair value)   | 18,047        | 3,251         |
| Mortgage-backed securities ("MBS") and other<br>investments - held to maturity, at amortized cost<br>(estimated fair value \$4,842 and \$6,215) | 5,066         | 7,087         |
| MBS and other investments - available for sale  | 11,119        | 13,471        |
| Federal Home Loan Bank of Seattle ("FHLB") stock  | 5,705         | 5,705         |
| Loans receivable, net of allowance for loan losses<br>of \$11,264 and \$14,172  | 524,621       | 546,578       |
| Loans held for sale   | 2,970         | 630           |
|   | -----         | -----         |
| Net loans receivable  | 527,591       | 547,208       |
| Premises and equipment, net   | 17,383        | 18,046        |
| Other real estate owned ("OREO") and other<br>repossessed assets  | 11,519        | 8,185         |

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|  |           |           |
|--|-----------|-----------|
| Accrued interest receivable  | 2,630     | 2,805     |
| Bank owned life insurance ("BOLI")   | 13,400    | 12,918    |
| Goodwill   | 5,650     | 5,650     |
| Core deposit intangible ("CDI")  | 564       | 755       |
| Mortgage servicing rights ("MSRs"), net  | 1,929     | 2,618     |
| Prepaid Federal Deposit Insurance Corporation ("FDIC") insurance assessment  | 3,268     | - -       |
| Other assets   | 7,030     | 7,515     |
|  | -----     | -----     |
| Total assets   | \$742,687 | \$701,676 |
|  | =====     | =====     |
| Liabilities and shareholders' equity   |           |           |
| Liabilities  |           |           |
| Deposits:  |           |           |
| Non-interest-bearing demand  | \$ 58,755 | \$ 50,295 |
| Interest-bearing   | 520,114   | 455,366   |
|  | -----     | -----     |
| Total deposits   | 578,869   | 505,661   |
|  | -----     | -----     |
| FHLB advances  | 75,000    | 95,000    |
| Federal Reserve Bank of San Francisco ("FRB") borrowings   | - -       | 10,000    |
| Repurchase agreements  | 622       | 777       |
| Other liabilities and accrued expenses   | 2,788     | 3,039     |
|  | -----     | -----     |
| Total liabilities  | 657,279   | 614,477   |
|  | -----     | -----     |
| Commitments and contingencies (See Note 17)  | - -       | - -       |
| Shareholders' equity   |           |           |
| Preferred stock, \$0.01 par value; 1,000,000 shares authorized; 16,641 shares, Series A, issued and outstanding, \$1,000 per share liquidation value | 15,764    | 15,554    |
| Common stock, \$0.01 par value; 50,000,000 shares authorized; 7,045,036 shares issued and outstanding  | 10,377    | 10,315    |
| Unearned shares issued to Employee Stock Ownership Plan ("ESOP")   | (2,247)   | (2,512)   |
| Retained earnings  | 62,238    | 65,854    |
| Accumulated other comprehensive loss   | (724)     | (2,012)   |
|  | -----     | -----     |
| Total shareholders' equity   | 85,408    | 87,199    |
|  | -----     | -----     |
| Total liabilities and shareholders' equity   | \$742,687 | \$701,676 |
|  | =====     | =====     |

See notes to consolidated financial statements.

Consolidated Statements of Operations

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(Dollars in Thousands, Except Per Share Amounts)

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Timberland Bancorp, Inc. and Subsidiary  
Years Ended September 30, 2010, 2009 and 2008

|   | 2010     | 2009     | 2008     |
|---|----------|----------|----------|
|   | -----    | -----    | -----    |
| Interest and dividend income  |          |          |          |
| Loans receivable  | \$35,344 | \$37,249 | \$40,924 |
| MBS and other investments   | 910      | 1,379    | 1,064    |
| Dividends from mutual funds and FHLB stock  | 35       | 38       | 1,123    |
| Interest-bearing deposits in banks  | 307      | 135      | 227      |
|   | -----    | -----    | -----    |
| Total interest and dividend income  | 36,596   | 38,801   | 43,338   |
|   | -----    | -----    | -----    |
| Interest expense  |          |          |          |
| Deposits  | 7,807    | 9,472    | 11,763   |
| FHLB advances - short term  | -        | -        | 593      |
| FHLB advances - long term   | 3,154    | 4,031    | 4,035    |
| FRB borrowings and repurchase agreements  | -        | 1        | 22       |
|   | -----    | -----    | -----    |
| Total interest expense  | 10,961   | 13,504   | 16,413   |
|   | -----    | -----    | -----    |
| Net interest income   | 25,635   | 25,297   | 26,925   |
| Provision for loan losses   | 10,550   | 10,734   | 3,900    |
|   | -----    | -----    | -----    |
| Net interest income after provision for<br>loan losses  | 15,085   | 14,563   | 23,025   |
| Non-interest income   |          |          |          |
| Other than temporary impairment ("OTTI")<br>on MBS and other investments                          | (998)    | (5,820)  | -        |
| Adjustment for portion recorded as<br>(transferred from) other comprehensive<br>loss before taxes | (1,178)  | 2,274    | -        |
|   | -----    | -----    | -----    |
| Net OTTI on MBS and other investments   | (2,176)  | (3,546)  | -        |
| Realized loss on MBS and other investments  | (20)     | (76)     | -        |
| Service charges on deposits   | 4,240    | 4,312    | 3,493    |
| ATM transaction fees  | 1,619    | 1,261    | 1,251    |
| BOLI net earnings   | 491      | 965      | 486      |
| Gain on sale of loans, net  | 1,547    | 2,828    | 1,011    |
| Loss on sale/redemption of mutual funds, net  | -        | -        | (2,822)  |
| Servicing income on loans sold  | 135      | 103      | 90       |
| Escrow fees   | 74       | 158      | 9        |
| Fee income from non-deposit investment sales  | 84       | 102      | 124      |
| Valuation allowance on MSRs   | (890)    | -        | -        |
| Other   | 592      | 842      | 536      |
|   | -----    | -----    | -----    |
| Total non-interest income, net  | 5,696    | 6,949    | 4,178    |
|   | -----    | -----    | -----    |

See notes to consolidated financial statements.

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Consolidated Statements of Operations (continued)

(Dollars in Thousands, Except Per Share Amounts)

Timberland Bancorp, Inc. and Subsidiary  
Years Ended September 30, 2010, 2009 and 2008

|   | 2010       | 2009       | 2008     |
|---|------------|------------|----------|
|   | -----      | -----      | -----    |
| Non-interest expense                                  |            |            |          |
| Salaries and employee benefits                        | \$12,066   | \$11,801   | \$11,569 |
| Premises and equipment                                | 2,768      | 2,574      | 2,307    |
| Advertising   | 829        | 895        | 897      |
| OREO and other repossessed assets expense<br>(income) | 882        | 643        | (3)      |
| ATM expenses  | 698        | 613        | 576      |
| Postage and courier                                   | 539        | 549        | 514      |
| Amortization of CDI                                   | 191        | 217        | 249      |
| State and local taxes                                 | 626        | 604        | 622      |
| Professional fees                                     | 664        | 745        | 678      |
| FDIC Insurance  | 1,659      | 778        | 130      |
| Insurance   | 435        | 82         | 88       |
| Other   | 3,284      | 3,238      | 2,722    |
|   | -----      | -----      | -----    |
| Total non-interest expense                            | 24,641     | 22,739     | 20,349   |
|   | -----      | -----      | -----    |
| Income (loss) before income taxes                     | (3,860)    | (1,227)    | 6,854    |
| Provision (benefit) for federal income taxes          | (1,564)    | (982)      | 2,824    |
| Provision (benefit) for state income taxes            | (5)        | (3)        | 25       |
|   | -----      | -----      | -----    |
| Net income (loss)                                     | (2,291)    | (242)      | 4,005    |
| Preferred stock dividends                             | (832)      | (643)      | - -      |
| Preferred stock discount accretion                    | (210)      | (129)      | - -      |
|   | -----      | -----      | -----    |
| Net Income (loss) to common shareholders              | \$ (3,333) | \$ (1,014) | \$ 4,005 |
|   | =====      | =====      | =====    |
| Net income (loss) per common share                    |            |            |          |
| Basic   | \$ (0.50)  | \$ (0.15)  | \$0.62   |
| Diluted   | (0.50)     | (0.15)     | 0.61     |

See notes to consolidated financial statements.



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Consolidated Statements of Shareholders' Equity

(Dollars in Thousands, Except Per Share Amounts)

Timberland Bancorp, Inc. and Subsidiary  
Years Ended September 30, 2010, 2009 and 2008

|  | Number of Shares   |                 | Amount             |                 | Unearned<br>Shares<br>Issued to<br>ESOP | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss |
|--|--------------------|-----------------|--------------------|-----------------|---|----------------------|---|
|  | Preferred<br>Stock | Common<br>Stock | Preferred<br>Stock | Common<br>Stock |   |                      |   |
| Balance, September 30, 2007  | - -                | 6,953,360       | \$ - -             | \$ 9,993        | \$ (3,040)                              | \$68,378             | \$ (784)                                      |
| Net income   | - -                | - -             | - -                | - -             | - -                                     | 4,005                | - -   |
| Issuance of MRDP (1) shares  | - -                | 20,315          | - -                | - -             | - -                                     | - -                  | - -   |
| Repurchase of common stock   | - -                | (144,950)       | - -                | (1,921)         | - -                                     | - -                  | - -   |
| Exercise of stock options  | - -                | 138,854         | - -                | 857             | - -                                     | - -                  | - -   |
| Cash dividends (\$0.43 per<br>common share)  | - -                | - -             | - -                | - -             | - -                                     | (2,977)              | - -   |
| Earned ESOP shares   | - -                | - -             | - -                | (409)           | 264                                     | - -                  | - -   |
| MRDP compensation expense  | - -                | - -             | - -                | 147             | - -                                     | - -                  | - -   |
| Stock option compensation<br>expense   | - -                | - -             | - -                | 5               | - -                                     | - -                  | - -   |
| Unrealized holding gain on<br>securities available for<br>sale, net of tax   | - -                | - -             | - -                | - -             | - -                                     | - -                  | 323   |
| Balance, September 30, 2008  | - -                | 6,967,579       | - -                | 8,672           | (2,776)                                 | 69,406               | (461)   |
| Net loss   | - -                | - -             | - -                | - -             | - -                                     | (242)                | - -   |
| Issuance of preferred stock<br>with attached common stock<br>warrants  | 16,641             | - -             | 15,425             | 1,158           | - -                                     | - -                  | - -   |
| Accretion of preferred stock<br>discount   | - -                | - -             | 129                | - -             | - -                                     | (129)                | - -   |
| Issuance of MRDP (1) shares  | - -                | 19,758          | - -                | - -             | - -                                     | - -                  | - -   |
| Exercise of stock options  | - -                | 57,699          | - -                | 392             | - -                                     | - -                  | - -   |
| Cash dividends<br>(\$0.39 per common share)<br>(5% preferred stock)  | - -                | - -             | - -                | - -             | - -                                     | (2,736)<br>(536)     | - -   |
| Earned ESOP shares   | - -                | - -             | - -                | (47)            | 264                                     | - -                  | - -   |
| MRDP compensation expense  | - -                | - -             | - -                | 137             | - -                                     | - -                  | - -   |
| Stock option compensation<br>expense   | - -                | - -             | - -                | 3               | - -                                     | - -                  | - -   |
| Cumulative effect of Financial<br>Accounting Standards Board<br>("FASB") guidance regarding<br>recognition of OTTI | - -                | - -             | - -                | - -             | - -                                     | 91                   | (91)  |
| Unrealized holding gain on<br>securities available for<br>sale, net of tax   | - -                | - -             | - -                | - -             | - -                                     | - -                  | 18  |
| Change in OTTI on securities<br>held to maturity, net of tax   | - -                | - -             | - -                | - -             | - -                                     | - -                  | (1,478)                                       |

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|                             |        |           |          |          |           |          |           |
|-----------------------------|--------|-----------|----------|----------|-----------|----------|-----------|
| Balance, September 30, 2009 | 16,641 | 7,045,036 | \$15,554 | \$10,315 | \$(2,512) | \$65,854 | \$(2,012) |
|-----------------------------|--------|-----------|----------|----------|-----------|----------|-----------|

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

See notes to consolidated financial statements.

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Consolidated Statements of Shareholders' Equity (continued)

(Dollars in Thousands, Except Per Share Amounts)

Timberland Bancorp, Inc. and Subsidiary  
Years Ended September 30, 2010, 2009 and 2008

|  | Number of Shares |              | Amount          |              | Unearned Shares | Retained Earnings | Accumulated Other Comprehensive Loss |
|--|------------------|--------------|-----------------|--------------|-----------------|-------------------|--------------------------------------|
|  | Preferred Stock  | Common Stock | Preferred Stock | Common Stock | Issued to ESOP  |                   |                                      |
| Balance, September 30, 2009  | 16,641           | 7,045,036    | \$15,554        | \$10,315     | \$(2,512)       | \$65,854          | \$(2,012)                            |
| Net loss   | --               | --           | --              | --           | --              | (2,291)           | --                                   |
| Accretion of preferred stock discount                                | --               | --           | 210             | --           | --              | (210)             | --                                   |
| Cash dividends (\$0.04 per common share) (5% preferred stock)        | --               | --           | --              | --           | --              | (283)             | --                                   |
| MRDP compensation expense  | --               | --           | --              | 134          | --              | --                | --                                   |
| Stock option compensation expense                                    | --               | --           | --              | 6            | --              | --                | --                                   |
| Unrealized holding gain on securities available for sale, net of tax | --               | --           | --              | --           | --              | --                | 491                                  |
| Change in OTTI on securities held to maturity, net of tax            | --               | --           | --              | --           | --              | --                | 766                                  |
| Accretion of OTTI on securities held to maturity, net of tax         | --               | --           | --              | --           | --              | --                | 31                                   |
| Balance, September 30, 2010  | 16,641           | 7,045,036    | \$15,764        | \$10,377     | \$(2,247)       | \$62,238          | \$(724)                              |

See notes to consolidated financial statements.

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Consolidated Statements of Cash Flows

(Dollars in Thousands)

Timberland Bancorp, Inc. and Subsidiary  
Years Ended September 30, 2010, 2009 and 2008

|  | 2010       | 2009      | 2008     |
|--|------------|-----------|----------|
|  | -----      | -----     | -----    |
| Cash flows from operating activities   |            |           |          |
| Net income (loss)  | \$ (2,291) | \$ (242)  | \$ 4,005 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities:               |            |           |          |
| Depreciation   | 1,141      | 1,136     | 1,100    |
| Deferred federal income taxes  | 466        | (1,813)   | (1,217)  |
| Amortization of CDI  | 191        | 217       | 249      |
| Earned ESOP shares   | 265        | 264       | 264      |
| MRDP compensation expense  | 173        | 169       | 131      |
| Stock option compensation expense  | 6          | 3         | 5        |
| Stock option tax effect  | --         | 46        | 15       |
| Less stock option excess tax benefit   | --         | --        | (11)     |
| Loss on redemption of mutual funds   | --         | --        | 2,600    |
| Loss on sale of mutual funds   | --         | --        | 222      |
| OTTI losses on securities  | 2,196      | 3,622     | --       |
| Gain on sale of OREO and other repossessed items, net  | (291)      | (60)      | (47)     |
| Gain on sale of loans  | (1,547)    | (2,828)   | (432)    |
| (Gain) loss on disposition of premises and equipment   | 6          | (233)     | (288)    |
| Provision for loan losses  | 10,550     | 10,734    | 3,900    |
| Valuation adjustment for OREO  | 535        | 306       | 14       |
| Loans originated for sale  | (69,123)   | (158,942) | (45,853) |
| Proceeds from sale of loans  | 68,330     | 162,913   | 45,269   |
| BOLI net earnings  | (491)      | (965)     | (486)    |
| Decrease in deferred loan origination fees   | (210)      | (308)     | (221)    |
| Net change in accrued interest receivable and other assets, and other liabilities and accrued expenses | (3,862)    | (2,546)   | 731      |
| Net cash provided by operating activities  | 6,044      | 11,473    | 9,950    |
| Cash flows from investing activities   |            |           |          |
| Net increase in CDs held for investment  | (14,796)   | (3,251)   | --       |
| Activity in securities held to maturity:   |            |           |          |
| Maturities and prepayments   | 1,222      | 1,763     | 579      |
| Activity in securities/mutual funds available for sale:  |            |           |          |
| Maturities and prepayments   | 3,062      | 3,451     | 22,862   |
| Proceeds from sales  | --         | --        | 6,929    |
| (Increase) decrease in loans receivable, net   | 3,532      | (11,158)  | (46,413) |
| Additions to premises and equipment  | (484)      | (2,347)   | (1,495)  |
| Proceeds from sale of OREO and other repossessed items   | 4,507      | 2,317     | 926      |
| Proceeds from the disposition of premises  |            |           |          |

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|                                       |         |         |          |
|---------------------------------------|---------|---------|----------|
| and equipment                         | - -     | 282     | 374      |
|                                       | -----   | -----   | -----    |
| Net cash used by investing activities | (2,957) | (8,943) | (16,238) |

See notes to consolidated financial statements.

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Consolidated Statements of Cash Flows (continued)

(Dollars in Thousands)

Timberland Bancorp, Inc. and Subsidiary  
Years Ended September 30, 2010, 2009 and 2008

|  | 2010      | 2009     | 2008      |
|--|-----------|----------|-----------|
|  | -----     | -----    | -----     |
| Cash flows from financing activities                 |           |          |           |
| Net increase in deposits                             | \$ 73,208 | \$ 7,089 | \$ 31,837 |
| Proceeds from FHLB advances - long term              | - -       | - -      | 50,000    |
| Repayment of FHLB advances - long term               | (20,000)  | (9,628)  | (15,069)  |
| Net decrease in FHLB advances - short term           | - -       | - -      | (30,000)  |
| Net increase (decrease) in FRB advances - short term | (10,000)  | 10,000   | - -       |
| Net increase (decrease) in repurchase agreements     | (155)     | 19       | 163       |
| Proceeds from exercise of stock options              | - -       | 346      | 841       |
| ESOP tax effect                                      | (78)      | (47)     | (409)     |
| MRDP compensation tax effect                         | (39)      | (32)     | 16        |
| Stock option excess tax benefit                      | - -       | - -      | 11        |
| Repurchase of common stock                           | - -       | - -      | (1,921)   |
| Issuance of stock warrants                           | - -       | 1,158    | - -       |
| Issuance of preferred stock                          | - -       | 15,425   | - -       |
| Payment of dividends                                 | (699)     | (3,272)  | (2,977)   |
|  | -----     | -----    | -----     |
| Net cash provided by financing activities            | 42,237    | 21,058   | 32,492    |
|  | -----     | -----    | -----     |
| Net increase in cash and cash equivalents            | 45,324    | 23,588   | 26,204    |
| Cash and cash equivalents                            |           |          |           |
| Beginning of year                                    | 66,462    | 42,874   | 16,670    |
|  | -----     | -----    | -----     |
| End of year  | \$111,786 | \$66,462 | \$42,874  |
|  | =====     | =====    | =====     |
| Supplemental disclosures of cash flow information    |           |          |           |
| Income taxes paid                                    | \$ 3      | \$ 1,452 | \$ 4,120  |
| Interest paid  | 11,189    | 13,674   | 16,656    |

Supplemental disclosures of non-cash investing and financing activities

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|   |          |          |          |
|---|----------|----------|----------|
| Loans transferred to OREO and other<br>repossessed assets | \$ 9,434 | \$10,237 | \$ 1,404 |
| Shares issued to MRDP                                     | -        | 138      | 259      |
| Loans originated to facilitate sale of OREO               | 1,349    | 1,021    | 257      |
| Mutual funds redeemed for MBS                             | -        | -        | 22,188   |

See notes to consolidated financial statements.

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### Consolidated Statements of Comprehensive Income (Loss)

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(Dollars in Thousands)

Timberland Bancorp, Inc. and Subsidiary  
Years Ended September 30, 2010, 2009 and 2008

|  | 2010       | 2009       | 2008    |
|--|------------|------------|---------|
|  | -----      | -----      | -----   |
| Comprehensive income (loss)  |            |            |         |
| Net income (loss)  | \$ (2,291) | \$ (242)   | \$4,005 |
| Cumulative effect of FASB guidance<br>regarding recognition of OTTI                                | -          | (91)       | -       |
| Unrealized holding gain on securities<br>available for sale, net of tax                            | 491        | 18         | 323     |
| Change in OTTI on securities held to<br>maturity, net of tax:                                      |            |            |         |
| Additions  | 23         | 1,804      | -       |
| Additional amount recognized related to<br>credit loss for which OTTI was<br>previously recognized | 534        | (3,034)    | -       |
| Amount reclassified to credit loss for<br>previously recorded market loss                          | 209        | (248)      | -       |
| Accretion of OTTI securities held to<br>maturity, net of tax                                       | 31         | -          | -       |
|  | -----      | -----      | -----   |
| Total comprehensive income (loss)  | \$ (1,003) | \$ (1,793) | \$4,328 |
|  | =====      | =====      | =====   |

See notes to consolidated financial statements.

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary

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September 30, 2010 and 2009

### Note 1 - Summary of Significant Accounting Policies

#### Principles of Consolidation

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

#### Nature of Operations

The Company is a bank holding company which operates primarily through its subsidiary, the Bank. The Bank was established in 1915 and, through its 22 branches located in Grays Harbor, Pierce, Thurston, Kitsap, King and Lewis counties in Washington State, attracts deposits from the general public, and uses those funds, along with other borrowings, primarily to provide residential real estate, construction, commercial real estate, land, commercial business and consumer loans to borrowers primarily in western Washington and to a lesser extent, to invest in mortgage-backed securities and other investment securities.

#### Consolidated Financial Statement Presentation

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

Certain prior year amounts have been reclassified to conform to the fiscal 2010 presentation with no change to net income (loss) or shareholders' equity previously reported.

#### Segment Reporting

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

(continued)

Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

Note 1 - Summary of Significant Accounting Policies (continued)

#### U.S. Treasury Department's Capital Purchase Program

On December 23, 2008, the Company received \$16.64 million from the U.S. Treasury Department ("Treasury") as part of the Treasury's Capital Purchase Program ("CPP"). The CPP was established as part of the Troubled Asset Relief Program ("TARP"). The Company sold 16,641 shares of senior preferred stock, with a related warrant to purchase 370,899 shares of the Company's common stock at a price of \$6.73 per share at any time through December 23, 2018. The preferred stock has a 5.0% dividend for the first five years, after which the rate increases to 9.0% until the preferred shares are redeemed by the Company.

Preferred stock is initially recorded at the amount of proceeds received. Any discount from the liquidation value is accreted to the expected call date and charged to retained earnings. This accretion is recorded using the level-yield method. Preferred dividends paid (or accrued) and any accretion is deducted from (added to) net income (loss) for computing net income (loss) to common shareholders and net income (loss) per share computations.

On February 1, 2010, the Federal Reserve Bank of San Francisco ("FRB") determined that the Company required additional supervisory attention and entered into a Memorandum of Understanding with the Company (the "Company MOU"). Under the agreement the Company must among other things obtain prior written approval, or non-objection from the FRB to declare or pay any dividends. (See Note 19.) The FRB has denied the Company's requests to pay dividends on its Series A Preferred Stock issued under the CPP for the payments due May 15, 2010, August 15, 2010 and November 15, 2010. There can be no assurances that the FRB will approve such payments or dividends in the future. The Company may not declare or pay dividends on its common stock or, with certain exceptions, repurchase common stock without first having paid all cumulative preferred dividends that are due. If dividends on the Series A Preferred Stock are not paid for six quarters, whether or not consecutive, the Treasury has the right to appoint two members to the Board of Directors of the Company.

#### Mortgage-Backed Securities and Other Investments

Mortgage-backed securities and other investments are classified upon acquisition as either held to maturity or available for sale. Securities that the Company has the positive intent and ability to hold to maturity are classified as held to maturity and reflected at amortized cost. Securities classified as available for sale are reflected at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income/loss, net of tax effects. Premiums and discounts are amortized to earnings by the interest method over the contractual life of the securities. Gains and losses on sale of securities are recognized on the trade date and determined using the specific identification method.

In estimating whether there are any other than temporary impairment losses, management considers 1) the length of time and the extent to which the fair value has been less than amortized cost, 2) the financial condition and near term prospects of the issuer, 3) the impact of changes in market interest rates and 4) the intent and ability of the Company to retain its investment for a period of time sufficient to allow for any anticipated recovery in fair

value.

(continued)

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

Note 1 - Summary of Significant Accounting Policies (continued)

Mortgage-Backed Securities and Other Investments (concluded)

Declines in the fair value of individual securities available for sale that are deemed to be other than temporary are reflected in earnings when identified. The fair value of the security then becomes the new cost basis. For individual securities where the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis, the other than temporary decline in the fair value of the security related to 1) credit loss is recognized in earnings and 2) market or other factors is recognized in other comprehensive income or loss. Credit loss is recorded if the present value of cash flows is less than the amortized cost. For individual securities where the Company intends to sell the security or more likely than not will not recover all of its amortized cost, the other than temporary impairment is recognized in earnings equal to the entire difference between the security's cost basis and its fair value at the balance sheet date. For individual securities for which credit loss has been recognized in earnings, interest accruals and amortization and accretion of premiums and discounts are suspended when the credit loss is recognized. Interest received after accruals have been suspended is recognized on a cash basis.

Federal Home Loan Bank Stock

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

The Company views its investment in the FHLB stock as a long-term investment. Accordingly, when evaluating for impairment, the value is determined based on the ultimate recovery of the par value rather than recognizing temporary declines in value. The determination of whether a decline affects the ultimate recovery is influenced by criteria such as: 1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount and length of time a decline has persisted; 2) the impact of legislative and regulatory changes on the FHLB and 3) the liquidity position of the FHLB. As of September 30, 2010, the FHLB of Seattle reported that it had met all of its regulatory capital requirements, but remained classified as "undercapitalized" by its regulator, the Federal Housing Finance Agency ("FHFA"). On October 25, 2010, the FHLB announced that it had entered into a Consent Agreement with the FHFA, which requires the FHLB to take certain specified actions related to its business and operations. The FHLB will not pay a dividend or repurchase capital stock while it is classified as undercapitalized. While the FHLB was classified as undercapitalized as of September 30, 2010, the Company does not



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believe that its investment in the FHLB is impaired. However, this estimate could change in the near term if: 1) significant other-than-temporary losses are incurred on the FHLB's mortgage-backed securities causing a significant decline in its regulatory capital status; 2) the economic losses resulting from credit deterioration on the FHLB's mortgage-backed securities increases significantly or 3) capital preservation strategies being utilized by the FHLB become ineffective.

(continued)

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

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

##### Loans Held for Sale

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

##### Loans Receivable

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

##### Troubled Debt Restructured Loans

A troubled debt restructured loan is a loan for which the Bank, for reasons related to a borrower's financial difficulties, grants a concession to the borrower that the Bank would not otherwise consider.

The loan terms which have been modified or restructured due to a borrower's financial difficulty, include but are not limited to: a reduction in the stated interest rate; an extension of the maturity at an interest rate below current market; a reduction in the face amount of the debt; a reduction in the accrued interest; or re-aging, extensions, deferrals and renewals. A troubled debt restructured loan is generally considered impaired.

##### Impaired Loans

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

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

### Allowance for Loan Losses

The allowance for loan losses is maintained at a level sufficient to provide for estimated loan losses based on evaluating known and inherent risks in the loan portfolio. The allowance is provided based upon management's comprehensive analysis of the pertinent factors underlying the quality of the loan portfolio. These factors include changes in the amount and composition of the loan portfolio, delinquency levels, actual loan loss experience, current economic conditions, and detailed analysis of individual loans for which full collectability may not be assured. The detailed analysis includes methods to  
(continued)

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

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

##### Allowance for Loan Losses (continued)

estimate the fair value of loan collateral and the existence of potential alternative sources of repayment. The allowance consists of specific and general components. The specific component relates to loans that are deemed impaired. For such loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the recorded value of that loan. The general component covers non-classified loans and classified loans that are not evaluated individually for impairment and is based on historical loss experience adjusted for qualitative factors. The appropriateness of the allowance for losses on loans is estimated based upon these factors and trends identified by management at the time financial statements are prepared.

In accordance with the FASB guidance for receivables, a loan is considered impaired when it is probable that a creditor will be unable to collect all amounts (principal and interest) due according to the contractual terms of the loan agreement. Smaller balance homogenous loans, such as residential mortgage loans and consumer loans, may be collectively evaluated for impairment. When a loan has been identified as being impaired, the amount of the impairment is measured by using discounted cash flows, except when, as an alternative, the current estimated fair value of the collateral, reduced by estimated costs to sell, is used. The valuation of real estate collateral is subjective in nature and may be adjusted in future periods because of changes in economic conditions. Management considers third-party appraisals, as well as independent fair market value assessments from realtors or persons involved in

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selling real estate in determining the estimated fair value of particular properties. In addition, as certain of these third-party appraisals and independent fair market value assessments are only updated periodically, changes in the values of specific properties may have occurred subsequent to the most recent appraisals. Accordingly, the amounts of any such potential changes and any related adjustments are generally recorded at the time such information is received. When the measurement of the impaired loan is less than the recorded investment in the loan (including accrued interest and net deferred loan origination fees or costs), impairment is recognized by creating or adjusting an allocation of the allowance for loan losses and uncollected accrued interest is reversed against interest income. If ultimate collection of principal is in doubt, all cash receipts on impaired loans are applied to reduce the principal balance.

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

The ultimate recovery of all loans is susceptible to future market factors beyond the Company's control. These factors may result in losses or recoveries differing significantly from those provided in the consolidated financial statements. The Bank experienced significant declines in current valuations for real estate collateral for the years ended September 30, 2009 and 2010. If real estate values continue to decline and as updated appraisals are received on collateral for impaired loans, the Company may need to increase the allowance for loan losses appropriately. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses, and may require the Company to make additions to the allowance based on their judgment about information available to them at the time of their examinations.  
(continued)

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

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

##### Interest on Loans and Loan Fees

Interest on loans is accrued daily based on the principal amount outstanding. Generally, the accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due or when they are past due 90 days as to either principal or interest (based on contractual terms), unless they are well secured and in the process of collection. All interest accrued but not collected for loans that are placed on non-accrual status or charged off is reversed against interest income. Subsequent collections on a cash basis are applied proportionately to past due principal and interest, unless collectability of principal is in

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doubt, in which case all payments are applied to principal. Loans are returned to accrual status when the loan is deemed current, and the collectability of principal and interest is no longer doubtful, or on one- to four-family loans, when the loan is less than 90 days delinquent.

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

### Mortgage Servicing Rights

The Bank holds rights to service loans that it has originated and sold to the Federal Home Loan Mortgage Corporation. Mortgage servicing rights are capitalized at estimated fair value when acquired through the origination of loans that are subsequently sold with the servicing rights retained and are amortized to servicing income on loans sold in proportion to and over the period of estimated net servicing income. The value of mortgage servicing rights at the date of the sale of loans is estimated based on the discounted present value of expected future cash flows using key assumptions for servicing income and costs and prepayment rates on the underlying loans. The estimated fair value is periodically evaluated for impairment by comparing actual cash flows and estimated future cash flows from the servicing assets to those estimated at the time servicing assets were originated. Fair values are estimated using discounted cash flows based on current market rates of interest. For purposes of measuring impairment, the rights must be stratified by one or more predominant risk characteristics of the underlying loans. The Company stratifies its capitalized mortgage servicing rights based on product type, interest rate and term of the underlying loans. The amount of impairment recognized is the amount, if any, by which the amortized cost of the rights for each stratum exceed their fair value. Impairment, if deemed temporary, is recognized through a valuation allowance to the extent that fair value is less than the recorded amount.

### Bank Owned Life Insurance ("BOLI")

BOLI policies are recorded at their cash surrender value less applicable cash surrender charges. Income from BOLI is recognized when earned.

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

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

##### Goodwill

Goodwill is initially recorded when the purchase price paid for an acquisition

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

During the quarter ended June 30, 2010, the Company engaged a third party firm to perform the annual test for goodwill impairment. The test concluded that recorded goodwill was not impaired. As of September 30, 2010, there have been no events or changes in the circumstances that would indicate a potential impairment. No assurance can be given, however, that the Company will not record an impairment loss on goodwill in the future.

### Core Deposit Intangible

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

### Premises and Equipment

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

### Impairment of Long-Lived Assets

Long-lived assets, consisting of premises and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the recorded amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the recorded amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the recorded amount of the assets exceeds the discounted recovery amount or estimated fair value of the assets. No events or changes in circumstances have occurred causing management to evaluate the recoverability of the Company's long-lived assets.

(continued)

## Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

Note 1 - Summary of Significant Accounting Policies (continued)

Other Real Estate Owned and Other Repossessed Assets

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Other real estate owned and other repossessed assets consist of properties or assets acquired through or in lieu of foreclosure, and are recorded initially at the estimated fair value of the properties less estimated costs of disposal. Costs relating to development and improvement of the properties or assets are capitalized while costs relating to holding the properties or assets are expensed. The valuation of real estate collateral is subjective in nature and may be adjusted in future periods because of changes in economic conditions. Management considers third-party appraisals, as well as independent fair market value assessments from realtors or persons involved in selling real estate in determining the estimated fair value of particular properties. In addition, as certain of these third-party appraisals and independent fair market value assessments are only updated periodically, changes in the values of specific properties may have occurred subsequent to the most recent appraisals. Accordingly, the amounts of any such potential changes and any related adjustments are generally recorded at the time such information is received.

### Transfers of Financial Assets

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

### Income Taxes

The Company files a consolidated federal income tax return with the Bank. The Bank provides for income taxes separately and remits to (receives from) the Company amounts currently due.

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

The Company adopted guidance issued by the FASB with respect to accounting for uncertainty in income taxes on October 1, 2007. A tax provision is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely to be realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. The Company recognizes interest and or/penalties related to income tax matters as income tax expense.

(continued)

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

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

#### Income Taxes (concluded)

The Company is no longer subject to United States federal income tax examination by tax authorities for years ended on or before September 30, 2006.

#### Employee Stock Ownership Plan

The Bank sponsors a leveraged Employee Stock Ownership Plan ("ESOP"). The ESOP is accounted for in accordance with the accounting requirements for stock compensation. Accordingly, the debt of the ESOP is recorded as other borrowed funds of the Bank, and the shares pledged as collateral are reported as unearned shares issued to the employee stock ownership plan on the consolidated balance sheets. The debt of the ESOP is payable to the Company and is therefore eliminated in the consolidated financial statements. As shares are released from collateral, compensation expense is recorded equal to the average market price of the shares for the period, and the shares become available for net income (loss) per common share calculations. Dividends paid on unallocated shares reduce the Company's cash contributions to the ESOP.

#### Cash and Cash Equivalents and Cash Flows

The Company considers amounts included in the balance sheets' captions "Cash and due from financial institutions", and "Interest-bearing deposits in banks", all of which mature within ninety days, to be cash equivalents for purpose of reporting cash flows. Cash flows from loans, deposits, FHLB advances short term, FRB borrowings and repurchase agreements are reported net.

Interest-bearing deposits in banks as of September 30, 2010 and 2009 included deposits with the Federal Reserve Bank of San Francisco of \$88,805,000 and \$26,040,000, respectively. The Company also maintains balances in correspondent bank accounts which, at times, may exceed FDIC insurance limits of \$250,000. Management believes that its risk of loss associated with such balances is minimal due to the financial strength of the correspondent banks.

#### Advertising

Costs for advertising and marketing are expensed as incurred.

#### Stock-Based Compensation

The Company accounts for stock based compensation in accordance with FASB requirements for stock compensation. The guidance 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. The fair value of stock grants under the MRDP is equal to the fair value of the shares at the grant date.

The Company's stock compensation plans are described more fully in Note 15.  
(continued)

Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

Note 1 - Summary of Significant Accounting Policies (continued)

Net Income (Loss) Per Common Share

Basic net income (loss) per common share is computed by dividing net income (loss) available for common stock by the weighted average number of common shares outstanding during the period, without considering any dilutive items. Diluted net income per common share is computed by dividing net income available for common stock by the weighted average number of common shares and common stock equivalents for items that are dilutive, net of shares assumed to be repurchased using the treasury stock method at the average share price for the Company's common stock during the period. Diluted loss per common share is the same as basic loss per common share for the years ended September 30, 2009 and 2010 due to the anti-dilutive effect of common stock equivalents. Common stock equivalents arise from assumed conversion of outstanding stock options and outstanding warrants to purchase common stock. In accordance with FASB guidance for stock compensation, shares owned by the Bank's ESOP that have not been allocated are not considered to be outstanding for the purpose of computing net income (loss) per common share.

Related Party Transactions

The Chairman of the Board for the Bank and the Company is a member of the law firm that provides general counsel to the Bank. Legal fees paid to this law firm for the years ended September 30, 2010, 2009 and 2008 totaled \$133,000, \$125,000 and \$62,000, respectively.

Recent Accounting Pronouncements

In June 2009, the FASB issued new guidance on the disclosure requirements for transfers and servicing of financial assets. The new guidance requires more information about transfers of financial assets, including securitization transactions, and where entities have continuing exposure to the risks related to transferred financial assets. It eliminates the concept of a "qualifying special-purpose entity," changes the requirements for derecognizing financial assets, and requires additional disclosures. The new authoritative accounting guidance became effective January 1, 2010 and did not impact the Company's consolidated financial statements.

In January 2010, the FASB issued updated guidance on fair value measurements and disclosures. The new guidance requires expanded disclosures related to fair value measurements including (i) the amounts of significant transfers of assets or liabilities between Levels 1 and 2 of the fair value hierarchy and the reasons for the transfers; and (ii) separate presentation of purchases, sales, issuances, and settlements in the reconciliation for fair value measurements using significant unobservable inputs (Level 3). The guidance also further clarifies that (i) fair value instrument disclosures should be provided for each class of assets and liabilities (rather than major category), which would generally be a subset of assets or liabilities



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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

Note 1 - Summary of Significant Accounting Policies (continued)

Recent Accounting Pronouncements (concluded)

within a line item in the statement of financial position and (ii) companies should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements for each class of assets and liabilities included in Levels 2 and 3 of the fair value hierarchy. The new guidance was effective on January 1, 2010 except for the disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements, which are effective for the Company on October 1, 2011. The adoption of the guidance effective on January 1, 2010 was disclosure-related only and did not impact the Company's consolidated financial statements.

In February 2010, the FASB issued updated guidance on subsequent events and disclosure requirements. The new guidance removes the requirement for a Securities and Exchange Commission ("SEC") filer to disclose a date through which subsequent events have been evaluated in both issued and revised financial statements. The FASB believes these amendments remove potential conflicts with the SEC's literature. This guidance was effective upon issuance and did not have a material impact on the Company's consolidated financial statements.

In July 2010, the FASB issued updated guidance on disclosure requirements for the credit quality of financing receivables and the allowance for credit losses. The new guidance requires entities to provide disclosures designed to facilitate financial statement users' evaluation of (i) the nature of credit risk inherent in the entity's portfolio of financing receivables, (ii) how that risk is analyzed and assessed in arriving at the allowance for credit losses and (iii) the changes and reasons for those changes in the allowance for credit losses. Disclosures must be disaggregated by portfolio segment, the level at which an entity develops and documents a systematic method for determining its allowance for credit losses, and class of financing receivable, which is generally a disaggregation of portfolio segment. The required disclosures include, among other things, a roll forward of the allowance for credit losses as well as information about modified, impaired, non-accrual and past due loans and credit quality indicators. This guidance will be effective for the Company's consolidated financial statements as of December 31, 2010, as it relates to disclosures required as of the end of a reporting period. Disclosures that relate to activity during a reporting period will be required for the Company's consolidated financial statements that include periods beginning on or after January 1, 2011. Since this new guidance is disclosure related only, the Company does not expect it to have an impact on its consolidated financial statements.

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### Note 2 - Restricted Assets

Federal Reserve Board regulations require that the Bank maintain certain minimum reserve balances on hand or on deposit with the Federal Reserve Bank, based on a percentage of transaction account deposits. The amounts of the reserve requirement balances as of September 30, 2010 and 2009 were approximately \$781,000 and \$206,000, respectively.

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

### Note 3 - Mortgage-Backed Securities and Other Investments

Mortgage-backed securities and other investments were as follows as of September 30 (in thousands):

|                             | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|-----------------------------|-------------------|------------------------------|-------------------------------|----------------------------|
|                             | -----             | -----                        | -----                         | -----                      |
| 2010                        |                   |                              |                               |                            |
| ----                        |                   |                              |                               |                            |
| Held to Maturity            |                   |                              |                               |                            |
| Mortgage-backed securities: |                   |                              |                               |                            |
| U.S. government agencies    | \$ 2,107          | \$ 29                        | \$ (5)                        | \$ 2,131                   |
| Private label residential   | 2,931             | 161                          | (411)                         | 2,681                      |
| U.S. agency securities      | 28                | 2                            | - -                           | 30                         |
|                             | -----             | -----                        | -----                         | -----                      |
| Total                       | \$ 5,066          | \$ 192                       | \$ (416)                      | \$ 4,842                   |
|                             | =====             | =====                        | =====                         | =====                      |
| Available for Sale          |                   |                              |                               |                            |
| Mortgage-backed securities: |                   |                              |                               |                            |
| U.S. government agencies    | \$ 7,846          | \$ 262                       | \$ - -                        | \$ 8,108                   |
| Private label residential   | 2,198             | 73                           | (248)                         | 2,023                      |
| Mutual Funds                | 1,000             | - -                          | (12)                          | 988                        |
|                             | -----             | -----                        | -----                         | -----                      |
| Total                       | \$11,044          | \$ 335                       | \$ (260)                      | \$11,119                   |
|                             | =====             | =====                        | =====                         | =====                      |
| 2009                        |                   |                              |                               |                            |
| ----                        |                   |                              |                               |                            |
| Held to Maturity            |                   |                              |                               |                            |
| Mortgage-backed securities: |                   |                              |                               |                            |
| U.S. government agencies    | \$ 2,455          | \$ 23                        | \$ (10)                       | \$ 2,468                   |
| Private label residential   | 4,605             | 3                            | (890)                         | 3,718                      |

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|                             |          |        |          |          |
|-----------------------------|----------|--------|----------|----------|
| U.S. agency securities      | 27       | 2      | - -      | 29       |
|                             | -----    | -----  | -----    | -----    |
| Total                       | \$ 7,087 | \$ 28  | \$ (900) | \$ 6,215 |
|                             | =====    | =====  | =====    | =====    |
| Available for Sale          |          |        |          |          |
| Mortgage-backed securities: |          |        |          |          |
| U.S. government agencies    | \$10,378 | \$ 221 | \$ (5)   | \$10,594 |
| Private label residential   | 2,774    | - -    | (865)    | 1,909    |
| Mutual funds                | 1,000    | - -    | (32)     | 968      |
|                             | -----    | -----  | -----    | -----    |
| Total                       | \$14,152 | \$ 221 | \$ (902) | \$13,471 |
|                             | =====    | =====  | =====    | =====    |

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Notes to Consolidated Financial Statements

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 Timberland Bancorp, Inc. and Subsidiary  
 September 30, 2010 and 2009

Note 3 - Mortgage-Backed Securities and Other Investments (continued)

The following table summarizes the estimated fair value and gross unrealized losses for all securities and the length of time the unrealized losses existed as of September 30, 2010 (in thousands):

|                             | Less Than 12 Months |            | 12 Months or Longer |            | Total     |
|-----------------------------|---------------------|------------|---------------------|------------|-----------|
|                             | Estimated           | Unrealized | Estimated           | Unrealized | Estimated |
|                             | Fair                | Losses     | Fair                | Losses     | Fair      |
|                             | Value               |            | Value               |            | Value     |
|                             | -----               | -----      | -----               | -----      | -----     |
| Held to Maturity            |                     |            |                     |            |           |
| Mortgage-backed securities: |                     |            |                     |            |           |
| U.S. government agencies    | \$ 165              | \$ (1)     | \$ 469              | \$ (4)     | \$ 634    |
| Private label residential   | 108                 | - -        | 1,907               | (411)      | 2,015     |
|                             | -----               | -----      | -----               | -----      | -----     |
| Total                       | \$ 273              | \$ (1)     | \$2,376             | \$ (415)   | \$2,649   |
|                             | =====               | =====      | =====               | =====      | =====     |
| Available for Sale          |                     |            |                     |            |           |
| Mortgage-backed securities: |                     |            |                     |            |           |
| Private label residential   | \$ - -              | \$ - -     | \$1,574             | \$ (248)   | \$1,574   |
| Mutual funds                | - -                 | - -        | 988                 | (12)       | 988       |
|                             | -----               | -----      | -----               | -----      | -----     |

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|       |                 |                 |                  |                   |                  |
|-------|-----------------|-----------------|------------------|-------------------|------------------|
| Total | \$ - -<br>===== | \$ - -<br>===== | \$2,562<br>===== | \$ (260)<br>===== | \$2,562<br>===== |
|-------|-----------------|-----------------|------------------|-------------------|------------------|

The Company has evaluated these securities and has determined that the decline in their value is temporary. The unrealized losses are primarily due to unusually large spreads in the market for private label mortgage-related products. The fair value of the mortgage-backed securities is expected to recover as the securities approach their maturity date and/or as the pricing spreads narrow on mortgage-related securities. The Company has the ability and the intent to hold the investments until the market value recovers. Furthermore, as of September 30, 2010, Management does not have the intent to sell any of the securities classified as available for sale where the estimated fair value is below the recorded value and believes that it is more likely than not that the Company will not have to sell such securities before a recovery of cost (or recorded value if previously written down).

During the year ended September 30, 2010, the Company recorded net OTTI charges through earnings on residential mortgage-backed securities of \$2,176,000. For the year ended September 30, 2009, the Company recorded net OTTI charges through earnings on residential mortgage-backed securities of \$3,546,000. Effective January 1, 2009, the Company adopted new accounting guidance in accordance with GAAP, which provides for the bifurcation of OTTI into (i) amounts related to credit losses which are recognized through earnings and (ii) amounts related to all other factors which are recognized as a component of other comprehensive income (loss).

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

Note 3 - Mortgage-Backed Securities and Other Investments (continued)

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

The following table presents a summary of the significant inputs utilized to measure management's estimates of the credit loss component on OTTI securities as of September 30, 2010 and 2009:

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|                          | Range   |         | Weighted<br>Average |
|--------------------------|---------|---------|---------------------|
|                          | Minimum | Maximum |                     |
| At September 30, 2010    |         |         |                     |
| Constant prepayment rate | 6.00%   | 15.00%  | 8.28%               |
| Collateral default rate  | 3.69%   | 68.09%  | 34.75%              |
| Loss severity rate       | 30.02%  | 60.43%  | 45.35%              |
| At September 30, 2009    |         |         |                     |
| Constant prepayment rate | 6.00%   | 15.00%  | 10.86%              |
| Collateral default rate  | 6.78%   | 59.62%  | 25.36%              |
| Loss severity rate       | 14.25%  | 52.02%  | 33.99%              |

The following table presents the OTTI losses for the years ended September 30, 2010 and 2009. There were no similar OTTI losses recorded during the year ended September 30, 2008 (in thousands).

|  | 2010                |                       | 2009                |                       |
|--|---------------------|-----------------------|---------------------|-----------------------|
|  | Held to<br>Maturity | Available<br>For Sale | Held to<br>Maturity | Available<br>For Sale |
| Total OTTI losses  | \$ 895              | \$ 103                | \$ 5,593            | \$ 227                |
| Portion of OTTI losses recognized<br>in other comprehensive loss<br>(before taxes) (1) | 1,178               |                       | (2,274)             | - -                   |
| Net impairment losses recognized<br>in earnings (2)                                    | \$2,073             | \$ 103                | \$ 3,319            | \$ 227                |

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

(2) Represents OTTI losses related to credit losses.

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Notes to Consolidated Financial Statements

Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

Note 3 - Mortgage-Backed Securities and Other Investments (continued)

The following table presents a roll forward of the credit loss component of held to maturity and available for sale debt securities that have been written down for OTTI with the credit loss component recognized in earnings and the remaining impairment loss related to all other factors recognized in other comprehensive loss at September 30, 2010 and 2009 (dollars in thousands).

2010 2009

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|  |                   |                   |
|--|-------------------|-------------------|
|  | -----             | -----             |
| Balance, beginning of year   | \$ 3,551          | \$ - -            |
| Additions:   |                   |                   |
| Credit losses for which OTTI was<br>not previously recognized  | 400               | 2,511             |
| Additional increases to the amount<br>related to credit loss for which OTTI<br>was previously recognized | 1,818             | 1,073             |
| Subtractions:  |                   |                   |
| Realized losses recorded previously<br>as credit losses  | (1,044)           | (33)              |
|  | -----             | -----             |
| Balance, end of year   | \$ 4,725<br>===== | \$ 3,551<br>===== |

There were no gross realized gains on sales of securities for the years ended September 30, 2010, 2009 and 2008. During the year ended September 30, 2010, the Company recorded a \$1,064,000 realized loss (as a result of securities being deemed worthless) on eighteen held to maturity residential mortgage-backed securities of which \$1,044,000 had been recognized previously as a credit loss. During the year ended September 30, 2009, the Company recorded a \$109,000 realized loss on three held to maturity residential mortgage-backed securities of which \$33,000 had been recognized previously as a credit loss. During the year ended September 30, 2008 there were gross realized losses on the sale and redemption of mutual funds classified as available for sale in the amount of \$2,822,000 and gross realized losses on held to maturity residential mortgage-backed securities of \$4,000. During the year ended September 30, 2008, the Company redeemed its investment in the AMF family of mutual funds and recognized a \$2,822,000 loss on the redemption. The Company redeemed \$29,120,000 in mutual funds and received \$22,190,000 in underlying mortgage-backed securities and \$6,930,000 in cash.

The recorded amount of residential mortgage-backed and agency securities pledged as collateral for public fund deposits, federal treasury tax and loan deposits, FHLB collateral, retail repurchase agreements and other non-profit organization deposits totaled \$12,800,000 and \$16,400,000 at September 30, 2010 and 2009, respectively.

(continued)

Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

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

The contractual maturities of debt securities at September 30, 2010, are as

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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<br>---- | Estimated<br>Fair<br>Value<br>----- | Amortized<br>Cost<br>---- | Estimated<br>Fair<br>Value<br>----- |
| Due within one year                 | \$ - -                    | \$ - -                              | \$ 283                    | \$ 271                              |
| Due after one year to five<br>years | 19                        | 20                                  | 9                         | 9                                   |
| Due after five to ten years         | 40                        | 42                                  | 132                       | 141                                 |
| Due after ten years                 | 5,007                     | 4,780                               | 9,620                     | 9,710                               |
|                                     | -----                     | -----                               | -----                     | -----                               |
| Total                               | \$5,066                   | \$4,842                             | \$10,044                  | \$10,131                            |
|                                     | =====                     | =====                               | =====                     | =====                               |

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

#### Note 4 - Loans Receivable and Loans Held for Sale

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

|                                   | 2010      | 2009      |
|-----------------------------------|-----------|-----------|
| Mortgage loans:                   |           |           |
| One- to four-family               | \$118,044 | \$109,926 |
| Multi-family                      | 32,267    | 25,638    |
| Commercial                        | 208,002   | 188,205   |
| Construction and land development | 69,271    | 139,728   |
| Land                              | 62,999    | 65,642    |
|                                   | -----     | -----     |
| Total mortgage loans              | 490,583   | 529,139   |
| Consumer loans:                   |           |           |
| Home equity and second mortgage   | 38,418    | 41,746    |
| Other                             | 9,086     | 9,827     |
|                                   | -----     | -----     |
| Total consumer loans              | 47,504    | 51,573    |
| Commercial business loans         | 17,979    | 13,775    |
|                                   | -----     | -----     |

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|  |           |           |
|--|-----------|-----------|
| Total loans receivable                               | 556,066   | 594,487   |
| Less:  |           |           |
| Undisbursed portion of construction loans in process | 17,952    | 31,298    |
| Deferred loan origination fees                       | 2,229     | 2,439     |
| Allowance for loan losses                            | 11,264    | 14,172    |
|  | -----     | -----     |
|  | 31,445    | 47,909    |
|  | -----     | -----     |
| Loans receivable, net                                | 524,621   | 546,578   |
| Loans held for sale (one- to four-family)            | 2,970     | 630       |
|  | -----     | -----     |
| Total loans receivable and loans held for sale, net  | \$527,591 | \$547,208 |
|  | =====     | =====     |

Certain related parties of the Bank, principally Bank directors and officers, were loan customers of the Bank in the ordinary course of business during the years ended September 30, 2010 and 2009. These loans were performing according to their terms at September 30, 2010 and 2009. Activity in related party loans during the years ended September 30 is as follows (in thousands):

|                            | 2010    | 2009     |
|----------------------------|---------|----------|
|                            | -----   | -----    |
| Balance, beginning of year | \$1,781 | \$ 3,051 |
| New loans                  | 1,044   | 291      |
| Repayments                 | (79)    | (1,561)  |
|                            | -----   | -----    |
| Balance, end of year       | \$2,746 | \$ 1,781 |
|                            | =====   | =====    |

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

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

At September 30, 2010, 2009 and 2008, the Bank had impaired loans totaling approximately \$42,245,000, \$47,622,000 and \$13,647,000 respectively. Interest income recognized on impaired loans for the years ended September 30, 2010, 2009 and 2008 was \$1,296,000, \$803,000 and \$41,000 respectively. Interest income recognized on a cash basis on impaired loans for the years ended September 30, 2010, 2009 and 2008 was \$816,000, \$647,000 and \$21,000, respectively. The average investment in impaired loans for the years ended September 30, 2010, 2009 and 2008 was \$42,747,000, \$32,597,000 and \$6,955,000 respectively. The Bank had \$16,400,000 in troubled debt restructured loans included in impaired loans at September 30, 2010. The Bank had \$1,055,000 in commitments to lend additional funds on these loans. The Bank had \$9,492,000 in troubled debt restructured loans included in impaired loans at September 30, 2009 and there were commitments to lend an additional \$1,433,000 in funds on these loans. The Bank had \$272,000 in troubled debt restructured loans included in impaired loans at September 30, 2008 and there were no commitments



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to lend additional funds on these loans.

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

|                            | 2010<br>-----      | 2009<br>-----     | 2008<br>-----    |
|----------------------------|--------------------|-------------------|------------------|
| Balance, beginning of year | \$ 14,172          | \$ 8,050          | \$4,797          |
| Provision for loan losses  | 10,550             | 10,734            | 3,900            |
| Allocated to commitments   | -                  | (169)             | --               |
| Loans charged off          | (13,820)           | (4,531)           | (648)            |
| Recoveries                 | 362                | 88                | 1                |
|                            | -----              | -----             | -----            |
| Net charge-offs            | (13,458)           | (4,443)           | (647)            |
|                            | -----              | -----             | -----            |
| Balance, end of year       | \$ 11,264<br>===== | \$14,172<br>===== | \$8,050<br>===== |

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

|  | 2010<br>-----     | 2009<br>-----     | 2008<br>-----     |
|--|-------------------|-------------------|-------------------|
| Impaired loans without a valuation allowance | \$36,475          | \$35,557          | \$ 8,872          |
| Impaired loans with a valuation allowance    | 5,770             | 12,065            | 4,775             |
|  | -----             | -----             | -----             |
| Total impaired loans                         | \$42,245<br>===== | \$47,622<br>===== | \$13,647<br>===== |

(continued)

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

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

An analysis of the valuation allowance related to impaired loans for the years ended September 30 is as follows (in thousands):

|  | 2010<br>----- | 2009<br>----- | 2008<br>----- |
|--|---------------|---------------|---------------|
| Balance, beginning of year               | \$ 3,835      | \$ 790        | \$ 75         |
| Additions                                | 2,760         | 5,648         | 1,631         |
| Deductions:                              |               |               |               |
| Charged off to allowance for loan losses | (5,467)       | (1,838)       | (647)         |

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|                      |        |          |        |
|----------------------|--------|----------|--------|
| Other reductions     | (266)  | (765)    | (269)  |
|                      | -----  | -----    | -----  |
| Balance, end of year | \$ 862 | \$ 3,835 | \$ 790 |
|                      | =====  | =====    | =====  |

At September 30, 2010, 2009 and 2008, the Bank had non-accruing loans totaling \$24,864,000, \$29,287,000 and \$11,990,000, respectively. All non-accrual loans are considered impaired. The Bank had \$1,325,000 and \$796,000 in loans that were 90 days or more past due and still accruing interest at September 30, 2010 and 2009, respectively. At September 30, 2008, no loans were 90 days or more past due and still accruing interest.

Note 5 - Mortgage Servicing Rights

Loans serviced for the Federal Home Loan Mortgage Corporation are not included in the accompanying consolidated balance sheets. The principal amounts of those loans at September 30, 2010, 2009 and 2008 were \$280,852,000, \$251,837,000 and \$175,807,000, respectively.

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

|                                 | 2010    | 2009    | 2008    |
|---------------------------------|---------|---------|---------|
|                                 | -----   | -----   | -----   |
| Balance, beginning of year      | \$2,618 | \$1,306 | \$1,051 |
| Additions                       | 805     | 1,785   | 578     |
| Amortization                    | (604)   | (473)   | (323)   |
| Valuation allowance             | (890)   | (169)   | - -     |
| Recovery of valuation allowance | - -     | 169     | - -     |
|                                 | -----   | -----   | -----   |
| Balance, end of year            | \$1,929 | \$2,618 | \$1,306 |
|                                 | =====   | =====   | =====   |

At September 30, 2010, 2009 and 2008, the fair value of mortgage servicing rights totaled \$1,929,000, \$2,650,000 and \$1,820,000, respectively. The fair values for 2010, 2009, and 2008 were estimated using discounted cash flow analyses with discount rates of 10.40%, 10.52% and 10.60%, respectively, and prepayment speed factors of 350, 185 and 214, respectively. At September 30, 2010, there was a mortgage servicing rights valuation allowance of \$890,000. There was no valuation allowance at September 30, 2009 or 2008.

Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

Note 6 - Premises and Equipment

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

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|  | 2010     | 2009     |
|--|----------|----------|
|  | -----    | -----    |
| Land                                   | \$ 4,291 | \$ 4,291 |
| Buildings and improvements             | 16,054   | 15,860   |
| Furniture and equipment                | 6,758    | 6,594    |
| Property held for future expansion     | 110      | 110      |
| Construction and purchases in progress | 95       | 71       |
|  | -----    | -----    |
|  | 27,308   | 26,926   |
| Less accumulated depreciation          | 9,925    | 8,880    |
|  | -----    | -----    |
|  | \$17,383 | \$18,046 |
|  | =====    | =====    |

The Bank leases premises under operating leases. Rental expense of leased premises was \$228,000, \$243,000 and \$241,000 for the years ended September 30, 2010, 2009 and 2008, respectively, which is included in premises and equipment expense.

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

|                                 |       |
|---------------------------------|-------|
| 2011                            | \$198 |
| 2012                            | 211   |
| 2013                            | 211   |
| 2014                            | 144   |
| 2015                            | 144   |
|                                 | ----  |
| Total minimum payments required | \$908 |
|                                 | ===== |

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

Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

Note 7 OREO and Other Repossessed Assets

The following table presents the activity related to OREO and other repossessed assets at September 30 (dollars in thousands):

| 2010 | 2009 |
|------|------|
|------|------|

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|  | Amount   | Number | Amount   | Number |
|--|----------|--------|----------|--------|
|  | -----    | -----  | -----    | -----  |
| Balance, beginning of year                       | \$ 8,185 | 26     | \$ 511   | 2      |
| Additions to OREO and other repossessed assets   | 9,434    | 31     | 10,005   | 37     |
| Capitalized improvements                         | 288      |        | 232      |        |
| Lower of cost or fair value losses               | (829)    |        | (306)    |        |
| Disposition of OREO and other repossessed assets | (5,559)  | (27)   | (2,257)  | (13)   |
|  | -----    | ---    | -----    | ---    |
| Balance, end of year                             | \$11,519 | 30     | \$ 8,185 | 26     |
|  | =====    | ===    | =====    | ===    |

At September 30, 2010, OREO and other repossessed assets consisted of 27 properties in Washington, with balances ranging from \$5,000 to \$3,048,000 and three other repossessed assets totaling \$67,000. At September 30, 2009, OREO consisted of 26 properties in Washington, with balances ranging from \$5,000 to \$2,314,000. The Bank recorded a net gain on sale of OREO and other repossessed assets for the years ended September 30, 2010, 2009 and 2008 of \$291,000, \$60,000 and \$47,000, respectively, which is netted against (included in) OREO and other repossessed assets expense (income) in the accompanying consolidated statements of operations.

Note 8 - Core Deposit Intangibles ("CDI")

During the year ended September 30, 2005, the Company recorded a core deposit intangible of \$2,201,000 in connection with the October 2004 acquisition of seven branches and related deposits. Net unamortized core deposit intangible totaled \$564,000 and \$755,000 at September 30, 2010 and 2009, respectively. Amortization expense related to the core deposit intangible for the years ended September 30, 2010, 2009 and 2008 was \$191,000, \$217,000 and \$249,000, respectively.

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

|       |       |
|-------|-------|
| 2011  | \$167 |
| 2012  | 147   |
| 2013  | 131   |
| 2014  | 116   |
| 2015  | 3     |
|       | ----  |
| Total | \$564 |
|       | ===== |

Notes to Consolidated Financial Statements

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 Timberland Bancorp, Inc. and Subsidiary  
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Note 9 - Deposits

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

|                                  | 2010      | 2009      |
|----------------------------------|-----------|-----------|
|                                  | -----     | -----     |
| Non-interest-bearing demand      | \$ 58,755 | \$ 50,295 |
| NOW checking                     | 153,304   | 117,357   |
| Savings                          | 67,448    | 58,609    |
| Money market accounts            | 55,723    | 62,478    |
| Certificates of deposit          | 243,639   | 213,168   |
| Certificates of deposit brokered | - -       | 3,754     |
|                                  | -----     | -----     |
| Total deposits                   | \$578,869 | \$505,661 |
|                                  | =====     | =====     |

Certificates of deposit of \$100,000 or greater totaled \$93,006,000 and \$77,926,000 at September 30, 2010 and 2009, respectively.

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

|            |           |
|------------|-----------|
| 2011       | \$177,911 |
| 2012       | 43,032    |
| 2013       | 6,244     |
| 2014       | 7,140     |
| 2015       | 9,002     |
| Thereafter | 310       |
|            | -----     |
| Total      | \$243,639 |
|            | =====     |

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

|                                    | 2010    | 2009    | 2008     |
|------------------------------------|---------|---------|----------|
|                                    | -----   | -----   | -----    |
| NOW checking                       | \$1,749 | \$1,031 | \$ 774   |
| Savings                            | 454     | 394     | 398      |
| Money market accounts              | 677     | 1,036   | 1,250    |
| Certificates of deposit            | 4,921   | 6,387   | 8,480    |
| Certificates of deposit - brokered | 6       | 624     | 861      |
|                                    | -----   | -----   | -----    |
| Total                              | \$7,807 | \$9,472 | \$11,763 |
|                                    | =====   | =====   | =====    |

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

#### Note 10 - Federal Home Loan Bank ("FHLB") Advances and Federal Reserve Bank of San Francisco ("FRB") Borrowings

The Bank has long- and short-term borrowing lines with the FHLB of Seattle with total credit on the lines equal to 30% of the Bank's total assets, limited by available collateral. Borrowings are considered short-term when the original maturity is less than one year. The Bank had \$75,000,000 and \$95,000,000 of long-term FHLB advances outstanding at September 30, 2010 and 2009, respectively.

The long-term borrowings at September 30, 2010 mature at various dates through September 2017 and bear interest at rates ranging from 3.49% to 4.66%. Under the Advances, Security and Deposit Agreement, virtually all of the Bank's assets, not otherwise encumbered, are pledged as collateral for advances. Principal reductions due for future years ending September 30 are as follows (in thousands):

|            |           |
|------------|-----------|
| 2011       | \$ 20,000 |
| 2012       | 10,000    |
| 2013       | - -       |
| 2014       | - -       |
| 2015       | - -       |
| Thereafter | 45,000    |
|            | -----     |
|            | \$ 75,000 |
|            | =====     |

A portion of the long-term advances have a puttable feature and may be called by the FHLB earlier than the scheduled maturities. On October 1, 2010 the Bank repaid the \$20 million in advances due during the 2011 fiscal year.

The Bank also maintains a short-term borrowing line with the FRB with total credit based on eligible collateral. At September 30, 2010 the Bank had a borrowing capacity on this line of \$41,396,000 with no balance outstanding. The Bank had borrowings of \$10,000,000 outstanding on this line at September 30, 2009.

Information concerning total short-term borrowings as of and for the years ended at September 30 is summarized as follows (dollars in thousands):

|   | 2010     | 2009     |
|---|----------|----------|
|   | -----    | -----    |
| Average daily balance during the period             | \$ 384   | \$ 48    |
| Average daily interest rate during the period       | 0.66%    | 0.69%    |
| Maximum month-end balance during the period         | \$10,000 | \$10,000 |
| Weighted average interest rate at end of the period | - -      | 0.50%    |

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

#### Note 11 - Repurchase Agreements

Repurchase agreements at September 30, 2010 and 2009 consisted of overnight repurchase agreements with customers totaling \$622,000 and \$777,000, respectively.

Information concerning repurchase agreements as of and for the years ended September 30 is summarized as follows (dollars in thousands):

|  | 2010<br>----- | 2009<br>----- |
|--|---------------|---------------|
| Average daily balance during the period                    | \$ 539        | \$ 624        |
| Average daily interest rate during the period              | 0.05%         | 0.08%         |
| ..   |               |               |
| Maximum month-end balance during the period                | \$ 750        | \$ 844        |
| Weighted average rate at end of period                     | 0.05%         | 0.05%         |
| Securities underlying the agreements at the end of period: |               |               |
| Recorded value   | \$ 690        | \$ 826        |
| Fair value   | 695           | 826           |

The securities underlying the agreements at September 30, 2010 and 2009 were under the Company's control in safekeeping at third-party financial institutions.

#### Note 12 - Other Liabilities and Accrued Expenses

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

|  | 2010<br>-----    | 2009<br>-----    |
|--|------------------|------------------|
| Accrued deferred compensation and profit sharing plans payable                       | \$ 81            | \$ 188           |
| Accrued preferred stock dividend payable   | 416              | - -              |
| Accrued interest payable on deposits, advances, borrowings and repurchase agreements | 737              | 965              |
| Accounts payable and accrued expenses - other  | 1,554            | 1,886            |
|  | -----            | -----            |
| Total other liabilities and accrued expenses   | \$2,788<br>===== | \$3,039<br>===== |

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
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### Note 13 - Federal Income Taxes

The components of the provision (benefit) for federal income taxes for the years ended September 30 were as follows (in thousands):

|                     | 2010      | 2009     | 2008     |
|---------------------|-----------|----------|----------|
|                     | -----     | -----    | -----    |
| Current             | \$(2,030) | \$ 831   | \$ 4,041 |
| Deferred            | 466       | (1,813)  | (1,217)  |
|                     | -----     | -----    | -----    |
| Provision (benefit) | \$(1,564) | \$ (982) | \$ 2,824 |
|                     | =====     | =====    | =====    |

At September 30, 2010 and 2009, the Company recorded income taxes receivables of \$2,564,000 and \$543,000, respectively, which are included in other assets in the accompanying consolidated balance sheet.

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

|                                  | 2010   | 2009   |
|----------------------------------|--------|--------|
|                                  | -----  | -----  |
| Deferred Tax Assets              |        |        |
| Accrued interest on loans        | \$ 479 | \$ 147 |
| Accrued vacation                 | -      | 120    |
| Unearned ESOP shares             | 439    | 455    |
| Allowance for loan losses        | 3,977  | 5,019  |
| OREO                             | 153    | 60     |
| CDI                              | 257    | 250    |
| Unearned MRDP shares             | 60     | 111    |
| Net unrealized securities losses | 341    | 1,035  |
| Capital loss carry-forward       | 680    | 846    |
| OTTI credit Impairment           | 111    | -      |
| Other                            | 159    | 59     |
|                                  | -----  | -----  |
| Total deferred tax assets        | 6,656  | 8,102  |

(continued)

Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

### Note 13 - Federal Income Taxes (concluded)

|  | 2010    | 2009    |
|--|---------|---------|
|  | -----   | -----   |
| Deferred Tax Liabilities                                   |         |         |
| FHLB stock dividends                                       | \$ 880  | \$ 906  |
| Depreciation   | 319     | 444     |
| Goodwill   | 768     | 659     |
| Mortgage servicing rights                                  | 656     | 916     |
| Prepaid expenses   | 195     | 102     |
| Other  | 17      | 20      |
|  | -----   | -----   |
| Total deferred tax liabilities                             | 2,835   | 3,047   |
| <br>   |         |         |
| Valuation allowance for capital loss on sale of securities | (421)   | (510)   |
| <br>   |         |         |
| Net deferred tax assets                                    | \$3,400 | \$4,545 |
|  | =====   | =====   |

The Company has a capital loss carry forward in the amount of \$2,000,000 that will expire in 2013.

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

|  | 2010       | 2009     | 2008    |
|--|------------|----------|---------|
|  | -----      | -----    | -----   |
| Taxes at statutory rate                      | \$ (1,312) | \$ (429) | \$2,390 |
| BOLI income                                  | (167)      | (337)    | (170)   |
| Non-deductible capital loss                  | - -        | - -      | 750     |
| Dividends on ESOP                            | (12)       | (121)    | (136)   |
| Other - net                                  | (73)       | (95)     | (10)    |
|  | -----      | -----    | -----   |
| <br>   |            |          |         |
| Provision (benefit) for federal income taxes | \$ (1,564) | \$ (982) | \$2,824 |
|  | =====      | =====    | =====   |

### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
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### Note 14 - Employee Stock Ownership and 401(k) Plan ("KSOP")

Effective October 3, 2007, the Bank established the Timberland Bank Employee Stock Ownership and 401(k) Plan ("KSOP") by combining the existing Timberland Bank Employee Stock Ownership Plan (established in 1997) and the Timberland Bank 401(k) Profit Sharing Plan (established in 1970). The KSOP is comprised of two components, the Employee Stock Ownership Plan ("ESOP") and the 401(k) Plan. The KSOP benefits employees with at least one year of service who are 21 years of age or older. It may be funded by Bank contributions in cash or stock for the ESOP and in cash only for the 401(k) profit sharing. Employee vesting occurs over six years.

#### ESOP

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The amount of the annual contribution is discretionary, except that it must be sufficient to enable the ESOP to service its debt. All dividends received by the ESOP are used to pay debt service. Dividends of \$35,000, \$331,000, and \$389,000 were used to service the debt during the years ended September 30, 2010, 2009 and 2008, respectively. As of September 30, 2010, 192,691 ESOP shares had been distributed to participants.

In January 1998, the ESOP borrowed \$7,930,000 from the Company to purchase 1,058,000 shares of common stock of the Company. The term of the loan was extended by 75 months in December 2006. The extension of the loan reduces the annual number of shares allocated to participants. The loan is being repaid primarily from the Bank's contributions to the ESOP and is scheduled to be fully repaid by March 31, 2019. The interest rate on the loan is 8.5%. Interest expense on the ESOP debt was \$315,000, \$337,000, and \$359,000 for the years ended September 30, 2010, 2009 and 2008, respectively. The balance of the loan at September 30, 2010 was \$3,538,000.

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

|                                | 2010    | 2009    | 2008    |
|--------------------------------|---------|---------|---------|
|                                | -----   | -----   | -----   |
| Unallocated shares             | 299,786 | 335,052 | 370,294 |
| Shares released for allocation | 565,523 | 550,755 | 523,477 |
|                                | -----   | -----   | -----   |
| Total ESOP shares              | 865,309 | 885,807 | 893,771 |
|                                | =====   | =====   | =====   |

The approximate fair market value of the Bank's unallocated shares at September 30, 2010, 2009 and 2008, was \$1,211,000, \$1,555,000 and \$2,796,000, respectively. Compensation expense recognized under the ESOP for the year ended September 30, 2010 was \$109,000. A compensation benefit of \$138,000 was recognized for the year ended September 30, 2009 and a compensation expense of \$7,000 was recognized for the year ended September 30, 2008.

#### 401(k)

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Eligible employees may contribute up to the maximum established by the Internal Revenue Service. Contributions by the Bank are at the discretion of the board of directors except for a 3% safe harbor contribution which is mandatory according to the plan document. Bank contributions totaled \$294,000, \$475,000 and \$422,000 for the years ended September 30, 2010, 2009 and 2008, respectively.

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Note 15 - Stock Compensation Plans

Stock Option Plans

Under the Company's stock option plans (1999 Stock Option Plan and 2003 Stock Option Plan), the Company was able to grant options for up to 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 stock on the date of grant. Generally, options vest in 20% annual installments on each of the five anniversaries from the date of the grant. At September 30, 2010, options for 249,738 shares were available for future grant under the 2003 Stock Option Plan and no shares were available for future grant under the 1999 Stock Option Plan.

Stock option activity for the years ended September 30 is summarized as follows:

|                                | Number of<br>Shares | Weighted Average<br>Exercise Price |
|--------------------------------|---------------------|------------------------------------|
|                                | -----               | -----                              |
| Outstanding September 30, 2007 | 412,674             | \$7.39                             |
| Options exercised              | (138,854)           | 6.06                               |
|                                | -----               |                                    |
| Outstanding September 30, 2008 | 273,820             | 8.07                               |
|                                | =====               |                                    |
| Options exercised              | (57,699)            | 6.00                               |
| Options forfeited              | (47,257)            | 6.00                               |
|                                | -----               |                                    |
| Outstanding September 30, 2009 | 168,864             | 9.35                               |
|                                | =====               |                                    |
| Options granted                | 26,000              | 4.55                               |
|                                | -----               |                                    |
| Outstanding September 30, 2010 | 194,864             | \$8.71                             |
|                                | =====               |                                    |

The Company uses the Black-Scholes option pricing model to estimate the fair value of stock-based awards with the weighted average assumptions noted in the following table. The risk-free interest rate is based on the U.S. Treasury rate of a similar term as the stock option at the particular grant date. The expected life is based on historical data, vesting terms, and estimated exercise dates. The expected dividend yield is based on the most recent quarterly dividend on an annualized basis in effect at the time the options were granted. The expected volatility is based on historical volatility of the Company's stock price. There were 26,000 options granted during the year ended September 30, 2010 with an aggregate grant date fair value of \$34,000.

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The weighted average assumptions for options granted during the year ended September 30, 2010 were as follows:

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

There were no options granted during the years ended September 30, 2009 and 2008.

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
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#### Note 15 - Stock Compensation Plans (continued)

There were no shares that vested during the year ended September 30, 2010. The total fair value of shares that vested during the years ended September 30, 2009 and 2008 was \$13,000 and \$30,000, respectively.

At September 30, 2010 there were 26,000 unvested options with an aggregate grant date fair value of \$34,000, all of which the Company assumes will vest. There was no aggregate intrinsic value of unvested options at September 30, 2010, as the exercise price was greater than the stock's current market value. There were no unvested options at September 30, 2009.

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

|                                      | 2010   | 2009   | 2008   |
|--------------------------------------|--------|--------|--------|
|                                      | -----  | -----  | -----  |
| Proceeds from options exercised      | \$ - - | \$ 346 | \$ 842 |
| Related tax benefit recognized       | - -    | 46     | 15     |
| Intrinsic value of options exercised | - -    | 56     | 531    |

Additional information regarding options outstanding at September 30, 2010, is as follows:

| Range of Exercise Prices | Options Outstanding |                                 |   | Options Exercisable |                                 |   |
|--------------------------|---------------------|---------------------------------|---|---------------------|---------------------------------|---|
|                          | Number              | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (Years) | Number              | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (Years) |
| -----                    | -----               | -----                           | -----   | -----               | -----                           | -----   |
| \$ 4.55                  | 26,000              | \$ 4.55                         | 9.1   | - -                 | \$ - -                          | - -   |
| 7.45                     | 56,638              | 7.45                            | 0.7   | 56,638              | 7.45                            | 0.7   |

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|         |         |         |     |         |         |     |
|---------|---------|---------|-----|---------|---------|-----|
| 7.85 -  |         |         |     |         |         |     |
| 7.98    | 6,000   | 7.91    | 1.6 | 6,000   | 7.91    | 1.6 |
| 9.52    | 56,680  | 9.52    | 2.4 | 56,680  | 9.52    | 2.4 |
| 11.46 - |         |         |     |         |         |     |
| 11.63   | 49,546  | 11.51   | 3.3 | 49,546  | 11.51   | 3.3 |
|         | -----   |         |     | -----   |         |     |
|         | 194,864 | \$ 8.71 | 3.0 | 168,864 | \$ 9.35 | 2.1 |
|         | =====   |         |     | =====   |         |     |

There was no aggregate intrinsic value of options outstanding at September 30, 2010 and 2009, as the exercise price of all options outstanding was greater than the stock's current market value. The aggregate intrinsic value of all options outstanding and exercisable at September 30, 2008 was \$168,000.

Stock Grant Plan

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

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2009 and 2008

Note 15 - Stock Compensation Plans (continued)

The MRDP allowed for the issuance to participants of up to 529,000 shares of the Company's common stock. Awards under the MRDP have been made in the form of restricted shares of common stock that are subject to restrictions on the transfer of ownership and are subject to a five-year vesting period. Compensation expense 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. At September 30, 2010, there were no shares available for future awards under the MRDP.

A summary of MRDP shares granted and vested for the years ended September 30, were as follows:

|  | 2010      | 2009      | 2008      |
|--|-----------|-----------|-----------|
|  | -----     | -----     | -----     |
| Shares granted                         | - -       | 19,758    | 20,315    |
| Weighted average grant date fair value | \$ - -    | \$ 7.01   | \$12.76   |
| Shares vested                          | 13,431    | 9,479     | 5,416     |
| Aggregate vesting date fair value      | \$ 56,000 | \$ 46,000 | \$ 46,000 |

A summary of unvested MRDP shares as of September 30, 2010 and changes during the year ended September 30, 2010, were as follows:

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|                                      | Shares   | Weighted Average<br>Grant Date<br>Fair Value |
|--------------------------------------|----------|--|
|                                      | -----    | -----  |
| Unvested shares, beginning of period | 49,858   | \$ 11.66                                     |
| Shares vested                        | (13,431) | 12.74  |
|                                      | -----    |  |
| Unvested shares, end of period       | 36,427   | \$ 11.27                                     |
|                                      | =====    |  |

At September 30, 2010, there were 36,427 unvested MRDP shares with an aggregate grant date fair value of \$410,000.

Expense for Stock Compensation Plans

-----  
 Compensation expense recorded in the consolidated financial statements for all stock-based plans were as follows for the years ended September 30, (in thousands):

|                                      | 2010  | 2009  | 2008  |
|--------------------------------------|-------|-------|-------|
|                                      | ----- | ----- | ----- |
| Stock options                        | \$ 6  | \$ 3  | \$ 5  |
| MRDP stock grants                    | 134   | 137   | 147   |
| Less: related tax benefit recognized | (49)  | (49)  | (53)  |
|                                      | ----- | ----- | ----- |
|                                      | \$ 91 | \$ 91 | \$ 99 |
|                                      | ===== | ===== | ===== |

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Notes to Consolidated Financial Statements

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 Timberland Bancorp, Inc. and Subsidiary  
 September 30, 2010 and 2009

Note 15 - Stock Compensation Plans (concluded)

The compensation expense to be recognized in the future 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<br>(MRDP) | Total<br>Awards |
|------|------------------|---------------------------|-----------------|
|      | -----            | -----                     | -----           |
| 2011 | \$ 7             | \$ 165                    | \$ 172          |
| 2012 | 7                | 111                       | 118             |
| 2013 | 6                | 38                        | 44              |
| 2014 | 6                | 2                         | 8               |
| 2015 | 1                | -                         | 1               |
|      | -----            | -----                     | -----           |
|      | \$ 27            | \$ 316                    | \$ 343          |
|      | =====            | =====                     | =====           |

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### Note 16 - Deferred Compensation Plans

The Bank has a deferred compensation/non-competition arrangement with its former chief executive officer, which provides for payments of \$2,000 per month. Payments under this agreement began in March 2004 and will continue until his death, at which time payments will continue to his surviving spouse until the earlier of her death or for 60 months. The present value of the payments as of September 30, 2010 and 2009 was \$81,000 and \$105,000, respectively, and is included in other liabilities in the accompanying consolidated balance sheets.

The Company adopted the Timberland Bancorp, Inc. Directors Deferred Compensation Plan in 2004. This plan allows directors to defer a portion of their monthly directors' fees until retirement with no income tax payable by the director until retirement benefits are received. There was no liability accrued under this plan at September 30, 2010 or 2009.

### Note 17 - Commitments and Contingencies

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

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments as it does for on-balance-sheet instruments.

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

### Note 17 - Commitments and Contingencies (continued)

A summary of the Bank's commitments at September 30, is as follows (in thousands):

|  | 2010     | 2009     |
|--|----------|----------|
|  | -----    | -----    |
| Undisbursed portion of construction loans in process<br>(see Note 4) | \$17,952 | \$31,298 |
| Undisbursed lines of credit  | 26,030   | 27,609   |
| Commitments to extend credit   | 8,357    | 16,513   |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Since commitments may expire without being drawn upon, the total commitment amounts

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do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the party. However, such loan to value ratios will subsequently change, based on increases and decreases in the supporting collateral values. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate, land, and income-producing commercial properties.

In March 2007, the Bank adopted the Timberland Bank Employee Severance Compensation Plan, which replaced the existing employee severance compensation agreement adopted in 1998. The new plan, which expires in 2017, was adopted to provide severance pay benefits to eligible employees in the event of a change in control of the Company or the Bank (as defined in the plan). In general, all employees (except those who are restricted from receiving golden parachute payments in any amount under the compensation limitations for participants in the Treasury's Capital Purchase Program) with two or more years of service will be eligible to participate in the plan. Under the plan, in the event of a change in control of the Company or the Bank, eligible employees who are terminated or who terminate employment (but only upon the occurrence of events specified in the plan) within 12 months of the effective date of a change in control would be entitled to a payment based on years of service or officer rank with the Bank. The maximum payment for any eligible employee would be equal to 24 months of their current compensation.

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

### Note 18 - Significant Concentrations of Credit Risk

Most of the Bank's lending activity is with customers located in the state of Washington and involves real estate. At September 30, 2010, the Bank had \$531,971,000 (including \$17,952,000 of undisbursed construction loan proceeds) in loans secured by real estate, which represents 95.2% of the total loan portfolio. The real estate loan portfolio is primarily secured by one- to four-family properties, multi-family properties, undeveloped land, and a variety of commercial real estate property types. At September 30, 2010, there were no concentrations of real estate loans to a specific industry or secured by a specific collateral type that equaled or exceeded 20% of the Bank's total loan portfolio, other than loans secured by one-to four-family properties. The ultimate collectability of a substantial portion of the loan portfolio is susceptible to changes in economic and market conditions in the region and the impact of those changes on the real estate market. The Bank typically originates real estate loans with loan-to-value ratios of no greater than 90%. Collateral and/or guarantees are required for all loans. The Company also had \$18,047,000 in CDs held for investment at September 30, 2010. The CDs are held with FDIC insured institutions, and each CD is below the FDIC insurance limit of \$250,000.



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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

### Note 19 - Regulatory Matters

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

Federally-insured state-chartered banks are required to maintain minimum levels of regulatory capital. Under current FDIC regulations, insured state-chartered banks generally must maintain (i) a ratio of Tier 1 leverage capital to total assets of at least 4.0%, (ii) a ratio of Tier 1 capital to risk weighted assets of at least 4.0% and (iii) a ratio of total capital to risk weighted assets of at least 8.0%.

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

In addition, on February 1, 2010, the FRB determined that the Company required additional supervisory attention and entered into the Company MOU. Under the Company MOU, the Company must among other things obtain prior written approval, or non-objection from the FRB to declare or pay any dividends, or make any other capital distributions; issue any trust preferred securities; or purchase or redeem any of its stock, (see note 1).

The following table compares the Company's and the Bank's actual capital amounts at September 30, 2010 to its minimum regulatory capital requirements at that date (dollars in thousands):

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

Note 19 - Regulatory Matters (concluded)

|                               | Actual   |       | Capital Adequacy Purposes |          | To be Well Capitalized Under Prompt Corrective Action Provisions |       |
|-------------------------------|----------|-------|---------------------------|----------|--|-------|
|                               | Amount   | Ratio | Amount                    | Ratio    | Amount   | Ratio |
| September 30, 2010            |          |       |                           |          |  |       |
| Tier 1 leverage capital:      |          |       |                           |          |  |       |
| Consolidated                  | \$80,243 | 11.0% | \$29,279                  | 4.0%     | N/A  | N/A   |
| Timberland Bank               | 72,784   | 10.0  | 72,809                    | 10.0 (1) | \$72,809   | 10.0% |
| Tier 1 risk adjusted capital: |          |       |                           |          |  |       |
| Consolidated                  | 80,243   | 15.0  | 21,397                    | 4.0      | N/A  | N/A   |
| Timberland Bank               | 72,784   | 13.6  | 32,036                    | 6.0 (1)  | 32,036   | 6.0   |
| Total risk based capital:     |          |       |                           |          |  |       |
| Consolidated                  | 86,986   | 16.3  | 42,794                    | 8.0      | N/A  | N/A   |
| Timberland Bank               | 79,515   | 14.9  | 53,393                    | 10.0 (1) | 53,393   | 10.0  |
| September 30, 2009            |          |       |                           |          |  |       |
| Tier 1 leverage capital:      |          |       |                           |          |  |       |
| Consolidated                  | \$83,196 | 12.2% | \$27,182                  | 4.0%     | N/A  | N/A   |
| Timberland Bank               | 67,780   | 10.1  | 26,774                    | 4.0      | \$33,467   | 5.0%  |
| Tier 1 risk adjusted capital: |          |       |                           |          |  |       |
| Consolidated                  | 83,196   | 14.7  | 22,683                    | 4.0      | N/A  | N/A   |
| Timberland Bank               | 67,780   | 12.0  | 22,576                    | 4.0      | 33,864   | 6.0   |
| Total risk based capital:     |          |       |                           |          |  |       |
| Consolidated                  | 90,372   | 15.9  | 45,366                    | 8.0      | N/A  | N/A   |
| Timberland Bank               | 74,923   | 13.3  | 45,152                    | 8.0      | 56,440   | 10.0  |

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

Restrictions on Retained Earnings

At the time of conversion of the Bank from a Washington-chartered mutual savings bank to a Washington-chartered stock savings bank, the Bank established a liquidation account in an amount equal to its retained earnings of \$23,866,000 as of June 30, 1997, the date of the latest statement of financial condition used in the final conversion prospectus. The liquidation account is maintained for the benefit of eligible account holders who have maintained their deposit accounts in the Bank after conversion. The liquidation account reduces annually to the extent that eligible account holders have reduced their qualifying deposits as of each anniversary date.

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Subsequent increases do not restore an eligible account holder's interest in the liquidation account. In the event of a complete liquidation of the Bank (and only in such an event), eligible depositors who have continued to maintain accounts will be entitled to receive a distribution from the liquidation account before any liquidation may be made with respect to common stock. The Bank may not declare or pay cash dividends if the effect thereof would reduce its regulatory capital below the amount required for the liquidation account.

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

#### Note 20 - Condensed Financial Information - Parent Company Only

Condensed Balance Sheets - September 30  
(in thousands)

|   | 2010     | 2009     |
|---|----------|----------|
|   | -----    | -----    |
| <b>Assets</b>                               |          |          |
| Cash and cash equivalents:                  |          |          |
| Cash and due from financial institutions    | \$ 641   | \$ 350   |
| Interest-bearing deposits in banks          | 3,516    | 10,603   |
|   | -----    | -----    |
| Total cash and cash equivalents             | 4,157    | 10,953   |
| Loan receivable from Bank                   | 3,538    | 3,811    |
| Investment in Bank                          | 77,949   | 71,784   |
| Other assets                                | 327      | 798      |
|   | -----    | -----    |
| Total assets                                | \$85,971 | \$87,346 |
|   | =====    | =====    |
| <b>Liabilities and shareholders' equity</b> |          |          |
| Accrued expenses                            | \$ 563   | \$ 147   |
| Shareholders' equity                        | 85,408   | 87,199   |
|   | -----    | -----    |
| Total liabilities and shareholders' equity  | \$85,971 | \$87,346 |
|   | =====    | =====    |

Condensed Statements of Operations - Years Ended September 30  
(in thousands)

|  | 2010  | 2009  | 2008  |
|--|-------|-------|-------|
|  | ----- | ----- | ----- |
| Operating income   |       |       |       |
| Interest on deposits in banks                            | \$ 31 | \$ 25 | \$ 22 |
| Interest on loan receivable from Bank                    | 315   | 338   | 359   |
| Dividends on investments                                 | - -   | - -   | 65    |
| Loss on sale of investment securities available for sale | - -   | - -   | (171) |

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|   |                   |                   |                 |
|---|-------------------|-------------------|-----------------|
| Dividends from Bank   | - -               | 416               | 3,850           |
|   | -----             | -----             | -----           |
| Total operating income  | 346               | 779               | 4,125           |
| Non-operating income  | - -               | 37                | - -             |
| Operating expenses  | 683               | 642               | 589             |
|   | -----             | -----             | -----           |
| Income (loss) before income taxes and equity in undistributed income (loss) of Bank   | (337)             | 174               | 3,536           |
| Benefit for income taxes  | (127)             | (200)             | (193)           |
|   | -----             | -----             | -----           |
| Income (loss) before equity in undistributed income (loss) of Bank                    | (210)             | 374               | 3,729           |
| Equity in undistributed income (loss) of bank (dividends in excess of income of Bank) | (2,081)           | (616)             | 276             |
|   | -----             | -----             | -----           |
| Net income (loss)   | <u>\$ (2,291)</u> | <u>\$ (242)</u>   | <u>\$ 4,005</u> |
| Preferred stock dividends   | \$ 832            | \$ 643            | \$ - -          |
| Preferred stock accretion   | 210               | 129               | - -             |
|   | -----             | -----             | -----           |
| Net income (loss) to common shareholders  | <u>\$ (3,333)</u> | <u>\$ (1,014)</u> | <u>\$ 4,005</u> |

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

Note 20 - Condensed Financial Information - Parent Company Only (concluded)

Condensed Statements of Cash Flows - Years Ended September 30  
(in thousands)

|  | 2010       | 2009     | 2008     |
|--|------------|----------|----------|
|  | -----      | -----    | -----    |
| Cash flows from operating activities   |            |          |          |
| Net income (loss)  | \$ (2,291) | \$ (242) | \$ 4,005 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |            |          |          |
| (Equity in undistributed income (loss) of Bank) dividends in excess of income            |            |          |          |

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|   |          |          |          |
|---|----------|----------|----------|
| of Bank   | 2,081    | 616      | (276)    |
| ESOP shares earned                                  | 265      | 264      | 264      |
| MRDP compensation expense                           | 173      | 169      | 131      |
| Stock option compensation expense                   | 6        | 3        | 5        |
| Stock option tax effect                             | - -      | 46       | 15       |
| Less stock option excess tax benefit                | - -      | - -      | (11)     |
| Loss on sale of available for sale securities       | - -      | - -      | 171      |
| Other, net  | 471      | (608)    | 1,764    |
|   | -----    | -----    | -----    |
| Net cash provided by operating activities           | 705      | 248      | 6,068    |
| Cash flows from investing activities                |          |          |          |
| Investment in Bank                                  | (6,958)  | (6,308)  | (562)    |
| Proceeds from sale of available for sale securities | - -      | - -      | 1,959    |
| Principal repayments on loan receivable from Bank   | 273      | 252      | 230      |
|   | -----    | -----    | -----    |
| Net cash provided by (used in) investing activities | (6,685)  | (6,056)  | 1,627    |
| Cash flows from financing activities                |          |          |          |
| Decrease in borrowings from Bank                    | - -      | - -      | (1,400)  |
| Proceeds from exercise of stock options             | - -      | 346      | 841      |
| Repurchase of common stock                          | - -      | - -      | (1,920)  |
| Payment of dividends                                | (699)    | (3,272)  | (2,977)  |
| ESOP tax effect                                     | (78)     | (47)     | (409)    |
| MRDP compensation tax effect                        | (39)     | (32)     | 16       |
| Stock option tax effect                             | - -      | - -      | 11       |
| Issuance of preferred stock                         | - -      | 15,425   | - -      |
| Issuance of stock warrants                          | - -      | 1,158    | - -      |
|   | -----    | -----    | -----    |
| Net cash provided by (used in) financing activities | (816)    | 13,578   | (5,838)  |
|   | -----    | -----    | -----    |
| Net increase (decrease) in cash                     | (6,796)  | 7,770    | 1,857    |
| Cash and cash equivalents                           |          |          |          |
| Beginning of year                                   | 10,953   | 3,183    | 1,326    |
|   | -----    | -----    | -----    |
| End of year   | \$ 4,157 | \$10,953 | \$ 3,183 |
|   | =====    | =====    | =====    |

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

Note 21 - Net Income (Loss) Per Common Share

Basic net income (loss) per common share is computed by dividing net income (loss) available for common stock by the weighted average number of common shares outstanding during the period, without considering any dilutive items. Diluted net income per common share is computed by dividing net income

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available for common stock by the weighted average number of common shares and common stock equivalents for items that are dilutive, net of shares assumed to be repurchased using the treasury stock method at the average share price for the Company's common stock during the period. Diluted net loss per common share is the same as basic net loss per common share due to the anti-dilutive effect of common stock equivalents. Common stock equivalents arise from assumed conversion of outstanding stock options and outstanding warrants to purchase common stock. In accordance with FASB guidance for stock compensation, shares owned by the Bank's ESOP that have not been allocated are not considered to be outstanding for the purpose of computing net income (loss) per common share. Information regarding the calculation of basic and diluted net income (loss) per common share for the years ended September 30 is as follows (dollars in thousands, except per share amounts):

|  | 2010<br>----- | 2009<br>----- | 2008<br>----- |
|--|---------------|---------------|---------------|
| Basic net income (loss) per common share computation         |               |               |               |
| Numerator - net income (loss)                                | \$ (2,291)    | \$ (242)      | \$4,005       |
| Preferred stock dividends                                    | (832)         | (643)         | - -           |
| Preferred stock discount accretion                           | (210)         | (129)         | - -           |
|  | -----         | -----         | -----         |
| Net income (loss) to common stockholders                     | \$ (3,333)    | \$ (1,014)    | \$4,005       |
| Denominator - weighted average common shares outstanding     | 6,713,766     | 6,621,399     | 6,475,385     |
| Basic net income (loss) per common share                     | \$ (0.50)     | \$ (0.15)     | \$0.62        |
| Diluted net income (loss) per common share computation       |               |               |               |
| Numerator - net income (loss)                                | \$ (2,291)    | \$ (242)      | \$4,005       |
| Preferred stock dividends                                    | (832)         | (643)         | - -           |
| Preferred stock discount accretion                           | (210)         | (129)         | - -           |
|  | -----         | -----         | -----         |
| Net income (loss) to common stockholders                     | \$ (3,333)    | \$ (1,014)    | \$4,005       |
| Denominator - weighted average common shares outstanding     | 6,713,766     | 6,621,399     | 6,475,385     |
| Effect of dilutive stock options                             | - -           | - -           | 95,107        |
| Weighted average common shares outstanding-assuming dilution | 6,713,766     | 6,621,399     | 6,570,492     |
| Diluted net income (loss) per common share                   | \$ (0.50)     | \$ (0.15)     | \$0.61        |

For the years ended September 30, 2010, 2009 and 2008, options to purchase 193,083, 176,899 and 40,443 shares of common stock, respectively, were outstanding but not included in the computation of diluted net income (loss) per common share because the options' exercise prices were greater than the average market price of the common shares and, therefore, their effect would have been anti-dilutive.

(continued)

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

#### Note 21 - Net Income (Loss) Per Common Share (concluded)

For the year ended September 30, 2009, the effect of dilutive stock options was computed to be 1,300 shares. However, the dilutive effect of these options has been excluded from the diluted net income (loss) per common share computation for the year ended September 30, 2009 because the Company reported a net loss to common shareholders for that period and, therefore, their effect would have been anti-dilutive.

For the years ended September 30, 2010 and 2009, a warrant to purchase a weighted average of 370,899 and 278,174 shares of common stock, respectively, was outstanding but not included in the computation of diluted net income (loss) per common share because the warrant's exercise price was greater than the average market price of the common shares and, therefore, its effect would have been anti-dilutive. There were no warrants to purchase shares of common stock outstanding during the year ended September 30, 2008.

For the year ended September 30, 2009, the effect of dilutive warrants was computed to be 541 shares. However, the dilutive effect of these warrants has been excluded from the diluted net income (loss) per common share computation for the year ended September 30, 2009 because the Company reported a net loss to common shareholders for that period and, therefore, their effect would have been anti-dilutive.

#### Note 22 - Accumulated Other Comprehensive Income (Loss)

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

|   | 2010<br>----- | 2009<br>----- | 2008<br>----- |
|---|---------------|---------------|---------------|
| Unrealized gain (loss) on securities:   |               |               |               |
| Net unrealized holding gain (loss) from available for sale securities                             | \$ 755        | \$ 28         | \$ (2,329)    |
| Cumulative effect of adoption of FASB guidance regarding recognition of OTTI                      | - -           | (140)         | - -           |
| OTTI on held to maturity securities recognized in other comprehensive income (loss)               | 1,178         | (2,274)       | - -           |
| Accretion of OTTI on held to maturity securities recognized in other comprehensive income (loss)  | 48            | - -           | - -           |
| Reclassification adjustment from losses included in net income (loss)                             | - -           | - -           | 2,826         |
|   | -----         | -----         | -----         |
| Unrealized gain (loss), net of reclassification adjustment, before income tax provision (benefit) | 1,981         | (2,386)       | 497           |
| Income tax provision (benefit)  | 693           | (835)         | 174           |
|   | -----         | -----         | -----         |

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|                               |         |            |        |
|-------------------------------|---------|------------|--------|
| Net unrealized gains (losses) | \$1,288 | \$ (1,551) | \$ 323 |
|                               | =====   | =====      | =====  |

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

Note 23 - Fair Value Measurement

GAAP requires disclosure of estimated fair values for financial instruments. Such estimates are subjective in nature, and significant judgment is required regarding the risk characteristics of various financial instruments at a discrete point in time. Therefore, such estimates could vary significantly if assumptions regarding uncertain factors were to change. In addition, as the Company normally intends to hold the majority of its financial instruments until maturity, it does not expect to realize many of the estimated amounts disclosed. The disclosures also do not include estimated fair value amounts for items which are not defined as financial instruments but which may have significant value. The Company does not believe that it would be practicable to estimate a representational fair value for these types of items as of September 30, 2010 and 2009. Because GAAP excludes certain items from fair value disclosure requirements, any aggregation of the fair value amounts presented would not represent the underlying value of the Company. Major assumptions, methods and fair value estimates for the Company's significant financial instruments are set forth below:

Cash and Due from Financial Institutions and Interest-Bearing Deposits in

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Banks

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

CDs Held for Investment

---

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

MBS and Other Investments

---

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

FHLB Stock

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



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### Loans Receivable, Net

-----

At September 30, 2010, because of the illiquid market for loan sales, loans were priced using comparable market statistics. The loan portfolio was segregated into various categories and a weighted average valuation discount that approximated similar loan sales was applied to each category. Fair value of loans receivable at September 30, 2009 was estimated by using FDIC portfolio sales for the period of January 1, 2007 through September 30, 2009 which included distressed loan sales.

(continued)

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

#### Note 23 - Fair Value Measurement (continued)

##### Loans Held for Sale

-----

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

##### Accrued Interest

-----

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

##### Deposits

-----

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

##### FHLB Advances

-----

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

##### FRB Borrowings

-----

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

##### Repurchase Agreements

-----

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

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### Off-Balance-Sheet Instruments

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

(continued)

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### Notes to Consolidated Financial Statements

Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

#### Note 23 - Fair Value Measurement (continued)

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

|   | 2010               |                            | 2009               |                            |
|---|--------------------|----------------------------|--------------------|----------------------------|
|   | Recorded<br>Amount | Estimated<br>Fair<br>Value | Recorded<br>Amount | Estimated<br>Fair<br>Value |
| <b>Financial Assets</b>   |                    |                            |                    |                            |
| Cash and due from financial institutions and interest-bearing deposits in banks | \$111,786          | \$111,786                  | \$ 66,462          | \$ 66,462                  |
| CDs, held for investment  | 18,047             | 18,047                     | 3,251              | 3,251                      |
| MBS and other investments   | 16,185             | 15,961                     | 20,558             | 19,686                     |
| FHLB stock  | 5,705              | 5,705                      | 5,705              | 5,705                      |
| Loans receivable, net   | 524,621            | 473,986                    | 546,578            | 357,422                    |
| Loans held for sale   | 2,970              | 3,059                      | 630                | 648                        |
| Accrued interest receivable   | 2,630              | 2,630                      | 2,805              | 2,805                      |
| <b>Financial Liabilities</b>  |                    |                            |                    |                            |
| Deposits  | \$578,869          | \$581,046                  | \$505,661          | \$507,465                  |
| FHLB advances - long term   | 75,000             | 81,579                     | 95,000             | 99,414                     |
| FRB borrowings - short term   | -                  | -                          | 10,000             | 10,000                     |
| Repurchase agreements   | 622                | 622                        | 777                | 777                        |
| Accrued interest payable  | 737                | 737                        | 965                | 965                        |

The Company assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the estimated fair value of the Company's financial instruments will change when interest rate levels change and that change may either be favorable or unfavorable to the Company. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed interest rate obligations are less likely to prepay in a rising interest rate environment and more likely to prepay in a falling interest rate environment. Conversely, depositors who are receiving

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fixed interest rates are more likely to withdraw funds before maturity in a rising interest rate environment and less likely to do so in a falling interest rate environment. Management monitors interest rates and maturities of assets and liabilities, and attempts to minimize interest rate risk by adjusting terms of new loans, and deposits and by investing in securities with terms that mitigate the Company's overall interest rate risk.

(continued)

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

#### Note 23 - Fair Value Measurement (concluded)

Accounting guidance regarding fair value measurements defines fair value and establishes a framework for measuring fair value in accordance with GAAP. Fair value is the exchange price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date. The following definitions describe the levels of inputs that may be used to measure fair value:

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

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

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

The following table summarizes the balances of assets and liabilities measured at estimated fair value on a recurring basis and the total losses resulting from these fair value adjustments for the year ended September 30, 2010 and 2009 (in thousands):

|                               | Fair Value |          |         | Total Losses |
|-------------------------------|------------|----------|---------|--------------|
|                               | Level 1    | Level 2  | Level 3 |              |
| 2010                          |            |          |         |              |
| -----                         |            |          |         |              |
| Available for Sale Securities |            |          |         |              |
| Mutual funds                  | \$ 988     | \$ - -   | \$ - -  | \$ - -       |
| MBS                           | - -        | 10,131   | - -     | 103          |
|                               | -----      | -----    | -----   | -----        |
| Total                         | \$ 988     | \$10,131 | \$ - -  | \$ 103       |
|                               | =====      | =====    | =====   | =====        |

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2009

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Available for Sale Securities

|              |        |          |        |        |
|--------------|--------|----------|--------|--------|
| Mutual funds | \$ 968 | \$ - -   | \$ - - | \$ - - |
| MBS          | - -    | 12,503   | - -    | 227    |
|              | -----  | -----    | -----  | -----  |
| Total        | \$ 968 | \$12,503 | \$ - - | \$ 227 |
|              | =====  | =====    | =====  | =====  |

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

Note 23 - Fair Value Measurement (concluded)

The following table summarizes the balance of assets and liabilities measured at fair value on a non-recurring basis and the total losses resulting from these fair value adjustments for the year ended September 30, 2010 and 2009 (in thousands):

|                                       | Fair Value |         |          |              |
|---------------------------------------|------------|---------|----------|--------------|
|                                       | Level 1    | Level 2 | Level 3  | Total Losses |
|                                       | -----      | -----   | -----    | -----        |
| 2010                                  |            |         |          |              |
| -----                                 |            |         |          |              |
| Impaired Loans (1)                    | \$ - -     | \$ - -  | \$ 5,770 | \$13,820     |
| MBS held to maturity (2)              | - -        | 866     | - -      | 2,115        |
| OREO and other repossessed assets (3) | - -        | - -     | 11,519   | 377          |
| MSRs (4)                              | - -        | - -     | 1,929    | 890          |
|                                       | -----      | -----   | -----    | -----        |
| Total                                 | \$ - -     | \$ 866  | \$19,218 | \$17,202     |
|                                       | =====      | =====   | =====    | =====        |
| 2009                                  |            |         |          |              |
| -----                                 |            |         |          |              |
| Impaired Loans (1)                    | \$ - -     | \$ - -  | \$ 9,014 | \$ 4,442     |
| MBS held to maturity (2)              | - -        | 1,835   | - -      | 3,395        |
|                                       | -----      | -----   | -----    | -----        |
| Total                                 | \$ - -     | \$1,835 | \$ 9,014 | \$ 7,837     |
|                                       | =====      | =====   | =====    | =====        |

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(1) The loss represents charge offs on collateral dependent loans for

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estimated fair value adjustments based on the estimated fair value of the collateral. A loan is considered to be impaired when, based on current information and events, it is probable the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. The specific reserve for collateral dependent impaired loans was based on the estimated fair value of the collateral less estimated costs to sell. The estimated fair value of collateral was determined based primarily on appraisals. In some cases, adjustments were made to the appraised values due to various factors including age of the appraisal, age of comparables included in the appraisal, and known changes in the market and in the collateral. When significant adjustments were based on unobservable inputs, the resulting estimated fair value measurement has been categorized as Level 3 measurement.

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

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

(4) The fair value of the MSRs was determined using a third-party model, which incorporates the expected life of the loans, estimated cost to service the loans, servicing fees received and other factors. The estimated fair value is calculated by stratifying the mortgage servicing rights based on the predominant risk characteristics that include the underlying loan's interest rate, cash flows of the loan, origination date and term. The amount of impairment recognized is the amount, if any, by which the amortized cost of the rights for each stratum exceed their estimated fair value. Impairment, if deemed temporary, is recognized through a valuation allowance to the extent that estimated fair value is less than the recorded amount.

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

#### Note 24- Selected Quarterly Financial Data (Unaudited)

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

|                              | September 30,<br>2010 | June 30,<br>2010 | March 31,<br>2010 | December 31,<br>2009 |
|------------------------------|-----------------------|------------------|-------------------|----------------------|
|                              | -----                 | -----            | -----             | -----                |
| Interest and dividend income | \$ 8,996              | \$ 9,102         | \$ 9,157          | \$ 9,341             |
| Interest expense             | (2,589)               | (2,711)          | (2,711)           | (2,950)              |
|                              | -----                 | -----            | -----             | -----                |
| Net interest income          | 6,407                 | 6,391            | 6,446             | 6,391                |

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|  |           |         |            |           |
|--|-----------|---------|------------|-----------|
| Provision for loan losses                | (2,005)   | (750)   | (5,195)    | (2,600)   |
| Non-interest income                      | 1,356     | 1,941   | 430        | 1,969     |
| Non-interest expense                     | (6,029)   | (6,422) | (6,692)    | (5,498)   |
|  | -----     | -----   | -----      | -----     |
| Income (loss) before income taxes        | (271)     | 1,160   | (5,011)    | 262       |
| Provision (benefit) for income taxes     | (130)     | 356     | (1,833)    | 38        |
|  | -----     | -----   | -----      | -----     |
| Net income (loss)                        | (141)     | 804     | (3,178)    | 224       |
| Preferred stock dividends                | (208)     | (208)   | (208)      | (208)     |
| Preferred stock discount accretion       | (54)      | (53)    | (52)       | (51)      |
|  | -----     | -----   | -----      | -----     |
| Net income (loss) to common shareholders | \$ (403)  | \$ 543  | \$ (3,438) | \$ (35)   |
|  | =====     | =====   | =====      | =====     |
| Net Income (loss) per common share       |           |         |            |           |
| Basic                                    | \$ (0.06) | \$ 0.08 | \$ (0.51)  | \$ (0.01) |
| Diluted                                  | (0.06)    | 0.08    | (0.51)     | (0.01)    |

(continued)

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2010 and 2009

Note 24 - Selected Quarterly Financial Data (Unaudited) (concluded)

|                              | September 30,<br>2009 | June 30,<br>2009 | March 31,<br>2009 | December 31,<br>2008 |
|------------------------------|-----------------------|------------------|-------------------|----------------------|
|                              | -----                 | -----            | -----             | -----                |
| Interest and dividend income | \$ 9,364              | \$ 9,611         | \$ 9,801          | \$10,025             |
| Interest expense             | (3,140)               | (3,419)          | (3,384)           | (3,561)              |
|                              | -----                 | -----            | -----             | -----                |
| Net interest income          | 6,224                 | 6,192            | 6,417             | 6,464                |
| Provision for loan losses    | (3,243)               | (1,000)          | (5,176)           | (1,315)              |
| Non-interest income          | 1,457                 | 2,674            | 1,912             | 906                  |

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|  |           |         |            |         |
|--|-----------|---------|------------|---------|
| Non-interest expense                     | (5,387)   | (6,373) | (5,442)    | (5,537) |
|  | -----     | -----   | -----      | -----   |
| Income (loss) before income taxes        | (949)     | 1,493   | (2,289)    | 518     |
| Provision (benefit) for income taxes     | (681)     | 435     | (896)      | 157     |
|  | -----     | -----   | -----      | -----   |
| Net income (loss)                        | (268)     | 1,058   | (1,393)    | 361     |
| Preferred stock dividends                | (207)     | (210)   | (208)      | (18)    |
| Preferred stock discount accretion       | (50)      | (79)    | - -        | - -     |
|  | -----     | -----   | -----      | -----   |
| Net income (loss) to common shareholders | \$ (525)  | \$ 769  | \$ (1,601) | \$ 343  |
|  | =====     | =====   | =====      | =====   |
| Net Income (loss) per common share       |           |         |            |         |
| Basic                                    | \$ (0.08) | \$ 0.12 | \$ (0.24)  | \$ 0.05 |
| Diluted                                  | (0.08)    | 0.12    | (0.24)     | 0.05    |

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Item 9. Changes in and Disagreements with Accountants on Accounting and

Financial Disclosure

On February 25, 2010, the Audit Committee of the Board of Directors of the Company notified McGladrey & Pullen LLP of its decision not to renew the engagement of McGladrey & Pullen LLP to serve as the Company's independent registered public accounting firm. The decision to change certifying accountants was approved by the Audit Committee of the Board of Directors, which subsequently advised the Board of Directors of its decision, on February 23, 2010.

During the fiscal year ended September 30, 2009, and the subsequent interim period through February 23, 2010, there were no: (1) disagreements with McGladrey & Pullen LLP on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedures, which disagreements, if not resolved to their satisfaction, would have caused them to make reference in connection with their opinion to the subject matter of the disagreement, or (2) reportable events (as defined in Regulation S-K Item 304 (a)(1)(v)). McGladrey & Pullen LLP issued an unqualified opinion on the Company's financial statements as of September 30, 2009, and for the two years then ended.

On February 23, 2010, the Audit Committee engaged the firm of Delap LLP as the independent registered public accounting firm of the Company and its

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subsidiary for the fiscal year ended September 30, 2010. During the fiscal year ended September 30, 2010, there were no disagreements with Delap LLP and Delap LLP issued an unqualified opinion on the Company's financial statements as of September 30, 2010, and for the year then ended.

### Item 9A. Controls and Procedures

-----

(a) Evaluation of Disclosure Controls and Procedures: An evaluation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act")) was carried out under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and several other members of the Company's senior management as of the end of the period covered by this annual report. The Company's Chief Executive Officer and Chief Financial Officer concluded that as of September 30, 2010 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 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 September 30, 2010, 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 auditor on ways to strengthen existing controls. The Company does not expect that its disclosure controls and procedures and internal controls over financial reporting will prevent all error and fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that 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; over time, controls become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

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



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Item 9B. Other Information  
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None.

PART III

Item 10. Directors and Executive Officers of the Registrant  
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The information required by this item is contained under the section captioned "Proposal I - Election of Directors" is included in the Company's Definitive Proxy Statement for the 2011 Annual Meeting of Stockholders ("Proxy Statement") and is incorporated herein by reference.

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

Compliance with Section 16(a) of the Exchange Act

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

Audit Committee Financial Expert

The Company has a separately designated standing Audit Committee, composed of Directors Mason, Robbel, Smith, Goldberg and Stoney. Each member of the Audit Committee is "independent" as defined in the Nasdaq Stock Market listing standards. The Company's Board of Directors has designated Directors Robbel and Stoney as the Audit Committee financial experts, as defined in the SEC's Regulation S-K. Directors Mason, Robbel, Smith, Goldberg and Stoney are independent as that term is used in Item 7(c) of Schedule 14A promulgated under the Exchange Act.

Code of Ethics

The Board of Directors ratified its Code of Ethics for the Company's officers (including its senior financial officers), directors and employees during the year ended September 30, 2010. The Code of Ethics requires the Company's officers, directors and employees to maintain the highest standards of professional conduct. The Company's Code of Ethics was filed as an exhibit to its Annual Report on Form 10-K for the year ended September 30, 2003 and is available on our website at [www.timberlandbank.com](http://www.timberlandbank.com).

Item 11. Executive Compensation  
-----

The information required by this item is contained under the sections captioned "Executive Compensation" and "Directors' Compensation" included in the Company's Proxy Statement and is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and  
-----  
Related Stockholder Matters  
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(a) Security Ownership of Certain Beneficial Owners.

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

reference.

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(b) Security Ownership of Management.

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

(c) Changes In Control.

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

(d) Equity Compensation Plan Information. The following table summarizes share and exercise price information about the Company's equity compensation plans as of September 30, 2010.

| Plan category   | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) |
|---|---|---|---|
|   | (a)   | (b)   | (c)   |
| Equity compensation plans approved by security holders:         |   |   |   |
| Management Recognition and Development Plan.....                | --  | \$ --   | --  |
| 1999 Stock Option Plan.....                                     | 156,732   | 9.18  | --  |
| 2003 Stock Option Plan.....                                     | 38,132  | 6.80  | 249,738   |
| Equity compensation plans not approved by security holders..... | --  | --  | --  |
| Total.....  | 194,864<br>=====  | \$ 8.71   | 249,738<br>=====  |

Item 13. Certain Relationships and Related Transactions, and Director

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### Independence

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The information required by this item is contained under the sections captioned "Meetings and Committees of the Board of Directors And Corporate Governance Matters - Corporate Governance - Related Party Transactions" and "Meetings and Committees of the Board of Directors and Corporate Governance Matters - Corporate Governance - Director Independence" included in the Company's Proxy Statement and are incorporated herein by reference.

### Item 14. Principal Accounting Fees and Services

-----

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

## PART IV

### Item 15. Exhibits, Financial Statement Schedules

-----

#### (a) Exhibits

- 3.1 Articles of Incorporation of the Registrant (1)
- 3.2 Amended and Restated Bylaws of the Registrant (2)
- 3.3 Articles of Amendment to Articles of Incorporation of the Registrant (3)
  
- 4.2 Warrant to purchase shares of the Company's common stock dated December 23, 2008 (3)
- 4.3 Letter Agreement (including Securities Purchase Agreement Standard Terms, attached as Exhibit A) dated December 23, 2008 between the Company and the United States Department of the Treasury (3)
- 10.1 Employee Severance Compensation Plan (4)
- 10.2 Employee Stock Ownership Plan (5)
- 10.3 1999 Stock Option Plan (6)
- 10.4 2003 Stock Option Plan (7)
- 10.5 Form of Incentive Stock Option Agreement (8)
- 10.6 Form of Non-qualified Stock Option Agreement (8)
- 10.7 Management Recognition and Development Plan (6)
- 10.8 Form of Management Recognition and Development Award Agreement (7)
- 10.10 Employment Agreement with Michael R. Sand (9)
- 10.11 Employment Agreement with Dean J. Brydon (9)
- 14 Code of Ethics (10)
- 21 Subsidiaries of the Registrant
- 23.1 Consent of Delap LLP
- 23.2 Consent of McGladrey & Pullen LLP
- 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
- 99.1 Certification of the Principal Executive Officer Pursuant to Section 111(b) of the Emergency Economic

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Stabilization Act of 2008 for the Fiscal Year Ended September 30, 2010
99.2 Certification of the Chief Financial Officer
Pursuant to Section 111(b) of the Emergency Economic Stabilization Act of 2008 for the Fiscal Year Ended September 30, 2010

- (1) Filed as an exhibit to the Registrant's Registration Statement on Form S-1 (333-35817) and incorporated by reference.
(2) Incorporated by reference to the Registrant's Current Report on Form 8-K dated April 27, 2010.
(3) Incorporated by reference to the Registrant's Current Report on Form 8-K filed on December 23, 2008.
(4) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 1997; and to the Registrant's Current Report on Form 8-K dated April 13, 2007.
(5) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 1997.
(6) Incorporated by reference to Exhibit 99 included in the Registrant's Registration Statement on Form S-8 (333-32386)
(7) Incorporated by reference to Exhibit 99.2 included in the Registrant's Registration Statement on Form S-8 (333-1161163)
(8) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended September 30, 2005.
(9) Incorporated by reference to the Registrant's Current Report on Form 8-K dated April 13, 2007.
(10) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended September 30, 2003.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

TIMBERLAND BANCORP, INC.

Date: December 10, 2010

By: /s/ Michael R. Sand

Michael R. Sand
President and Chief Executive Officer

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

SIGNATURES TITLE DATE
/s/ Michael R. Sand President, Chief Executive Officer December 10, 2010
and Director
Michael R. Sand (Principal Executive Officer)

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|   |  |                   |
|---|--|-------------------|
| /s/ Jon C. Parker<br>-----<br>Jon C. Parker         | Chairman of the Board  | December 10, 2010 |
| /s/ Dean. J. Brydon<br>-----<br>Dean J. Brydon      | Chief Financial Officer<br>(Principal Financial and Accounting<br>Officer) | December 10, 2010 |
| /s/ Andrea M. Clinton<br>-----<br>Andrea M. Clinton | Director   | December 10, 2010 |
| /s/ Larry D. Goldberg<br>-----<br>Larry D. Goldberg | Director   | December 10, 2010 |
| /s/ James C. Mason<br>-----<br>James C. Mason       | Director   | December 10, 2010 |
| /s/ Ronald A. Robbel<br>-----<br>Ronald A. Robbel   | Director   | December 10, 2010 |
| /s/ David A. Smith<br>-----<br>David A. Smith       | Director   | December 10, 2010 |
| /s/ Michael J. Stoney<br>-----<br>Michael J. Stoney | Director   | December 10, 2010 |

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EXHIBIT INDEX

| Exhibit No. | Description of Exhibit  |
|-------------|---|
| -----       | -----   |
| 21          | Subsidiaries of the Registrant  |
| 23.1        | Consent of Delap LLP  |
| 23.2        | Consent of McGladrey & Pullen LLP   |
| 31.1        | Certification of Chief Executive Officer Pursuant to Section<br>302 of the Sarbanes-Oxley Act   |
| 31.2        | Certification of Chief Financial Officer Pursuant to Section<br>302 of the Sarbanes-Oxley Act   |
| 32          | Certification Pursuant to Section 906 of the Sarbanes-Oxley Act   |
| 99.1        | Certification of the Principal Executive<br>Officer Pursuant to Section 111(b) of the Emergency Economic<br>Stabilization Act of 2008 for the Fiscal Year Ended September<br>30, 2010 |

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99.2 Certification of the Chief Financial Officer  
Pursuant to Section 111(b) of Emergency Economic Stabilization  
Act of 2008 for the Fiscal Year Ended September 30, 2010