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TIMBERLAND BANCORP INC  
Form 10-K  
December 11, 2008

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

FORM 10-K

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

For the Fiscal Year Ended September 30, 2008

OR

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

Commission File Number: 0-23333

TIMBERLAND BANCORP, INC.

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

Washington

91-1863696

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

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

624 Simpson Avenue, Hoquiam, Washington

98550

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

-----  
(Zip Code)

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

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

Common Stock, par value \$.01 per share

The Nasdaq Stock Market LLC

-----  
(Title of Each Class)

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

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

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

YES            NO        X  
-----        -----

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 of Section 15(d) of the Act.

YES            NO        X  
-----        -----

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

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

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

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

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

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As of November 30, 2008, the Registrant had 6,980,329 shares of Common Stock issued and outstanding. The aggregate market value of the Common Stock held by nonaffiliates of the Registrant, based on the closing sales price of the Registrant's common stock as quoted on the NASDAQ Global Select Market on March 31, 2008, was \$80.1 million (6,876,653 shares at \$11.65). For purposes of this calculation, Common Stock held by officers and directors of the Registrant and the Timberland Bank Employee Stock Ownership Plan and Trust are considered nonaffiliates.

DOCUMENTS INCORPORATED BY REFERENCE

1. Portions of Definitive Proxy Statement for the 2009 Annual Meeting of Stockholders (Part III).

TIMBERLAND BANCORP, INC.  
2008 ANNUAL REPORT ON FORM 10-K  
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PART I

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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, 2008, the Company had total assets of \$681.9 million, total deposits of \$498.6 million and total shareholders' equity of \$74.8 million. The Company's business activities generally are limited to passive investment activities and oversight of its investment in the Bank. Accordingly, the information set forth in this report, including consolidated financial statements and related data, relates primarily to the Bank and its subsidiary.

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

The Bank is a community-oriented bank which has traditionally offered a variety of savings products to its retail customers while concentrating its lending activities on real estate mortgage loans. Lending activities have been focused primarily on the origination of loans secured by real estate, including an emphasis on construction loans, one- to four-family residential loans, multi-family loans, commercial real estate loans and land loans. The Bank originates adjustable-rate residential mortgage loans that do not qualify for sale in the secondary market 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.

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").

#### Market Area

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

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

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- \* 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);

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- \* five branch offices in Thurston County (Olympia, Yelm, Tumwater, and two branches in Lacey);
- \* two branch offices in Kitsap County (Poulsbo and Silverdale); and
- \* two branch offices and a loan production office in Lewis County (Winlock, Toledo and Centralia).

See "Item 2. Properties."

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

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

Grays Harbor County has a population of 71,000 according to the U.S. Census Bureau 2007 estimates and a median family income of \$52,600 according to 2008 HUD estimates. The economic base in Grays Harbor has been historically dependent on the timber and fishing industries. Other industries that support the economic base are tourism, agriculture, shipping, transportation and technology. According to the Washington State Employment Security Department, the unemployment rate in Grays Harbor County increased to 7.5% at September 30, 2008 from 6.2% at September 30, 2007. The median price of a resale home in Grays Harbor County for the quarter ended September 30, 2008 decreased 13.9% to \$155,000 as compared to the quarter one year prior. The number of home sales decreased 13.0% for the quarter ended September 30, 2008 compared the same quarter one year earlier. The Bank has six branches (including its home office) located throughout the county. The recent slowdown in Grays Harbor County's real estate activity has had a negative effect on the Bank's profitability.

Pierce County is the second most populous county in the state and has a population of 773,000 according to the U.S. Census Bureau 2007 estimates. The county's median family income is \$66,200 according to 2008 HUD estimates. The economy in Pierce County is diversified with the presence of military related government employment (Fort Lewis Army Base and McChord Air Force Base), transportation and shipping employment (Port of Tacoma), and aerospace related

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employment (Boeing). According to the Washington State Employment Security Department, the unemployment rate for the Pierce County area increased to 5.9% at September 30, 2008 from 4.6% at September 30, 2007. The median price of a resale home in Pierce County for the quarter ended September 30, 2008 decreased 11.9% to \$254,000 as compared to the quarter one year prior. The number of home sales decreased 24.0% for the quarter ended September 30, 2008 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 recent slowdown in Pierce County's real estate activity has had a negative effect on the Bank's construction lending opportunities and on the Bank's profitability.

Thurston County has a population of 239,000 according to the U.S. Census Bureau 2007 estimates and a median family income of \$66,300 according to 2008 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 increased to 5.2% at September 30, 2008 from 4.2% at September 30, 2007. The median price of a resale home in Thurston County for the quarter ended September 30, 2008 decreased 7.2% to \$251,000 as compared to the same quarter one year earlier. The number of home sales decreased 23.8% for the quarter ended September 30, 2008 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

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primarily attributable to the state government presence; however, the recent slowdown in Thurston County's real estate activity has had a negative effect on the Bank's construction lending opportunities and the Bank's profitability.

Kitsap County has a population of 237,000 according to the U.S. Census Bureau 2007 estimates and a median family income of \$69,900 according to 2008 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 increased to 5.3% at September 30, 2008 from 4.3% at September 30, 2007. The median price of a resale home in Kitsap County for the quarter ended September 30, 2008 decreased 10.0% to \$270,000, as compared to the same quarter one year earlier. The number of home sales decreased 23.3% for the quarter ended September 30, 2008 compared to the same quarter one year earlier. The recent slowdown in Kitsap County's real estate activity has had a negative effect on the Bank's lending opportunities.

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 2007 estimates. The Bank has one branch in King County. The county's median family income is \$81,400 according to 2008 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 increased to 4.6% at September 30, 2008 from 3.9% at September 30, 2007. The median price of a resale home in King County for the quarter ended September 30, 2008 decreased 9.5% to \$427,000, as compared to the same quarter one year earlier. The number of home sales decreased 30.7% for the quarter ended September 30, 2008 compared to the same quarter one year earlier. The recent

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slowdown in King County's real estate activity has had a negative effect on the Bank's lending opportunities in this market.

Lewis County has a population of 74,000 according to the U.S. Census Bureau 2007 estimates and a median family income of \$52,600 according to 2008 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 increased to 7.7% at September 30, 2008 from 6.3% at September 30, 2007. The median price of a resale home in Lewis County for the quarter ended September 30, 2008 decreased 39.2% to \$175,000, as compared to the same quarter one year earlier. The number of home sales decreased 43.6% for the quarter ended September 30, 2008 compared to the same quarter one year earlier. The Bank currently has two branches and a loan production office located in Lewis County. In August 2008, the Bank announced plans to open an additional full-service branch in Lewis County. The Bank's existing loan production office in Lewis County will be consolidated into the new facility, which is expected to open in 2009. The recent slowdown in Lewis County's real estate activity has had a negative effect on the Bank's lending opportunities in this market.

### Lending Activities

General. Historically, the principal lending activity of the Bank has consisted of the origination of loans secured by first mortgages on owner-occupied, one- to four-family residences and loans for the construction of one- to four-family residences. Since 1998, the Bank has emphasized its origination of construction and land development loans and commercial real estate loans. The Bank's net loans receivable, including loans held for sale, totaled \$557.7 million at September 30, 2008, representing 81.8% of consolidated total assets, and at that date construction and land development loans (including undisbursed loans in process), and loans secured by commercial properties were \$332.6 million, or 54.4%, of total loans. Construction and land development loans and commercial real estate loans typically have higher rates of return than one- to four-family loans; however, they also present a higher degree of risk. See "- Lending Activities - Construction and Land Development Lending" and "- Lending Activities - Commercial Real Estate Lending."

The Bank's internal loan policy limits the maximum amount of loans to one borrower to 25% of its Tier 1 capital. At September 30, 2008, the maximum amount which the Bank could have lent to any one borrower and the borrower's related entities was approximately \$15.3 million under this policy. At September 30, 2008, the largest amount outstanding to any one borrower and the borrower's related entities was \$16.6 million (including \$2.4 million

in undisbursed loans in process balance). The Board of Directors approved this exception to the borrowing limit because of the strength of the primary borrower and the borrower's related entities. These loans represent two condominium construction projects, several one- to four-family speculative construction projects, and commercial real estate holdings. All of the loans are secured by projects located in Grays Harbor County, except for one of the condominium construction projects which is located in Oregon. These loans were performing according to the required loan terms at September 30, 2008. The next largest amount outstanding to any one borrower and the borrower's related entities was \$10.1 million (including \$7.4 million in undisbursed

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loans in process balance.) These loans were secured by two mini-storage facilities being constructed in Pierce County and a one- to four-family home, all of which were performing according to terms at September 30, 2008. The Bank also had 88 borrowers or related borrowers with total loans outstanding in excess of \$1.0 million at September 30, 2008.

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,										
2008		2007		2006		2005				
Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	
(Dollars in thousands)										
Mortgage Loans:										
One- to four-										
family(1)....	\$112,299	18.35%	\$102,434	17.40%	\$ 98,709	20.11%	\$101,763	23.24%	\$ 99,000	23.24%
Multi-family..	25,927	4.24	35,157	5.97	17,689	3.60	20,170	4.61	17,000	4.25%
Commercial....	146,223	23.90	127,866	21.72	137,609	28.04	124,849	28.51	108,000	26.56%
Construction										
and land										
development..	186,344	30.46	186,261	31.64	146,855	29.92	112,470	25.68	106,000	25.68%
Land.....	60,701	9.92	60,706	10.30	29,598	6.03	24,981	5.71	19,000	4.65%
-----										
Total mortgage										
loans.....	531,494	86.87	512,424	87.03	430,460	87.70	384,233	87.75	351,000	86.53%
-----										
Consumer Loans:										
Home equity										
and second										
mortgage.....	48,690	7.96	47,269	8.02	37,435	7.63	32,298	7.38	23,000	5.71%
Other.....	10,635	1.73	10,922	1.86	11,127	2.27	9,330	2.13	9,000	2.25%
-----										
	59,325	9.69	58,191	9.88	48,562	9.90	41,628	9.51	32,000	7.96%
-----										
Commercial										
business										
loans.....	21,018	3.44	18,164	3.09	11,803	2.40	12,013	2.74	11,000	2.74%
-----										
Total loans..	611,837	100.00%	588,779	100.00%	490,825	100.00%	437,874	100.00%	395,000	97.50%
-----										
Less:										
Undisbursed										
portion of										
construction										
loans in										
process.....	(43,353)		(65,673)		(59,260)		(42,771)		(43,000)	
-----										
Deferred loan										
origination										
fees.....	(2,747)		(2,968)		(2,798)		(2,895)		(3,000)	
-----										
Allowance for										
loan losses..	(8,050)		(4,797)		(4,122)		(4,099)		(3,000)	
-----										
Total loans										
receivable,										



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net.....	\$557,687	\$515,341	\$424,645	\$388,109	\$344,
	=====	=====	=====	=====	=====

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 (1) Includes loans held-for-sale.

Residential One- to Four-Family Lending. At September 30, 2008, \$112.3 million, or 18.4%, 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 including five and seven year balloon reset loans in its loan portfolio and classifies them as held-to-maturity. The Bank uses an automated underwriting program, which preliminarily qualifies a loan as conforming to FHLMC underwriting standards when the loan is originated. At

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September 30, 2008, \$61.1 million, or 54.4%, 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 rather than intended for sale. The Bank offers several ARM products which adjust annually after an initial period ranging from one to five years subject to a limitation on the annual increase of 2% and an overall limitation of 6%. These ARM products are priced utilizing the weekly average yield on one year U.S. Treasury securities adjusted to a constant maturity of one year plus a margin of 2.875% to 4.00%. Loans tied to the prime rate or to LIBOR indices typically do not have periodic, or lifetime adjustment limits. Loans tied to these indices normally have margins ranging from 0.0% to 3.0%. ARM loans held in the Bank's portfolio do not permit negative amortization of principal. Borrower demand for ARM loans versus fixed-rate mortgage loans is a function of the level of interest rates, the expectations of changes in the level of interest rates and the difference between the initial interest rates and fees charged for each type of loan. The relative amount of fixed-rate mortgage loans and ARM loans that can be originated at any time is largely determined by the demand for each in a competitive environment. At September 30, 2008, \$51.2 million, or 45.6%, 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,

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

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

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

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

The Bank's lending policies generally limit the maximum loan-to-value ratio on mortgage loans secured by owner-occupied properties to 95% of the lesser of the appraised value or the purchase price. However, the Bank usually obtains private mortgage insurance ("PMI") on the portion of the principal amount that exceeds 80% of the appraised value of the security property. The maximum loan-to-value ratio on mortgage loans secured by non-owner-occupied properties is generally 80% (90% for loans originated for sale in the secondary market to the FHLMC). At September 30, 2008 three

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single family loans totaling \$300,000 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, and Kitsap County markets.

The Bank currently originates three types of residential construction loans: (i) speculative construction loans, (ii) custom construction loans and (iii) owner/builder construction loans. The Bank 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, 2008 and 2007, the composition of the Bank's construction and land development loan portfolio was as follows:

	At September 30,			
	2008		2007	
	Outstanding Balance	Percent of Total	Outstanding Balance	Percent of Total
	(In thousands)			
Speculative construction...	\$ 30,895	16.58%	\$ 43,012	23.09%
Custom and owner/builder construction.....	47,168	25.31	52,375	28.12
Multi-family (including condominium).....	40,509	21.74	27,584	14.81
Land development.....	28,152	15.11	22,292	11.97
Commercial real estate.....	39,620	21.26	40,998	22.01
	-----	-----	-----	-----
Total.....	\$186,344	100.00%	\$186,261	100.00%
	=====	=====	=====	=====

Speculative construction loans are made to home builders and are termed "speculative" because the home builder does not have, at the time of loan origination, a signed contract with a home buyer who has a commitment for permanent financing with either the Bank or another lender for the finished home. The home buyer may be identified either during or after the construction period, with the risk that the builder will have to debt service the speculative construction loan and finance real estate taxes and other carrying costs of the completed home for a significant time after the completion of construction until the home buyer is identified and a sale is consummated. The Bank lends to approximately 45 builders located in the Bank's primary market area, each of which generally 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 the prime rate to the prime rate plus 1.5%, and with a loan-to-value ratio of no more than 80% of the appraised estimated value of the completed property. During this 12 month period, the borrower is required to make monthly payments of accrued interest on the outstanding loan balance, a portion, or all of which may be paid from an interest reserve. At September 30, 2008, speculative construction loans

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totalled \$30.9 million, or 16.6%, of the total construction loan portfolio. At September 30, 2008, the Bank had 14 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 \$3.2 million (including \$668,000 of undisbursed loans in process balance). The largest outstanding balance for a single speculative loan was \$1.5 million (including \$69,000 of undisbursed loans in process balance) and was performing

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according to its terms. At September 30, 2008, 17 out of 91 speculative construction loans with an aggregate balance of \$5.4 million were not performing according to their terms. These non-performing loans were located in Pierce County, Thurston County and Lewis County. See "- Lending Activities - Non-performing Assets and Delinquencies."

Unlike speculative construction loans, custom construction loans are made to home builders who, at the time of construction, have a signed contract with a home buyer who has a commitment 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 7.0% to 7.5% and with loan-to-value ratios of 80% of the appraised estimated value of the completed property or sales price, whichever is less. During the construction period, the borrower is required to make monthly payments of accrued interest on the outstanding loan balance, a portion, or all of which may be paid from an interest reserve.

Owner/builder construction loans are originated to the home owner rather than the home builder as a single loan that automatically converts to a permanent loan at the completion of construction. The construction phase of an owner/builder construction loan generally lasts up to 12 months with fixed interest rates currently ranging from 7.0% to 7.5%, and with loan-to-value ratios of 80% (or up to 95% with PMI) of the appraised estimated value of the completed property. During the construction period, the borrower is required to make monthly payments of accrued interest on the outstanding loan balance, a portion, or all of which may be paid from an interest reserve. At the completion of construction, the loan converts automatically to either a fixed-rate mortgage loan, which conforms to secondary market standards, or an ARM loan for retention in the Bank's portfolio. At September 30, 2008, custom and owner/builder construction loans totaled \$47.2 million, or 25.3%, of the total construction loan portfolio. At September 30, 2008, the largest outstanding custom and owner/builder construction loan had an outstanding balance of \$1.1 million (including \$550,000 of undisbursed loans in process balance) and was performing according to its terms.

The Bank originates 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). At September 30, 2008, the Bank had 24 land development loans totaling \$28.2 million, or 15.1% 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%. Monthly interest payments are required during the term of the loan. 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

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corporate borrower, the Bank also generally obtains personal guarantees from corporate principals and reviews their personal financial statements. At September 30, 2008, the Bank had two land development loans totaling \$4.5 million that were non-performing. The non-performing loans consisted of a 3.1 million loan secured by a land development project in Richland, Washington and a \$1.4 million participation interest in a loan secured by a land development project in Clark 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 attempts to minimize this risk by generally limiting the maximum loan-to-value ratio on land loans to 75% of the estimated developed value of the secured property.

The Bank also provides construction financing for multi-family and commercial properties. At September 30, 2008, these loans amounted to \$80.1 million, or 43.0% of construction loans. These loans are secured by condominiums, apartment buildings, mini-storage facilities, office buildings and retail rental space predominantly located in the Bank's primary market area. At September 30, 2008, the largest outstanding multi-family construction loan was secured by a condominium project and had a balance of \$6.0 million (including \$123,000 of undisbursed loans in process balance) and was performing according to its terms. At September 30, 2008, the largest outstanding commercial real estate construction loan had a balance of \$12.0 million (including \$6.2 million of undisbursed loans in process balance). This loan was secured by two mini-storage facilities being constructed in Pierce County and was performing according to its terms.

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

Loan disbursements during the construction period are made to the builder, materials' supplier or subcontractor, based on a line item budget. Periodic on-site inspections are made by qualified inspectors to document the reasonableness of 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.

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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 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 lending is 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, 2008, the Bank had \$25.9 million, or 4.2% 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, 2008, the largest multi-family loan had an outstanding principal balance of \$5.1 million and was secured by an apartment building located in the Bank's primary market area. At September 30, 2008, this loan was performing according to its terms.

The maximum loan-to-value ratio for multi-family loans is generally up to 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 times for loans secured by multi-family properties.

Multi-family mortgage lending affords the Bank an opportunity to receive interest at rates higher than those generally available from one- to four-family residential lending. However, loans secured by multi-family properties

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

Commercial Real Estate Lending. Commercial real estate loans totaled \$146.2 million, or 23.9% of the total loan portfolio at September 30, 2008, and consisted of 338 loans. The Bank originated \$29.3 million of commercial real-estate loans during the year ended September 30, 2008 compared to \$35.9 million originated during the year ended September 30, 2007. 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, 2008, the largest commercial real estate loan was secured by a commercial property located in Olympia, Washington, had a balance of \$4.6 million and was performing according to its terms. At September 30, 2008, one commercial real estate loan with a balance of \$714,000 was not performing according to its 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%. The Bank generally obtains loan guarantees from financially capable parties and reviews their personal financial statements.

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

Land Lending. The Bank originates loans for the acquisition of land upon which the purchaser can then build or make improvements necessary to build or to sell as improved lots. At September 30, 2008, land loans totaled \$60.7 million, or 9.9% of the Bank's total loan portfolio as compared to \$60.7 million, or 10.3% of the Bank's total loan portfolio at September 30, 2007. 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

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balance of \$3.0 million at September 30, 2008 and was performing according to its terms. At September 30, 2008, seven land loans totaling \$726,000 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%.

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,

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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, 2008, consumer loans amounted to \$59.3 million, or 9.7%, of the total loan portfolio.

At September 30, 2008, the largest component of the consumer loan portfolio consisted of second mortgage loans and home equity lines of credit, which totaled \$48.7 million, or 8.0%, of the total loan portfolio. Home equity lines of credit and second mortgage loans are made for purposes such as the improvement of residential properties, debt consolidation and education expenses, among others. The majority of these loans are made to existing customers and are secured by a first or second mortgage on residential property. The Bank occasionally solicits these loans. The loan-to-value ratio is typically 80% or less, when taking into account both the first and second mortgage loans. Second mortgage loans typically carry fixed interest rates with a fixed payment over a term between five and 15 years. Home equity lines of credit are generally made at interest rates tied to the 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



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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, 2008, three consumer loans totaling \$160,000 were delinquent in excess of 90 days. See "- Lending Activities - Non-performing Assets and Delinquencies."

**Commercial Business Lending.** Commercial business loans totaled \$21.0 million, or 3.4% of the loan portfolio at September 30, 2008, and consisted of 126 loans. Commercial business loans are generally secured by business equipment, accounts receivable, inventory or other property and are made at variable rates of interest equal to a negotiated margin above the prime rate. The Bank also generally obtains personal guarantees from financially capable applicants based on a review of personal financial statements. The largest commercial business loan had an outstanding balance of \$2.4 million at September 30, 2008 and was performing according to its terms. At September 30, 2008, one commercial business loan with a balance of \$250,000 was not performing according to its 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, 2008 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 1 Year Through 3 Years	After 3 Years Through 5 Years	After 5 Years Through 10 Years	After 10 Years	Total
Within 1 Year	-----	-----	-----	-----	-----	-----
(In thousands)						
<b>Mortgage loans:</b>						
One- to four-family						
(1).....	\$ 1,248	\$ 3,206	\$ 3,461	\$ 8,444	\$ 95,940	\$112,299
Multi-family.....	1,616	--	1,284	21,905	1,122	25,927
Commercial.....	13,685	4,580	20,082	95,706	12,170	146,223
Construction and land						
development (2).....	175,357	10,934	53	--	--	186,344
Land.....	22,926	15,959	17,606	2,944	1,266	60,701
<b>Consumer loans:</b>						
Home equity and second						

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mortgage.....	13,394	2,068	1,935	6,899	24,394	48,690
Other.....	2,270	1,222	1,934	824	4,385	10,635
Commercial business loans.....	12,455	2,554	2,979	2,109	921	21,018
Total.....	\$242,951	\$40,523	\$49,334	\$138,831	\$140,198	\$611,837

Less:

Undisbursed portion of construction loans in process....	(43,353)
Deferred loan origination fees....	(2,747)
Allowance for loan losses.....	(8,050)
Loans receivable, net.....	\$557,687

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

The following table sets forth the dollar amount of all loans due after one year from September 30, 2008, which have fixed interest rates and have floating or adjustable interest rates.

	Fixed Rates	Floating or Adjustable Rates	Total
	(In thousands)		
Mortgage loans:			
One- to four-family(1).....	\$ 60,142	\$ 50,909	\$111,051
Multi-family.....	5,612	18,699	24,311
Commercial.....	17,147	115,391	132,538
Construction and land development....	5,819	5,168	10,987
Land.....	26,493	11,282	37,775
Consumer loans:			
Home equity and second mortgage.....	25,408	9,888	35,296
Other.....	8,213	152	8,365
Commercial business loans.....	4,034	4,529	8,563
Total.....	\$152,868	\$216,018	\$368,886

- (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

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repaid. The average life of mortgage loans tends to increase, however, when current mortgage loan interest rates are substantially higher than interest rates on existing mortgage loans and, conversely, decrease when interest rates on existing mortgage loans are substantially higher than current mortgage loan interest rates.

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

Loan applications are initiated by loan officers and are required to be approved by an authorized loan underwriter, one of the Bank's Loan Committees or the Bank's Board of Directors. The Bank's Consumer Loan Committee, which 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, 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, 2008 and 2007, the Bank's total gross loan originations were \$258.6 million and \$279.1 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. During the years ended September 30, 2008 and 2007, the Bank purchased loan participation interests of \$2.9 million and \$20.4 million, respectively. 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, 2008, the Bank's loan servicing portfolio totaled \$175.6 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

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particular loan type or concentrations to a particular borrower. The Bank sold \$17.0 million in loan participation interests to other lenders during the year ended September 30, 2008.

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

	Year Ended September 30,		
	2008	2007	2006
	-----		
Loans originated:	(In thousands)		
Mortgage loans:			
One- to four-family.....	\$ 45,844	\$ 33,252	\$ 33,483
Multi-family.....	4,710	4,397	3,037
Commercial.....	29,306	35,886	32,174
Construction and land development.....	118,186	127,082	129,623
Land.....	25,858	35,066	17,518
Consumer.....	22,411	32,354	29,858
Commercial business loans.....	12,268	11,020	10,559
	-----	-----	-----
Total loans originated.....	258,583	279,057	256,252
Loans purchased:			
Mortgage loans:			
One- to four-family.....	--	--	48
Multi-family.....	--	5,200	-
Commercial.....	--	--	79
Construction and land development.....	2,862	15,175	-
Land.....	--	--	28
	-----	-----	-----
Total loans purchased.....	2,862	20,375	155
	-----	-----	-----
Total loans originated and purchased..	261,445	299,432	256,407
Loans sold:			
Whole loans sold.....	(45,269)	(29,893)	(26,445)
Participation loans sold.....	(17,035)	(6,650)	--
	-----	-----	-----
Total loans sold.....	(62,304)	(36,543)	(26,445)
Loan principal repayments.....	(176,083)	(164,935)	(177,011)
Decrease (increase) in other items, net....	19,288	(7,258)	(16,415)
	-----	-----	-----
Net increase in loans receivable.....	\$ 42,346	\$ 90,696	\$ 36,536
	=====	=====	=====

Loan Origination Fees. The Bank receives loan origination fees on a majority 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.

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Deferred loan origination fees totaled \$2.7 million at September 30, 2008.

**Non-performing Assets and Delinquencies.** The Bank assesses late fees or penalty charges on delinquent loans of approximately 5% of the monthly loan payment amount. 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 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,				
	2008	2007	2006	2005	2004
	-----	-----	-----	-----	-----
Loans accounted for on a non-accrual basis:	(In thousands)				
Mortgage loans:					
One- to four-family.....	\$ 300	\$ 252	\$ 80	\$ 2,208	\$ 430
Commercial.....	714	90	--	261	640
Construction and land development.....	9,840	1,000	--	-	--
Land.....	726	28	--	23	322
Consumer loans.....	160	--	--	133	23
Commercial business loans..	250	120	--	301	27
	-----	-----	-----	-----	-----
Total.....	11,990	1,490	80	2,926	1,442

Accruing loans which are

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contractually past due 90 days or more.....	--	--	--	--	--
Total of non-accrual and 90 days past due loans....	11,990	1,490	80	2,926	1,442
Other real estate owned and other repossessed assets.....	511	--	15	509	421
	-----	-----	-----	-----	-----
Total non-performing assets (1).....	\$ 12,501	\$ 1,490	\$ 95	\$ 3,435	\$ 1,863
	=====	=====	=====	=====	=====
Troubled debt restructured loans.....	\$ 272	\$ --	\$ --	\$ --	\$ --
Non-accrual and 90 days or more past due loans as a percentage of loans receivable, net.....	2.12%	0.29%	0.02%	0.75%	0.41%
Non-accrual and 90 days or more past due loans as a percentage of total assets.....	1.76%	0.23%	0.01%	0.53%	0.31%
Non-performing assets as a percentage of total assets.....	1.83%	0.23%	0.02%	0.62%	0.40%
Loans receivable, net (2) ..	\$565,737	\$520,138	\$428,767	\$392,208	\$348,585
	=====	=====	=====	=====	=====
Total assets.....	\$681,883	\$644,848	\$577,087	\$552,765	\$460,419
	=====	=====	=====	=====	=====

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 (1) Includes non-accrual loans, other real estate owned and other repossessed assets.

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

The Bank's non-accrual loans increased by \$10.5 million to \$12.0 million at September 30, 2008 from \$1.5 million at September 30, 2007, primarily as a result of a \$8.8 million increase in construction and land development loans on non-accrual status, a \$698,000 increase in land loans on non-accrual status and a \$624,000 increase in commercial real estate loans on non-accrual status. The largest non-performing loan was secured by a land development project in

Richland, Washington and had a balance of \$3.1 million at September 30, 2008. Management's evaluation of the collateral determined potential impairment of \$523,000 existed at September 30, 2008, which was factored into the Bank's allowance for loan loss analysis.

Additional interest income which would have been recorded for the year ended September 30, 2008 had non-accruing loans been current in accordance

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with their original terms totaled \$584,000.

Other Real Estate Owned and Other Repossessed Items. Real estate acquired by the Bank as a result of foreclosure or by deed-in-lieu of foreclosure is classified as other real estate owned until sold. When property is acquired, it is recorded at the lower of its cost, which is the unpaid principal balance of the related loan plus foreclosure costs, or fair market value. Subsequent to foreclosure, the property is recorded at the lower of the foreclosed amount or fair value, less estimated selling costs. At September 30, 2008, the Bank had \$511,000 of other real estate owned and other repossessed items. This consisted of one single-family residence and two vehicles.

Restructured Loans. Under accounting principles generally accepted in the United States of America, the Bank is required to account for certain loan modifications or restructuring as a "troubled debt restructuring." In general, the modification or restructuring of a debt constitutes a troubled debt restructuring if the Bank for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrowers that the Bank would not otherwise consider. Debt restructuring or loan modifications for a borrower does not necessarily always constitute troubled debt restructuring, however, and troubled debt restructurings do not necessarily result in non-accrual loans. The Bank had \$272,000 in restructured loans at September 30, 2008.

Other Loans of Concern. Loans not reflected in the table above, but where known information about possible credit problems of borrowers causes management to have doubts as to the ability of the borrower to comply with present repayment terms and that may result in disclosure of such loans and leases as 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 and non-performing loans was \$42.8 million at September 30, 2008 and \$15.7 million at September 30, 2007. The vast majority of these loans are collateralized. 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 general allowances for loan losses in an amount deemed prudent by management. These allowances represent loss allowances which have been established to recognize the inherent risk associated with lending activities and the risks associated with particular problem assets. When an insured institution classifies problem assets as loss, it charges off the balance of the asset against the allowance for loan losses. Assets which do not currently expose the insured institution to sufficient risk to warrant classification in one of the aforementioned categories but possess weaknesses are required to be

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designated as special mention. The Bank's determination of the classification of its assets and the amount of its valuation allowances is subject to review by the FDIC and the Division which can order the establishment of additional loss allowances.

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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,		
	2008	2007	2006
	(In thousands)		
Loss.....	\$ --	\$ --	\$ --
Doubtful.....	--	--	--
Substandard(1) (2).....	24,603	8,812	3,985
Special mention(1).....	18,225	6,917	9,015
Total classified and special mention loans.....	\$42,828 =====	\$15,729 =====	\$13,000 =====
Allowance for loan losses.....	\$ 8,050	\$ 4,797	\$ 4,122

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

(2) Includes non-performing loans.

The Bank's classified and special mention loans increased by \$27.1 million from September 30, 2007 to September 30, 2008, primarily as a result of a \$15.8 million increase in loans classified as substandard and an \$11.3 million increase in loans classified as special mention.

Special mention loan are defined as those credits deemed by management to have some potential weakness that deserve management's close attention. If left uncorrected these potential weaknesses may result in the deterioration of the payment prospects of the loan. Assets in this category are not adversely classified and currently do not expose the Bank to sufficient risk to warrant a substandard classification. Five individual loans comprise \$12.8 million, or 70.3%, of the \$18.2 million in loans classified as special mention. They include a \$3.8 million loan secured by a commercial mixed-use building in Thurston County, a \$3.5 million loan secured by a mini-storage facility in King County, a \$2.4 million loan secured by commercial acreage in Kitsap County, a \$1.6 million loan secured by commercial property in Grays Harbor County, and a \$1.5 million loan secured by a speculative single family construction home on lake front property in Pierce County. At September 30, 2008 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



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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, 2008 increased by \$15.8 million to \$24.6 million from \$8.8 million at September 30, 2007. At September 30, 2008, 68 loans were classified as substandard compared to 26 at September 30, 2007.

Eight credit relationships comprise \$19.7 million, or 80.1%, of the \$24.6 million in loans classified as substandard (including non-performing loans). The largest of these eight relationships is with a long-time builder of the Bank who currently has \$4.7 million (including \$757,000 in undisbursed construction loans in process) in loans classified as substandard. These loans are secured by two land development projects, six single-family speculative construction homes, and a lien on the borrower's personal residence. The properties are located in Thurston and King Counties and were performing according to their terms at September 30, 2008.

The next largest credit relationships classified as substandard are summarized below.

- \* \$3.3 million in loans secured by a 16-unit condominium project in Leavenworth, Washington. These loans were performing according to their terms at September 30, 2008.

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- \* \$3.1 million loan secured by a land development project in Richland, Washington. This loan was not performing according to terms at September 30, 2008 and was on non-accrual status. Management's evaluation of the collateral determined potential impairment of \$523,000 existed at September 30, 2008, which was factored into the Bank's allowance for loan loss analysis.
- \* \$2.6 million (including \$81,000 of undisbursed construction loans in process) in loans secured by four completed single-family speculative homes on acreage, one single family speculative home in process and four land parcels, all of which are located in Thurston County. These loans were not performing according to their terms at September 30, 2008 and were on non-accrual status. Management's evaluation of the collateral determined potential impairment of \$106,000 existed at September 30, 2008, which was factored into the Bank's allowance for loan loss analysis.
- \* \$2.0 million (including \$127,000 in undisbursed construction loans in process) in loans secured by two completed single family speculative homes and four single family speculative homes, all of which are located in Pierce County. These loans were not performing according to their terms at September 30, 2008 and were on non-accrual status. Management's evaluation of the collateral, including costs to complete construction and market the properties determined that there was no impairment at September 30, 2008.
- \* \$1.4 million participation interest in a loan secured by a land development project in Clark County. This loan was not performing according to its terms at September 30, 2008 and was on non-accrual status. As part of management's evaluation of the collateral, \$348,000 of the loan was charged off. This reduced the balance to \$1.4 million at September 30, 2008.

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- \* \$1.4 million loan secured by a nine-unit condominium project in Grays Harbor County. This loan was 60 days past due at September 30, 2008.
- \* \$1.2 million commercial business loan secured by a mini-storage / RV facility on leased land in Pierce County. This loan was performing according to its terms at September 30, 2008.

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

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

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

At September 30, 2008, the Bank's allowance for loan losses totaled \$8.1 million. This represents 1.42% of the total loans receivable and 67.14% of non-performing loans. The Bank's allowance for loan losses as a percentage

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of total loans receivable has increased to 1.42% at September 30, 2008 from 0.92% at September 30, 2007 primarily due to uncertainties in the housing market and the economy, and an increased level of charge-offs (which has translated into higher loss factors assigned to certain loan categories), increased levels of non-performing loans, and increased levels of classified loans.

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

While the Bank believes it has established its existing allowance for

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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,				
	2008	2007	2006	2005	2004
	(Dollars in thousands)				
Allowance at beginning of year...	\$4,797	\$4,122	\$4,099	\$3,991	\$ 3,891
Provision for loan losses.....	3,900	686	--	141	167
Recoveries:					
Mortgage loans:					
One- to four-family.....	--	--	--	--	6
Consumer loans:					
Home equity and second mortgage.....	--	--	--	5	--
Other.....	1	1	5	3	16
Commercial business loans.....	--	--	20	9	3
Total recoveries.....	1	1	25	17	25
Charge-offs:					
Mortgage loans:					
One- to four-family.....	--	--	--	--	6
Multi-family.....	--	--	--	1	--
Construction.....	648	--	--	--	--
Commercial business loans.....	--	--	--	--	3
Land.....	--	--	--	1	--
Consumer loans:					
Home equity and second mortgage.....	--	--	--	--	9
Other.....	--	12	2	12	68
Commercial business loans.....	--	--	--	36	6
Total charge-offs.....	648	12	2	50	92
Net charge-offs (recoveries) ..	647	11	(23)	33	67
Balance at end of year.....	\$8,050	\$4,797	\$4,122	\$4,099	\$3,991

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Allowance for loan losses as a percentage of total loans receivable (net) (1) outstanding at the end of the year.....	1.42%	0.92%	0.96%	1.05%	1.14%
Net charge-offs (recoveries) as a percentage of average loans outstanding during the year.....	0.12%	0.00%	(0.01%)	0.01%	0.02%
Allowance for loan losses as a percentage of non-performing loans at end of year excluding troubled debt restructurings....	67.14%	321.95%	5,152.50%	140.09%	276.77%

-----  
 (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,									
2008		2007		2006		2005			
Percent of Loans in Category to Total		Percent of Loans in Category to Total		Percent of Loans in Category to Total		Percent of Loans in Category to Total			
Amount	Loans	Amount	Loans	Amount	Loans	Amount	Loans	Amount	
(Dollars in thousands)									
Mortgage loans:									
One- to four-									
family.....	\$ 476	18.35%	\$ 396	17.40%	\$ 502	20.11%	\$ 494	23.24%	\$ 38
Multi-family..	248	4.24	200	5.97	112	3.60	194	4.61	24
Commercial....	1,521	23.90	1,368	21.72	1,222	28.04	1,544	28.51	1,44
Construction..	3,254	30.46	1,047	31.64	761	29.92	652	25.68	53
Land.....	1,435	9.92	549	10.30	275	6.03	255	5.71	22
Non-mortgage loans:									
Consumer									
loans.....	457	9.69	412	9.88	497	9.90	255	9.51	42
Commercial business									
loans.....	659	3.44	825	3.09	753	2.40	705	2.74	72
Total allowance for loan losses.....									
	\$8,050	100.00%	\$4,797	100.00%	\$4,122	100.00%	\$4,099	100.00%	\$3,99
	=====	=====	=====	=====	=====	=====	=====	=====	=====

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, 2008, the Company's investment portfolio totaled \$31.3 million, primarily consisting of \$16.2 million of mortgage-backed securities available-for-sale, \$936,000 of mutual funds available-for-sale, and \$14.2 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 \$64.0 million at September 30, 2007, primarily consisting of \$31.9 million of mutual funds available-for-sale, \$13.0 million of mortgage-backed securities available-for-sale, \$19.0 million of U.S. agency securities available-for-sale, and \$71,000 of securities held-to-maturity. In June 2008, the Company redeemed its \$29.1 million investment in the AMF family of mutual funds and recognized a \$2.8 million loss on the redemption. The net asset value of the mutual funds had declined primarily as a result of the uncertainty in spreads in the bond market for private label mortgage-related securities and credit downgrades to a small percentage of the underlying securities. As a result of the redemption, the Company received \$22.2 million in underlying mortgaged-backed securities and \$6.9 million in cash. The Company also had \$19.0 million in U.S. agency securities that matured or were called during the year ended September 30, 2008. The Company used the proceeds from the security maturities and redemptions primarily to fund loan growth. The composition of the portfolios by type of security, at each respective date is presented in the following table.

At September 30,					
2008		2007		2006	
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	0.09%	\$ --	--%	\$ --	--%
Mortgage-backed securities.....	14,205	45.34	71	0.11	75	0.09

Available-for-Sale

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(at fair value):

U.S. agency securities.....	--	--	18,976	29.66	31,718	38.93
Mortgage-backed securities.....	16,162	51.58	13,047	20.39	17,603	21.60
Mutual funds.....	936	2.99	31,875	49.84	32,087	39.38
	-----	-----	-----	-----	-----	-----
Total portfolio.....	\$31,331	100.00%	\$63,969	100.00%	\$81,483	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, 2008. 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.....	--	--	1	4.60	58	4.71	14,146
Available-for-Sale:							
Mortgage-backed securities.....	--	--	576	5.03	283	5.93	15,303
Mutual funds.....	936	4.21	--	--	--	--	--
	----	----	----	----	----	----	-----
Total portfolio.....	\$936	4.21%	\$591	4.99%	\$355	5.68%	\$29,449
	=====	=====	=====	=====	=====	=====	=====

There were no securities which had an aggregate book value in excess of 10% of the Company's total equity at September 30, 2008.

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

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Pacific Coast Banker's Bank ("PCBB") 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, 2008, the Bank had 28.6% of total deposits in non-interest bearing accounts and NOW checking accounts.

At September 30, 2008 the Bank had \$73.1 million of jumbo certificates of deposit of \$100,000 or more. The Bank also had brokered certificates of deposits totaling \$26.0 million at September 30, 2008. The Bank believes that its jumbo certificates of deposit and its brokered deposits, which represented 19.9% of total deposits at September 30, 2008, present similar interest rate risk compared to its other deposits.

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The following table sets forth information concerning the Bank's deposits at September 30, 2008.

Category	Weighted Average Interest Rate	Amount	Percentage of Total Deposits
-----			
(In thousands)			
Non-interest bearing.....	--%	\$ 51,955	10.42%
Negotiable order of withdrawal ("NOW") checking.....	0.90	90,468	18.15
Savings.....	0.70	56,391	11.31
Money market.....	2.40	70,379	14.11
		-----	-----
Subtotal	1.24	269,193	53.99
Certificates of Deposit(1)			
-----			
Maturing within 1 year.....	3.72	175,817	35.26
Maturing after 1 year but within 2 years.....	3.54	46,407	9.31
Maturing after 2 years but within 5 years.....	3.93	6,759	1.36
Maturing after 5 years.....	3.40	396	0.08
		-----	-----
Total certificates of deposit.....	3.30	229,379	46.01
	----	-----	-----
Total deposits.....	2.19%	\$498,572	100.00%
	=====	=====	=====

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(1) Based on remaining maturity of certificates.

The following table indicates the amount of the Bank's jumbo certificates of deposit by time remaining until maturity as of September 30, 2008. 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.....	\$26,413
Over three through six months.....	11,504
Over six through twelve months.....	21,472
Over twelve months.....	13,718
Total.....	\$73,107

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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,					
	2008			2007		
	Amount	Percent of Total	Increase (Decrease)	Amount	Percent of Total	Increase (Decrease)
	(Dollars in thousands)					
Non-interest-bearing....	\$ 51,955	10.42%	\$ (3,007)	\$ 54,962	11.77%	\$ (2,943)
NOW checking.....	90,468	18.15	10,096	80,372	17.22	(9,137)
Savings.....	56,391	11.31	(21)	56,412	12.09	(3,823)
Money market.....	70,379	14.11	22,311	48,068	10.30	5,690
Certificates of deposit which mature:						
Within 1 year.....	175,817	35.26	(32,513)	208,330	44.63	54,391
After 1 year, but within 2 years.....	46,407	9.31	33,668	12,739	2.73	(7,296)
After 2 years, but within 5 years.....	6,759	1.36	1,028	5,731	1.23	(1,279)
Certificates maturing thereafter.....	396	0.08	275	121	0.03	73
Total.....	\$498,572	100.00%	\$ 31,837	\$466,735	100.00%	\$35,674

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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,			
	2008	2007	2006
(In thousands)			
0.00 - 1.99%.....	\$ 866	\$ 676	\$ 2,176
2.00 - 3.99%.....	203,859	46,810	69,736
4.00 - 5.99%.....	24,274	179,008	108,636
6.00% - and over.....	380	427	486
Total.....	\$229,379	\$226,921	\$181,034

Certificates of Deposit by Maturities. The following table sets forth the amount and maturities of certificates of deposit at September 30, 2008.

Amount Due					
	Less Than One Year	One to Two Years	After Two to Five Years	After Five Years	Total
(In thousands)					
0.00 - 1.99%.....	\$ 803	\$ 63	\$ --	\$ --	\$ 866
2.00 - 3.99%.....	160,090	37,830	5,543	396	203,859
4.00 - 5.99%.....	14,914	8,199	1,161	--	24,274
6.00% and over.....	10	315	55	--	380
Total.....	\$175,817	\$46,407	\$6,759	\$396	\$229,379

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

Year Ended September 30,			
	2008	2007	2006
(In thousands)			
Beginning balance.....	\$466,735	\$431,061	\$411,665
Net deposits before interest credited ..	20,075	24,382	11,491
Interest credited.....	11,762	11,292	7,905
Net increase in deposits.....	31,837	35,674	19,396
Ending balance.....	\$498,572	\$466,735	\$431,061

Borrowings. Deposits are generally the primary source of funds for the

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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, 2008, 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 \$104.6 million was outstanding. The Bank also

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utilizes overnight repurchase agreements with customers. These overnight repurchase agreements are classified as other borrowings and totaled \$758,000 at September 30, 2008, \$595,000 at September 30, 2007 and \$947,000 at September 30, 2006. At September 30, 2008, the Bank also maintained a \$10.0 million overnight borrowing line with PCBB under which there was no outstanding balance.

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

	At or For the Year Ended September 30,		
	2008	2007	2006
	(Dollars in thousands)		
Average total borrowings.....	\$108,858	\$ 85,599	\$55,773
Weighted average rate paid on total borrowings.....	4.27%	5.24%	5.22%
Total borrowings outstanding at end of period.....	\$105,386	\$100,292	\$63,708

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

	At or For the Year Ended September 30,		
	2008	2007	2006
	(Dollars in thousands)		
Maximum amount outstanding at any month end:			

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FHLB advances.....	\$42,600	\$72,750	\$29,000
Repurchase agreements.....	1,884	4,460	1,895
PCBB advances.....	--	--	--
Average outstanding during period:			
FHLB advances.....	\$13,366	\$34,156	\$ 3,516
Repurchase agreements.....	943	1,019	1,148
PCBB advances.....	12	32	--
	-----	-----	-----
Total average outstanding during period.....	\$14,321	\$35,207	\$ 4,664
	=====	=====	=====
Weighted average rate paid during period:			
FHLB advances.....	4.44%	5.58%	4.81%
Repurchase agreements.....	2.12	4.61	4.27
PCBB advances.....	5.27	6.45	--
Total weighted average rate paid during period.....	4.29%	5.55%	4.67%
Outstanding at end of period:			
FHLB advances.....	\$ --	\$30,000	\$29,000
Repurchase agreements.....	758	595	947
PCBB advances.....	--	--	--
	-----	-----	-----
Total outstanding at end of period.....	\$ 758	\$30,595	\$29,947
	=====	=====	=====
Weighted average rate at end of period:			
FHLB advances.....	--%	5.19%	5.49%
Repurchase agreements.....	1.05	4.42	5.01
PCBB advances.....	--	--	--
Total weighted average rate at end of period.....	1.05%	5.17%	5.47%

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Bank Owned Life Insurance

The Bank has purchased life insurance policies covering certain officers. These policies are recorded at their cash surrender value, net of any policy premium charged. Increases in cash surrender value, net of policy premiums, and proceeds from death benefits are recorded in non-interest income. At September 30, 2008, the Bank had \$12.9 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

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laws and regulations. The Bank is subject to periodic examination and reporting requirements by and of the Division and the FDIC.

Insurance of Accounts and Regulation by the FDIC. The Bank's deposits are insured up to applicable limits by the Deposit Insurance Fund 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.

Under regulations effective January 1, 2007, the FDIC adopted a new risk-based premium system that provides for quarterly assessments based on an insured institution's ranking in one of four risk categories based upon supervisory and capital evaluations. Institutions are assessed at annual rates ranging from 5 to 43 basis points, respectively, depending on each institution's risk of default as measured by regulatory capital ratios and other supervisory measures. Under a proposal announced by the FDIC on October 7, 2008, the assessment rate schedule would be raised uniformly by 7 basis points (annualized) beginning on January 1, 2009. Beginning with the second quarter of 2009, changes would be made to the deposit insurance assessment system by requiring riskier institutions to pay a larger share. The proposal would impose higher assessment rates on institutions with a significant reliance on secured liabilities and on institutions which rely significantly on brokered deposits (but, for well-managed and well-capitalized institutions, only when accompanied by rapid asset growth). The proposal would reduce assessment rates for institutions that hold long-term unsecured debt and, for smaller institutions, high levels of Tier 1 (defined below) capital.

FDIC-insured institutions are required to pay a Financing Corporation assessment, in order to fund the interest on bonds issued to resolve thrift failures in the 1980s. For the quarterly period ended September 30, 2008, the Financing Corporation assessment equaled 1.10 basis points for each \$100 in domestic deposits. These assessments, which may be revised based upon the level of deposits, will continue until the bonds mature in the years 2017 through 2019.

The FDIC may terminate the deposit insurance of any insured depository institution, including the Bank, if it determines after a hearing 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. It also may suspend deposit insurance temporarily during the hearing process for the permanent termination of insurance, if the institution has no tangible capital. If insurance of accounts is terminated, the accounts at the institution at the time of the termination, less subsequent withdrawals, shall continue to be insured for a period of six months to two years, as determined 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.

Prompt Corrective Action. The FDIC is required to take certain supervisory actions against undercapitalized savings institutions, the severity of which depends upon the institution's degree of undercapitalization. Generally, an

institution that has a ratio of total capital to risk-weighted assets of less

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than 8%, a ratio of Tier I (core) capital to risk-weighted assets of less than 4%, or a ratio of core capital to total assets of less than 4% (3% or less for institutions with the highest examination rating) is considered to be undercapitalized. An institution that has a total risk-based capital ratio less than 6%, a Tier I capital ratio of less than 3% or a leverage ratio that is less than 3% is considered to be significantly undercapitalized and an institution that has a tangible capital to assets ratio equal to or less than 2% is deemed to be critically undercapitalized. Subject to a narrow exception, the FDIC is required to appoint a receiver or conservator for a savings institution that is critically undercapitalized. FDIC regulations also require that a capital restoration plan be filed with the FDIC within 45 days of the date a savings institution receives notice that it is undercapitalized, significantly undercapitalized or critically undercapitalized. Compliance with the plan must be guaranteed by any parent holding company in an amount of up to the lesser of 5% of the institution's assets or the amount which would bring the institution into compliance with all capital standards. In addition, numerous mandatory supervisory actions become immediately applicable to an undercapitalized institution, including, but not limited to, increased monitoring by regulators and restrictions on growth, capital distributions and expansion. The FDIC also could take any one of a number of discretionary supervisory actions, including the issuance of a capital directive and the replacement of senior executive officers and directors.

At September 30, 2008, the Bank was categorized as "well capitalized" under the prompt corrective action regulations of the FDIC.

**Standards for Safety and Soundness.** The federal banking regulatory agencies have prescribed, by regulation, guidelines for all insured depository institutions relating to: internal controls, information systems and internal audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, asset quality, earnings, and compensation, fees and benefits. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. 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.** FDIC regulations recognize two types or tiers of capital: core ("Tier 1") capital and supplementary ("Tier 2") capital. Tier 1 capital generally includes common shareholders' equity and noncumulative perpetual preferred stock, less most intangible assets. Tier 2 capital, which is limited to 100% of Tier 1 capital, includes such items as qualifying general loan loss reserves, cumulative perpetual preferred stock, mandatory convertible debt, term subordinated debt and limited life preferred stock; however, the amount of term subordinated debt and intermediate term preferred

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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, 2008, the Bank had a Tier 1 leverage capital ratio of 9.2%. The FDIC retains the right to require an institution to maintain a higher capital level based on the institution's particular risk profile.

FDIC regulations also establish a measure of capital adequacy based on ratios of qualifying capital to risk-weighted assets. Assets are placed in one of four categories and given a percentage weight based on the relative risk of

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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, 2008, the Bank's ratio of total capital to risk-weighted assets was 12.3% and the ratio of Tier 1 capital to risk-weighted assets was 11.1%.

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, 2008, the Bank had a net worth of 9.0% of total assets.

The table below sets forth the Bank's capital position relative to its FDIC capital requirements at September 30, 2008. The definitions of the terms used in the table are those provided in the capital regulations issued by the FDIC, and the Bank has not been notified by the FDIC of any higher capital requirements specifically applicable to it.

	At September 30, 2008	
	Amount	Percent of Adjusted Total Assets (1)
	(Dollars in thousands)	
Tier 1 (leverage) capital (2).....	\$61,326	9.2%
Tier 1 (leverage) capital requirement.....	26,649	4.0
Excess.....	\$34,677	5.2%
	=====	=====

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Tier 1 risk adjusted capital.....	\$61,326	11.1%
Tier 1 risk adjusted capital requirement....	22,192	4.0
	-----	----
Excess.....	\$39,134	7.1%
	=====	=====
Total risk-based capital.....	\$68,275	12.3%
Total risk-based capital requirement.....	44,384	8.0
	-----	----
Excess.....	\$23,891	4.3%
	=====	=====

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- (1) For the Tier 1 (leverage) capital and Washington regulatory capital calculations, percent of total average assets of \$666.2 million. For the Tier 1 risk-based capital and total risk-based capital calculations, percent of total risk-weighted assets of \$554.8 million.
- (2) As a Washington-chartered savings bank, the Bank is subject to the capital requirements of the FDIC and the Division. The FDIC requires state-chartered savings banks, including the Bank, to have a minimum leverage ratio of Tier 1 capital to total assets of at least 3%, provided, however, that all institutions, other than those (i) receiving the highest rating during the examination process and (ii) not anticipating any significant growth, are required to maintain a ratio of 1% to 2% above the stated minimum, with an absolute total capital to risk-weighted assets of at least 8%. The Bank has not been notified by the FDIC of any leverage capital requirement specifically applicable to it.

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

Emergency Economic Stabilization Act of 2008. In October 2008, the EESA was enacted. The EESA authorizes the Treasury Department to purchase from financial institutions and their holding companies up to \$700 billion in mortgage loans, mortgage-related securities and certain other financial instruments, including debt and equity securities issued by financial institutions and their holding companies in a troubled asset relief program ("TARP"). The purpose of TARP is to restore confidence and stability to the U.S. banking system and to encourage financial institutions to increase their lending to customers and to each other. The Treasury Department has allocated \$250 billion towards the TARP Capital Purchase Program ("CPP"). Under the CPP, the Treasury will purchase debt or equity securities from participating institutions. The TARP also will include direct purchases or guarantees of troubled assets of financial institutions. Participants in the CPP are subject to executive compensation limits and are encouraged to expand their lending and mortgage loan modifications. The Company has submitted an initial application for the sale of preferred shares equal to 3.0% of its risk-weighted assets.

EESA also increased FDIC deposit insurance on most accounts from \$100,000 to \$250,000. This increase expires at the end of 2009 and it not covered by

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deposit insurance premiums paid by the banking industry.

**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 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, 2008, the Bank's aggregate loans in excess of the supervisory loan-to-value ratios were 19% 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 16% of total capital.

**Initiatives Prompted by the Subprime Mortgage Crisis.** In response to the recent subprime mortgage crisis," federal and state regulatory agencies have focused attention on subprime and nontraditional mortgage products both with an aim toward enhancing the regulation of such loans and providing relief to adversely affected borrowers.

**Guidance on Subprime Mortgage Lending.** On June 29, 2007, the federal banking agencies issued guidance on subprime mortgage lending to address issues related to certain mortgage products marketed to subprime borrowers, particularly adjustable rate mortgage products that can involve "payment shock" and other risky characteristics. Although the guidance focuses on subprime borrowers, the banking agencies note that institutions should look to the principles contained in the guidance when offering such adjustable rate mortgages to non-subprime borrowers. The guidance prohibits predatory lending programs; provides that institutions should underwrite a mortgage loan on the borrower's ability to repay the debt by its final maturity at the fully-indexed rate, assuming a fully amortizing repayment schedule; encourages reasonable workout arrangements with borrowers who are in default; mandates clear and balanced advertisements and other communications; encourages arrangements for the escrowing of real estate taxes and insurance; and states that institutions should develop strong control and monitoring systems. The guidance recommends that institutions refer to the Real Estate Lending Standards (discussed above) which provide underwriting standards for all real estate loans.

The federal banking agencies announced their intention to carefully review the risk management and consumer compliance processes, policies and procedures of their supervised financial institutions and their intention to take action against institutions that engage in predatory lending practices, violate consumer protection laws or fair lending laws, engage in unfair or deceptive acts or practices, or otherwise engage in unsafe or unsound lending practices.



Guidance on Loss Mitigation Strategies for Servicers of Residential Mortgages. On September 5, 2007, the federal banking agencies issued a statement encouraging regulated institutions and state-supervised entities that service residential mortgages to pursue strategies to mitigate losses while preserving homeownership to the extent possible and appropriate. The guidance recognizes that many mortgage loans, including subprime loans, have been transferred into securitization trusts and servicing for such loans is governed by contract documents. The guidance advises servicers to review governing documentation to determine the full extent of their authority to restructure loans that are delinquent or are in default or are in imminent risk of default.

The guidance encourages that servicers take proactive steps to preserve homeownership in situations where there are heightened risks to homeowners losing their homes to foreclosures. Such steps may include loan modification; deferral of payments; extensions of loan maturities; conversion of adjustable rate mortgages into fixed rate or fully indexed, fully amortizing adjustable rate mortgages; capitalization of delinquent amounts; or any combination of these actions. Servicers are instructed to consider the borrower's ability to repay the modified obligation to final maturity according to its terms, taking into account the borrower's total monthly housing-related payments as a percentage of the borrower's gross monthly income, the borrower's other obligations, and any additional tax liabilities that may result from loan modifications. Where appropriate, servicers are encouraged to refer borrowers to qualified non-profit and other homeownership counseling services and/or to government programs that are able to work with all parties and avoid unnecessary foreclosures. The guidance states that servicers are expected to treat consumers fairly and to adhere to all applicable legal requirements.

Consumer Relief Initiative for Borrowers. In October 2007, the Treasury Secretary announced the Homeowner Assistance Initiative to encourage mortgage servicers, mortgage counselors, government officials and non-profit groups to coordinate their efforts to help struggling borrowers restructure their mortgage payments and stay in their homes. The initiative, called HOPE NOW, is aimed at coordinating and improving outreach to borrowers, developing best practices for mortgage counselors across the country and ensuring that groups able to help homeowners work out new loan arrangements with lenders have adequate resources to carry out this mission.

Economic Stimulus Act of 2008 and Housing and Economic Recovery Act of 2008. President Bush signed the Economic Stimulus Act of 2008 into law on February 13, 2008. While the main thrust of the act is to stimulate the economy, the act also temporarily increased the maximum size of mortgage loans (the conforming loan limit) that Fannie Mae and Freddie Mac may purchase from the current \$417,000 cap to a maximum of \$729,750 for certain loans made during the July 1, 2007 - December 31, 2008 period. The cap on the Federal Housing Administration's conforming loan limit for mortgage loans was raised from \$362,000 to \$729,750 for certain loans made on or before December 31, 2008. These changes are intended, among other purposes, to provide more liquidity and stability for the jumbo loan market. The Housing and Economic Recovery Act of 2008, signed by President Bush on July 30, 2008, was designed to address a variety of issues relating to the subprime mortgage crises. This act established a new conforming loan limit for Fannie Mae and Freddie Mac in high cost areas to 150% of the conforming loan limit, to take effect after the limits established by the Economic Stimulus Act of 2008 expire. The FHA's conforming loan limit has been increased from 95% to 110% of the area median home price up to 150% of the Fannie Mae/Freddie Mac conforming loan limit, to

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take effect at the same time. Among other things, the Housing and Economic Recovery Act of 2008 enhanced the regulation of Fannie Mae, Freddie Mac and Federal Housing Administration loans; established a new Federal Housing Finance Agency to replace the prior Federal Housing Finance Board and Office of Federal Housing Enterprise Oversight; will require enhanced mortgage disclosures; and will require a comprehensive licensing, supervisory, and tracking system for mortgage originators. Using its new powers, on September 7, 2008 the Federal Housing Finance Agency announced that it had put Fannie Mae and Freddie Mac under conservatorship. The Housing and Economic Recovery Act of 2008 also establishes the HOPE for Homeowners program, which is a new, temporary, voluntary program to back Federal Housing Administration-insured mortgages to distressed borrowers. The new mortgages offered by Federal Housing Administration-approved lenders will refinance distressed loans at a significant discount for owner-occupants at risk of losing their homes to foreclosure.

New Regulations Establishing Protections for Consumers in the Residential Mortgage Market. The Federal Reserve Board has issued new regulations under the federal Truth-in-Lending Act and the Home Ownership and Equity Protection Act. For mortgage loans governed by the Home Ownership and Equity Protection Act, the new regulations

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further restrict prepayment penalties, and enhance the standards relating to the consumer's ability to repay. For a new category of closed-end "higher-priced" mortgage loans, the new regulations restrict prepayment penalties, and require escrows for property taxes and property-related insurance for most first lien mortgage loans. For all closed-end loans secured by a principal dwelling, the new regulations prohibit the coercion of appraisers; require the prompt crediting of payments; prohibit the pyramiding of late fees; require prompt responses to requests for pay-off figures; and require the delivery of transaction-specific Truth-in-Lending Act disclosures within three business days following the receipt of an application for a closed-end home loan. The new regulations also impose new restrictions on mortgage loan advertising for both open-end and closed-end products. In general, the new regulations are effective October 10, 2009, but the rules governing escrows for higher-priced mortgages are effective on April 1, 2010, and for higher-priced mortgage loans secured by manufactured housing, on October 1, 2010.

Pending Legislation and Regulatory Proposals. As a result of the subprime mortgage crisis, federal and state legislative agencies are considering a broad variety of legislative and regulatory proposals covering mortgage loan products, loan terms and underwriting standards, risk management practices and consumer protection. It is unclear which, if any, of these initiatives will be adopted, what effect they will have on the Company or the Bank and whether any of these initiatives will change the competitive landscape in the mortgage industry.

Guidance on Nontraditional Mortgage Product Risks. On September 29, 2006, the federal banking agencies issued guidance to address the risks posed by nontraditional residential mortgage products, that is, mortgage products that allow borrowers to defer repayment of principal or interest. The guidance instructs institutions to ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's ability to repay the debt by final maturity at the fully indexed rate and assuming a fully amortizing repayment schedule;

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requires institutions to recognize, for higher risk loans, the necessity of verifying the borrower's income, assets and liabilities; requires institutions to address the risks associated with simultaneous second-lien loans, introductory interest rates, lending to subprime borrowers, non-owner-occupied investor loans, and reduced documentation loans; requires institutions to recognize that nontraditional mortgages, particularly those with risk-layering features, are untested in a stressed environment; requires institutions to recognize that nontraditional mortgage products warrant strong controls and risk management standards, capital levels commensurate with that risk, and allowances for loan and lease losses that reflect the collectibility of the portfolio; and ensure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making product and payment choices. The guidance recommends practices for addressing the risks raised by nontraditional mortgages, including enhanced communications with consumers, beginning when the consumer is first shopping for a mortgage; promotional materials and other product descriptions that provide information about the costs, terms, features and risks of nontraditional mortgages, including with respect to payment shock, negative amortization, prepayment penalties, and the cost of reduced documentation loans; more informative monthly statements for payment option adjustable rate mortgages; and specified practices to avoid. Subsequently, the federal banking agencies produced model disclosures that are designed to provide information about the costs, terms, features and risks of nontraditional mortgages.

Guidance on Real Estate Concentrations. On December 6, 2006, the federal banking agencies issued a guidance on sound risk management practices for concentrations in commercial real estate lending. The particular focus 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 sensitive to conditions in the commercial real estate market (as opposed to real estate collateral held as a secondary source of repayment or as an abundance of caution). The purpose of the guidance is not to limit a bank's commercial real estate lending but to guide banks in developing risk management practices and capital levels commensurate with the level and nature of real estate concentrations. The FDIC and other bank regulatory agencies will be focusing their supervisory resources on institutions that may have significant commercial real estate loan concentration risk. A bank that has experienced rapid growth in commercial real estate lending, has notable exposure to a specific type of commercial real estate loan, or is approaching or exceeding the following supervisory criteria may be identified for further supervisory analysis with respect to real estate concentration risk:

- \* Total reported loans for construction, land development and other land represent 100% or more of the bank's capital; or

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- \* Total commercial real estate loans (as defined in the guidance) represent 300% or more of the bank's total capital and the outstanding balance of the bank's commercial real estate loan portfolio has increased 50% or more during the prior 36 months.

The strength of an institution's lending and risk management practices with respect to such concentrations will be taken into account in supervisory evaluation of capital adequacy.

On March 17, 2008, the FDIC issued a release to re-emphasize the importance of strong capital and loan loss allowance levels and robust credit

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risk management practices for institutions with concentrated commercial real estate exposures. The FDIC suggested that institutions with significant construction and development and commercial real estate loan concentrations increase or maintain strong capital levels; ensure that loan loss allowances are appropriately strong; manage construction and development and commercial real estate loan portfolios closely; maintain updated financial and analytical information on their borrowers and collateral; and bolster the loan workout infrastructure.

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, 2009 for noninterest-bearing transaction accounts (typically business checking accounts) and certain funds swept into noninterest-bearing savings accounts ("TAGP"). Institutions participating in the TAGP pay a 10 basis points 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, under which the FDIC guarantees certain senior unsecured debt of FDIC-insured institutions and their holding companies ("DGP"). The unsecured debt must be issued on or after October 14, 2008 and not later than June 30, 2009, and the guarantee is effective through the earlier of the maturity date or June 30, 2012. The DGP coverage limit is generally 125% of the eligible entity's eligible debt outstanding on September 30, 2008 and scheduled to mature on or before June 30, 2009 or, for certain insured institutions, 2% of their liabilities as of September 30, 2008. Depending on the term of the debt maturity, the nonrefundable DGP fee ranges from 50 to 100 basis points (annualized) for covered debt outstanding until the earlier of maturity or June 30, 2012. 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.

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

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

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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.

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

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

Federal Reserve System. The Federal Reserve Board requires under Regulation D that all depository institutions, including savings banks, maintain reserves on transaction accounts or non-personal time deposits (however, as of September 30, 2008, the reserve requirement for non-personal time deposits is 0%). These reserves may be in the form of cash or non-interest-bearing deposits with the regional Federal Reserve Bank. Negotiable order of withdrawal accounts and other types of accounts that permit payments or transfers to third parties fall within the definition of transaction accounts and are subject to Regulation D reserve requirements, as are any non-personal time deposits at a savings bank. As of September 30, 2008, 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. Under the Community Reinvestment Act ("CRA"), every FDIC-insured institution has a continuing and affirmative obligation consistent with safe and sound banking practices to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's

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discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with the CRA. The CRA requires the FDIC, in connection with its examination of the Bank, to assess the institution's record of meeting the credit needs of its community and to take such record into account in its evaluation of certain applications, such as a merger or the establishment of a branch, by the Bank. An unsatisfactory rating may be used as the basis for the denial of an application by the FDIC. As a result of the heightened attention being given to the CRA in the past few years, the Bank may be required to devote additional funds for investment and lending in its local community. The Bank was examined for CRA compliance and received a rating of "satisfactory" in its latest examination.

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

The amount of dividends actually paid during any one period will be strongly affected by the Bank's management policy of maintaining a strong capital position. Federal law further provides that no insured depository

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institution may make any capital distribution (which would include a cash dividend) if, after making the distribution, the institution would be "undercapitalized," as defined in the prompt corrective action regulations. Moreover, the federal bank regulatory agencies also have the general authority to limit the dividends paid by insured banks if such payments should be deemed to constitute an unsafe and unsound practice.

**Privacy Standards.** The Gramm-Leach-Bliley Financial Services Modernization Act of 1999 ("GLBA"), which was enacted in 1999, modernized the financial services industry by establishing a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms and other financial service providers. The Bank is subject to FDIC regulations implementing the privacy protection provisions of the GLBA. These regulations require the Bank to disclose its privacy policy, including identifying with whom it shares "non-public personal information," to customers at the time of establishing the customer relationship and annually thereafter. The privacy policy must be provided to consumers before nonpublic personal information is shared with a nonaffiliated third party. Customers and certain consumers must be provided the right to opt out of the sharing of certain information by the Bank with both affiliates and non-affiliated third parties. FDIC regulations that became mandatory on October 1, 2008 limit the right of an affiliate of the Bank to use consumer information obtained from the Bank for marketing purposes, unless the consumer is provided with a clear and conspicuous notice of his/her right to opt out from that use and the consumer has not opted out. The Bank is also subject to state privacy laws, which may impose more stringent information sharing requirements. The Bank is in compliance with these requirements.

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Bank Secrecy Act and USA Patriot Act. The Bank Secrecy Act, or the BSA, is a law that is part of the federal government's framework to prevent and detect money laundering and to deter other criminal enterprises. Under the BSA, financial institutions such as the Bank are required to maintain certain records and file certain reports regarding domestic currency transactions and cross-border transporting of currency. Among other requirements, the BSA requires financial institutions to report imports and exports of currency in the amount of \$10,000 or more and, in general, all cash transactions of \$10,000 or more. The BSA also requires that financial institutions report to relevant law enforcement agencies any suspicious transactions potentially involving violations of law.

The terrorist attacks in September 2001 impacted the financial services industry and led to the enactment of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, or the USA Patriot Act. Part of the USA Patriot Act is the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001, or IMLAFATA. Pursuant to IMLAFATA, an additional purpose was added to the BSA: "To assist in the conduct of intelligence or counter-intelligence activities, including analysis, to protect against international terrorism."

IMLAFATA also significantly expanded the role of financial institutions in combating money laundering. In particular, it required financial institutions to establish anti-money laundering programs, which, at a minimum, include internal policies, procedures, and controls designed to prevent the institution from being used for money laundering; the designation of a BSA compliance officer; ongoing employee training; and an independent audit program to test the effectiveness of the institution's anti-money laundering programs. The FDIC and the other federal banking agencies promptly adopted regulations requiring each financial institution to establish comprehensive anti-money laundering compliance programs designed to assure compliance with the BSA and otherwise meeting the statutory requirements for such programs set forth in IMLAFATA. In addition, these regulations required each financial institution to establish a customer identification program to be implemented as part of the institution's anti-money laundering compliance program. Failure to establish and maintain such BSA/anti-money laundering programs are grounds for the taking of enforcement actions by the federal banking regulators.

IMLAFATA authorizes the Treasury Secretary, in consultation with the heads of other government agencies, to adopt special measures applicable to banks, bank holding companies, and/or other financial institutions. These measures may include enhanced recordkeeping and reporting requirements for certain financial transactions that are of primary money laundering concern, due diligence requirements concerning the beneficial ownership of certain types of accounts, and restrictions or prohibitions on certain types of accounts with foreign financial institutions.

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Among its other provisions, IMLAFATA requires each financial institution to (i) establish due diligence policies, procedures, and controls with respect to its private banking accounts and correspondent banking accounts involving foreign individuals and certain foreign banks, and (ii) avoid establishing, maintaining, administering, or managing correspondent accounts in the U.S. for, or on behalf of, a foreign bank that does not have a physical presence in any country. In addition, IMLAFATA contains a provision encouraging cooperation among financial institutions, regulatory authorities and law

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enforcement authorities with respect to individuals, entities, and organizations engaged in, or reasonably suspected of engaging in, terrorist acts or money laundering activities. IMLAFATA expands the circumstances under which funds in a bank account may be forfeited and requires covered financial institutions to respond under certain circumstances to requests for information from federal banking agencies within 120 hours. IMLAFATA also requires the federal banking agencies to consider the effectiveness of a financial institution's anti-money laundering activities in connection with a potential bank merger under the Bank Merger Act.

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 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



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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

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to serve as a source of strength to its subsidiary banks will generally be considered by the Federal Reserve to be an unsafe and unsound banking practice or a violation of the Federal Reserve's regulations or both.

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

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

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

**Interstate Banking.** The Federal Reserve must approve an application of an adequately capitalized and adequately managed bank holding company to acquire control of, or acquire all or substantially all of the assets of, a bank located in a state other than such holding company's home state, without regard to whether the transaction is prohibited by the laws of any state. The Federal Reserve may not approve the acquisition of a bank that has not been in existence for the minimum time period, not exceeding five years, specified by the statutory law of the host state. Nor may the Federal Reserve approve an

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application if the applicant, and its depository institution affiliates, controls or would control more than 10% of the insured deposits in the United States or 30% or more of the deposits in the target bank's home state or in any state in which the target bank maintains a branch. Federal law does not affect the authority of states to limit the percentage of total insured deposits in the state which may be held or controlled by a bank holding company to the extent such limitation does not discriminate against out-of-state banks or bank holding companies. Individual states may also waive the 30% state-wide concentration limit contained in the federal law.

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

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

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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 gross consideration for the purchase or redemption, when combined with the net consideration paid for all such purchases or redemptions during the preceding 12 months, is equal to 10% or more of their consolidated net worth. The Federal Reserve may disapprove such a purchase or redemption if it determines that the proposal would constitute an unsafe or unsound practice or would violate any law, regulation, Federal Reserve order, or any condition imposed by, or written agreement with, the Federal Reserve.

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

The Company's total risk based capital must equal 8% of risk-weighted assets and one half of the 8%, or 4%, must consist of Tier 1 (core) capital and its Tier 1 (core) capital must equal 4% of total assets. As of September 30, 2008, the Company's total risk based capital was 13.6% of risk-weighted assets and its risk based capital of Tier 1 (core) capital was 12.4% of risk-weighted assets.

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

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

The provisions repealing the current thrift bad debt rules were passed by Congress as part of "The Small Business Job Protection Act of 1996." These rules required that all institutions recapture all or a portion of their bad debt reserves added since the base year (last taxable year beginning before January 1, 1988). The Bank had previously recorded deferred taxes equal to the bad debt recapture and as such the new rules had no effect on the net income or federal income tax expense. For taxable years beginning after December 31, 1995, the Bank's bad debt deduction is determined under the experience method using a formula based on actual bad debt experience over a period of years or, if the Bank is a "large" association (assets in excess of \$500 million) on the basis of net charge-offs during the taxable

year. The unrecaptured base year reserves will not be subject to recapture as long as the institution continues to carry on the business of banking. In addition, the balance of the pre-1988 bad debt reserves continue to be subject to provisions of present law referred to below that require recapture in the case of certain excess distributions to shareholders. The Bank has recaptured all federal tax bad debt reserves that had been accumulated since October 1, 1988.

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

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

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

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

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

### Competition

The Bank operates in an intensely competitive market for the attraction of deposits (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.

### Subsidiary Activities

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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.

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Personnel

As of September 30, 2008, the Bank had 254 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 September 30, 2008	Position	
		Company	Bank
Michael R. Sand	54	President and Chief Executive Officer	President and Chief Executive Officer
Dean J. Brydon	41	Executive Vice President, Chief Financial Officer and Secretary	Executive Vice President, Chief Financial Officer and Secretary
Robert A. Drugge	57	Executive Vice President	Executive Vice President and Business Banking Division Manager
John P. Norawong	43	Executive Vice President	Executive Vice President and Community Banking Division Manager
Marci A. Basich	39	Senior Vice President and Treasurer	Senior Vice President and Treasurer
Kathie M. Bailey	57	Senior Vice President	Senior Vice President and Chief Operations Officer
Michael J. Scott	62		Senior Vice President and Chief Credit Administrator

Biographical Information.

Michael R. Sand has been affiliated with the Bank since 1977 and has

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

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

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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.

### 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 operation and/or cash flows. Before making an investment decision, you should carefully consider the risks described below together with all of the other information included in this Form 10-K. If any of the circumstances described in the following risk factors actually occur to a significant degree, the value of our common stock could decline, and you could lose all or part of your investment.

#### Business Risks

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Our business may be adversely affected by downturns in the local economies on which we depend that could adversely impact our results of operations and financial condition.

Our business is directly affected by market conditions, trends in industry and finance, legislative and regulatory changes, and changes in governmental monetary and fiscal policies and inflation, all of which are beyond our control. In 2007, the housing and real estate sectors experienced an economic slowdown that has continued into 2008. A sustained weakness or weakening in business and economic conditions generally or specifically in the principal markets in which we do business could have one or more of the following adverse impacts on business:

- \* A decrease in the demand for loans and other products and services offered by us;
- \* A decrease in the value of our loans held for sale;
- \* An increase or decrease in the usage of unfunded commitments; or
- \* An increase in the number of our customers and counterparties who become delinquent, file for protection under bankruptcy laws or default on their loans or other obligations to us. An increase in the number of delinquencies, bankruptcies or defaults could result in a higher level of non-performing assets, net charge-offs, provision for loan losses, and valuation adjustments on loans held for sale.

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

Our business activities and credit exposure are primarily concentrated in our local market areas of Grays Harbor, Thurston, Pierce, King, Kitsap and Lewis Counties. Our residential loan portfolio, and our commercial real estate and multi-family loan portfolio and a certain number of our other loans have been affected by the downturn in the residential real estate market. We anticipate that further declines in the real estate markets in our primary market areas will negatively impact our business. As of September 30, 2008, substantially all of our loan portfolio consisted of loans secured by real estate located in Washington. If real estate values continue to decline the collateral for our loans will provide less security. As a result, our ability to recover on defaulted loans by selling the underlying real estate will be diminished, and we would be more likely to suffer losses on defaulted loans. The events and conditions described in this risk factor could therefore have a material adverse effect on our business, results of operations and financial condition.

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

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

Our loan portfolio includes increased risk due to changes in category composition of the portfolio. The percentage of loans secured by first mortgages on one-to four-family residential properties has decreased as the

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portfolio has been positioned into higher-yielding loan categories that typically involve a higher degree of risk.

From September 30, 2004 through September 30, 2008, our total loans have grown by 54.8%. During this period the percentage of one- to four-family loans in the loan portfolio has decreased to 18.4% from 25.3%. Our commercial real estate loans, construction and land development loans, multi-family loans, land loans, commercial business loans, and consumer loans accounted for approximately 81.6% of our total loan portfolio as of September 30, 2008. We consider these types of loans to involve a higher degree of risk compared to first mortgage loans on one- to four-family, owner-occupied residential properties, and therefore, may cause higher future loan losses. Accordingly, as a result of the inherent risks associated with these types of loans, and the unseasoned nature of a portion of these loans, it may become necessary to increase the level of our provision for loan losses. An increase in our provision for loan losses would reduce our profits.

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

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

From September 30, 2004 through September 30, 2008, our total construction and land development loans have grown by 35.0%. During this period the percentage of construction and land development loans in the loan portfolio increased to 30.5% from 26.9%. Construction lending is generally considered to involve a higher level of risk as compared to single-family residential or consumer lending, as a result of the concentration of principal in a limited number of loans and borrowers, and the effects of general economic conditions on developers and builders. Moreover, a construction loan can involve additional risks because of the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost (including interest) of the project. The nature of these loans is such that they are generally more difficult to evaluate and monitor. In addition, speculative construction loans to a builder are often associated with homes that are not pre-sold, and thus pose a greater potential risk to us than construction loans to individuals on their personal residences. Construction loans on land under development or held for future construction also poses additional risk because of the lack of income being produced by the property and the potential illiquid nature of the security.

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

Like other financial institutions, we are subject to interest rate risk. Our primary source of income is net interest income, which is the difference between interest earned on loans and investment securities and the interest paid on deposits and borrowings. We expect that we will periodically experience imbalances in the interest rate sensitivity of our assets and liabilities and the relationships of various interest rates to each other. Over any period of time, our interest-earning assets may be more sensitive to changes in market interest rates than our interest-bearing liabilities, or vice versa. In addition, the individual market interest rates underlying our loan and deposit products may not change to the same degree over a given time



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period. In any event, if market interest rates should move contrary to our position, our earnings may be negatively affected. In addition, loan volume and quality and deposit volume and mix can be affected by market interest rates. Changes in levels of market interest rates could materially adversely affect our net interest spread, asset quality, origination volume and overall profitability.

Interest rates have recently decreased after increasing for several years. The U.S. Federal Reserve increased its target for the federal funds rate 17 times, from 1.00% to 5.25% during the period from June 30, 2004 to June 29, 2006. The target rate for federal funds remained at 5.25% until September 18, 2007 when the U.S. Federal Reserve began a series of nine rate reductions that lowered the target rate by 425 points to 1.00% on October 29, 2008. A sustained falling interest rate environment would negatively impact margins as the Bank has more interest earning assets that would adjust downward than interest-bearing liabilities that would adjust downward.

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

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

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

The FDIC, along with the Federal Reserve and the Office of the Comptroller of the Currency, has issued final guidance for financial institutions with concentrations in commercial real estate lending. The guidance provides that a bank has a concentration in commercial real estate lending if (i) total reported loans for construction, land development, and other land represent 100% or more of total capital or (ii) total reported loans secured by multi-family and non-farm residential properties and loans for construction, land development, and other land represent 300% or more of total capital and its construction loan portfolio has increase 50% or more during the prior 36 months. If a concentration is present, management must employ heightened risk management practices including board and management oversight and strategic planning, development of underwriting standards, risk assessment and monitoring through market analysis and stress testing, and increasing capital requirements. Based on the Bank's projected commercial real estate lending levels, it is considered to have a concentration in commercial real estate lending and must implement the practices outlined in the final guidance.

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

Our commercial business lending has increased since 2003 and we intend to continue to offer commercial business loans to small and medium sized businesses. Our ability to originate commercial business loans is determined by the demand for these loans and our ability to attract and retain qualified

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commercial lending personnel. Because payments on commercial business loans generally depend on the successful operation of the business involved, repayment of commercial business loans may be subject to a greater extent to adverse conditions in the economy than

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other types of lending. Although commercial business loans often have equipment, inventory, accounts receivable or other business assets as collateral, the sale of the collateral in the event the borrower does not repay the loan is often not sufficient to repay the loan because the collateral may be uncollectible and inventories and equipment may be obsolete or of limited use, among other things.

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

We rely on customer deposits and advances from the FHLB of Seattle and other borrowings to fund our operations. Although we have historically been able to replace maturing deposits and advances if desired, we may not be able to replace such funds in the future if our financial condition or the financial condition of the FHLB of Seattle or market conditions were to change. Our financial flexibility will be severely constrained if we are unable to maintain our access to funding or if adequate financing is not available to accommodate future growth at acceptable interest rates. Finally, if we are required to rely more heavily on more expensive funding sources to support future growth, our revenues may not increase proportionately to cover our costs. In this case, our profitability would be adversely affected.

Although we consider such sources of funds adequate for our liquidity needs, we may seek additional debt in the future to achieve our long-term business objectives. 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 growth and future prospects could be adversely affected.

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

We make various assumptions and judgments about the collectibility of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. In determining the amount of the allowance for loan losses, we review several factors including our loan loss and delinquency experience, underwriting practices, and economic conditions. If our assumptions are incorrect, our allowance for loan losses may not be sufficient to cover future losses in the loan portfolio, resulting in the need for greater additions to our allowance. Material additions to the allowance could materially decrease our net income. Our allowance for loan losses was 1.42% of total loans receivable (net) and 67.1% of non-performing loans at September 30, 2008.

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

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Our deposit insurance premiums are expected to increase substantially, which will adversely affect our profits.

Our deposit insurance premiums during fiscal 2008 totaled \$296,000. These premiums were, however, offset by \$166,000 in credits, leaving the net expense recorded for deposit insurance premiums during the year ended September 30, 2008 at \$130,000. These credits were fully depleted during the quarter ended June 30, 2008. Those premiums are expected to increase in 2009 due to recent strains on the FDIC deposit insurance fund due to the cost of large bank failures and increase in the number of troubled banks. The current rates for FDIC assessments have ranged from 5 to 43 basis points, depending on the health of the insured institution. The FDIC has proposed increasing that assessment range to 12 to 50 basis points for the first quarter of 2009. For the remainder of 2009, it has proposed a range of 10 to 45 basis points for institutions that do not trigger risk factors for brokered deposits and unsecured debt and higher rates for those that do trigger those risk factors. The FDIC also proposed that it could increase assessment rates in the future without formal rulemaking.

Competition with other financial institutions could adversely affect our profitability.

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

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

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

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

We believe that our success depends largely on the efforts and abilities of our senior management. Their experience and industry contacts significantly benefit us. The competition for qualified personnel in the financial services industry is intense, and the loss of any of our key personnel or an inability to continue to attract, retain and motivate key personnel could adversely affect our business.

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We are subject to extensive government regulation and supervision.

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

We rely heavily on the proper functioning of our technology.

We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer relationship management, general ledger, deposit, loan and other systems. While we have policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, such failures, interruptions or security breaches may still occur and, if they do occur, they may not 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 may not be able to negotiate terms that are as favorable to us, or 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.

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

The Company is a separate and distinct legal entity from its subsidiary. We receive substantially all of our revenue from dividends from our subsidiary. These dividends are the principal source of funds to pay dividends on our common stock and interest and principal on our debt. Various federal and/or state laws and regulations limit the amount of dividends that

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the Bank may pay to the Company. Also, our right to participate in a distribution of assets upon a subsidiary's liquidation or reorganization is subject to the prior claims of the subsidiary's creditors. In the event the Bank is unable to pay dividends to the Company, we may not be able to service our debt, pay obligations or pay dividends on our common stock. The inability to receive dividends from the Bank could have a material adverse effect on our business, financial condition and results of operations

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

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

Changes in accounting standards may affect our performance.

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

### Risks Related to the U.S. Financial Industry

Recently enacted legislation and other measures undertaken by the Treasury, the Federal Reserve and other governmental agencies to help stabilize the U.S. financial system or improve the housing market may not be successful.

On October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act of 2008 (the "EESA"), which, among other measures, authorized the Treasury Secretary to establish the Troubled Asset Relief Program ("TARP"). EESA gives broad authority to Treasury to purchase, manage, modify, sell and insure the troubled mortgage related assets that triggered the current economic crisis as well as other "troubled assets." EESA includes additional provisions directed at bolstering the economy, including:

- \* Authority for the Federal Reserve to pay interest on depository institution balances;
- \* Mortgage loss mitigation and homeowner protection;
- \* Temporary increase in FDIC insurance coverage from \$100,000 to

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\$250,000 through December 31, 2009; and

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- \* Authority to the SEC to suspend mark-to-market accounting requirements for any issuer or class of category of transactions.

Pursuant to the TARP, the Treasury has the authority to, among other things, purchase up to \$700 billion (of which \$250 billion is currently available) of mortgages, mortgage-backed securities and certain other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U.S. financial markets. In addition, the Treasury has created a capital purchase program, under the TARP pursuant to which it is providing access to capital to financial institutions through a standardized program to acquire preferred stock (accompanied by warrants) from eligible financial institutions that will serve as Tier I capital. The Company submitted an initial application for the sale of preferred shares equal to 3.0% of its risk-weighted assets.

EESA also contains a number of significant employee benefit and executive compensation provisions, some of which apply to employee benefit plans generally, and others which impose on financial institutions that participate in the TARP program restrictions on executive compensation.

EESA followed, and has been followed by, numerous actions by the Federal Reserve, Congress, Treasury, the SEC and others to address the currently liquidity and credit crisis that has followed the sub-prime meltdown that commenced in 2007. These measures include homeowner relief that encourage loan restructuring and modification; the establishment of significant liquidity and credit facilities for financial institutions and investment banks; the lowering of the federal funds rate, including a 50 basis point decrease on October 8, 2008; emergency action against short selling practices; a temporary guaranty program for money market funds; the establishment of a commercial paper funding facility to provide back-stop liquidity to commercial paper issuers; and coordinated international efforts to address illiquidity and other weaknesses in the banking sector.

In addition, the Internal Revenue Service has issued an unprecedented wave of guidance in response to the credit crisis, including a relaxation of limits on the ability of financial institutions that undergo an "ownership change" to utilize their pre-change net operating losses and net unrealized built-in losses. The relaxation of these limits may make significantly more attractive the acquisition of financial institutions whose tax basis in their loan portfolios significantly exceeds the fair market value of those portfolios.

On October 14, 2008, the FDIC announced the establishment of a temporary liquidity guarantee program to provide full deposit insurance for all non-interest bearing transaction accounts and guarantees of certain newly issued senior unsecured debt issued by FDIC-insured institutions and their holding companies. Insured institutions are automatically covered by this program for the period commencing October 14, 2008 and will continue to be covered as long as they do not opt out of the program by December 5, 2008. We did not opt out of the program. Under the program, the FDIC will guarantee timely payment of newly issued senior unsecured debt issued on or before June 30, 2009. The debt includes all newly issued unsecured senior debt (e.g., promissory notes, commercial paper and inter-bank funding). The aggregate coverage for an institution may not exceed 125% of its debt outstanding on

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September 30, 2008 that was scheduled to mature before June 30, 2009, or for certain insured institutions, 2% of liabilities as of September 30, 2008. The guarantee will extend to June 30, 2012 even if the maturity of the debt is after that date. Many details of the program still remain to be worked out.

The actual impact that EESA and such related measures undertaken to alleviate the liquidity and credit crisis will have generally on the financial markets, including the extreme levels of volatility and limited credit availability currently being experienced is unknown. The failure of such measures to help stabilize the financial markets and a continuation or worsening of current financial market conditions could materially and adversely affect our business, financial condition, results of operations, access to credit or the trading price of our common stock. The specific impact that such measures may have on us, and whether we will be eligible to obtain capital from the Treasury under the TARP program, is also unknown.

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Difficult market conditions have adversely affected our industry.

We are particularly exposed to downturns in the U.S. housing market. Dramatic declines in the housing market over the past year, with falling home prices and increasing foreclosures, unemployment and under-employment, have negatively impacted the credit performance of mortgage loans and resulted in significant write-downs of asset values by financial institutions, including government-sponsored entities, major commercial and investment banks, and regional financial institutions such as our Company. Reflecting concern about the stability of the financial markets generally and the strength of counterparties, many lenders and institutional investors have reduced or ceased providing funding to borrowers, including to other financial institutions. This market turmoil and tightening of credit have led to an increased level of commercial and consumer delinquencies, lack of consumer confidence, increased market volatility and widespread reduction of business activity generally. The resulting economic pressure on consumers and lack of confidence in the financial markets have adversely affected our business, financial condition and results of operations. We do not expect that the difficult conditions in the financial markets are likely to improve in the near future. A worsening of these conditions would likely exacerbate the adverse effects of these difficult market conditions on us and others in the financial institutions industry. In particular, we may face the following risks in connection with these events:

- \* We expect to face increased regulation of our industry. Compliance with such regulation may increase our costs and limit our ability to pursue business opportunities.
- \* Our ability to assess the creditworthiness of our customers may be impaired if the models and approaches we use to select, manage and underwrite our customers become less predictive of future behaviors.
- \* The analysis we use to estimate losses inherent in our credit exposure requires difficult, subjective and complex judgments. Forecasts of economic conditions and how these economic predictions might impair the ability of our borrowers to repay their loans, may no longer be capable of accurate estimation. This may impact the reliability of our analysis.

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- \* Our ability to borrow from other financial institutions on favorable terms, or at all, could be adversely affected by further disruptions in the capital markets or other events, including actions by rating agencies and deteriorating investor expectations.
- \* Competition in our industry could intensify as a result of the increasing consolidation of financial services companies in connection with current market conditions.
- \* We may be required to pay significantly higher deposit insurance premiums because market developments have significantly depleted the insurance fund of the FDIC and reduced the ratio of reserves to insured deposits.

Current levels of market volatility are unprecedented.

The capital and credit markets have been experiencing volatility and disruption for more than a year. In recent months, the volatility and disruption has reached unprecedented levels. In some cases, the markets have produced downward pressure on stock prices and credit availability for certain issuers without regard to those issuers' underlying financial strength. If current levels of market disruption and volatility continue or worsen our ability to access capital may be adversely affected which, in turn, could adversely affect our business, financial condition and results of operations.

### Item 1B. Unresolved Staff Comments

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Not applicable.

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### Item 2. Properties

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At September 30, 2008 the Bank operated 21 full service facilities and one loan production office. The following table sets forth certain information regarding the Bank's offices, all of which are owned, except for the Tacoma office, the Gig Harbor office, the Lacey office at 1751 Circle Lane SE, the Centralia loan production office, and the Check Processing Department office at 504 8th Street, which are leased.

Location	Year Opened	Approximate Square Footage	Deposits at September 30, 2008
(In thousands)			
<b>Main Office:</b>			
624 Simpson Avenue Hoquiam, Washington 98550	1966	7,700	\$111,367
<b>Branch Offices:</b>			
300 N. Boone Street Aberdeen, Washington 98520	1974	3,400	32,314
201 Main Street South Montesano, Washington 98563	2004	3,200	48,171



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361 Damon Road Ocean Shores, Washington 98569	1977	2,100	23,080
2418 Meridian East Edgewood, Washington 98371	1980	2,400	34,495
202 Auburn Way South Auburn, Washington 98002	1994	4,200	19,652
12814 Meridian East (South Hill) Puyallup, Washington 98373	1996	4,200	36,764
1201 Marvin Road, N.E. Lacey, Washington 98516	1997	4,400	13,169
101 Yelm Avenue W. Yelm, Washington 98597	1999	1,800	13,086
20464 Viking Way NW Poulsbo, Washington 98370	1999	3,400	6,947
2419 224th Street E. Spanaway, Washington 98387	1999	3,900	17,785
801 Trospen Road SW Tumwater, Washington 98512	2001	3,300	19,792
7805 South Hosmer Street Tacoma, Washington 98408	2001	5,000	10,177

(table continued on following page)

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Location -----	Year Opened -----	Approximate Square Footage -----	Deposits at September 30, 2008 ----- (In thousands)
2401 Bucklin Hill Road Silverdale, Washington 98383	2003	4,000	12,108
423 Washington Street SE Olympia, Washington 98501	2003	3,000	11,799
3105 Judson St Gig Harbor, Washington 98335	2004	2,700	7,276
117 N. Broadway Aberdeen, Washington 98520	2004	3,700	13,599
313 West Waldrip Elma, Washington 98541	2004	5,900	23,420
1751 Circle Lane SE Lacey, Washington 98503	2004	900	11,192

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101 2nd Street Toledo, Washington 98591	2004	1,800	17,640
209 NE 1st Street Winlock, Washington 98586	2004	3,400	14,739
Loan Production Office:			
1641 Kresky Avenue, Suite 2 Centralia, Washington 98531	2006	800	
Check Processing Facility:			
504 8th Street Hoquiam, Washington 98550	2003	5,400	
Loan Center/Data Center:			
120 Lincoln Street Hoquiam, Washington 98550	2003	6,000	
Other Properties:			
305 8th Street (1) Hoquiam, Washington 98550	2004	4,100	

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(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.

At September 30, 2008 the Bank operated 21 proprietary ATMs that are part of a nationwide cash exchange network.

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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. Submission of Matters to a Vote of Security Holders  
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No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended September 30, 2008.

PART II

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

The Company's common stock is traded on the Nasdaq Global Market under the symbol "TSBK." As of November 30, 2008, there were 6,980,329 shares of common stock issued and approximately 650 shareholders of record. The following table sets forth the market price range of the Company's common stock for the years ended September 30, 2008 and 2007. This information was provided by the Nasdaq Stock Market. All amounts have been adjusted to reflect the two-for-one stock split, paid in the form of a 100% stock dividend, on June 5, 2007.

	High	Low	Dividends
Fiscal 2008			
First Quarter.....	\$16.28	\$11.85	\$0.10
Second Quarter.....	13.00	10.55	0.11
Third Quarter.....	12.34	7.80	0.11
Fourth Quarter.....	9.40	5.90	0.11
Fiscal 2007			
First Quarter.....	\$18.94	\$17.48	\$0.09
Second Quarter.....	18.82	17.63	0.09
Third Quarter.....	18.61	15.70	0.09
Fourth Quarter.....	16.40	15.10	0.10

#### Dividends

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

#### Equity Compensation Plan Information

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

#### Stock Repurchases

The Company has had various buy-back programs since January 1998. On February 25, 2008, the Company announced a plan to repurchase 343,468 shares

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of the Company's common stock. This was the Company's 16th stock repurchase plan. As of September 30, 2008, the Company had not repurchased any shares under this plan. Cumulatively, the Company has repurchased 7,783,934 shares at an average price of \$8.98 per share. This represents 58.9% of the 13,225,000 shares that were issued when the Company went public in January 1998.

The following table sets forth the Company's repurchases of its outstanding Common Stock during the fourth quarter of the year ended September 30, 2008.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans
July 1, 2008 - July 31, 2008.....	--	--	--	343,468
August 1, 2008 - August 31, 2008.....	--	--	--	343,468
September 1, 2008 - September 30, 2008....	--	--	--	343,468
Total.....	--	--	--	343,468

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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 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, 2003.

[GRAPH APPEARS HERE]

	Period Ending					
Index	09-30-03	09-30-04	09-30-05	09-30-06	09-30-07	09-30-08

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Timberland Bancorp, Inc.....	\$100.00	100.64	102.06	158.11	143.99	72.34
NASDAQ Composite...	100.00	106.25	120.41	126.39	151.18	117.06
SNL \$250m-\$500 M Thrift Index.....	100.00	112.57	110.69	120.45	111.30	94.64
SNL \$500m-\$1 B Thrift Index.....	100.00	112.71	114.99	133.59	128.75	96.40

\* 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 subsidiaries at and for the dates indicated. The consolidated data is derived in part from, and should be read in conjunction with, the Consolidated Financial Statements of the Company and its subsidiary presented herein.

	At September 30,				
	2008	2007	2006	2005	2004
	(In thousands)				
SELECTED FINANCIAL CONDITION DATA:					
Total assets.....	\$681,883	\$644,848	\$577,087	\$552,765	\$460,419
Loans receivable and loans held for sale, net.....	557,687	515,341	424,645	388,109	344,594
Investment securities available-for-sale.....	--	50,851	63,805	65,860	41,560
Investment securities held-to-maturity.....	28	--	--	--	--
Mortgage-backed securities held-to-maturity.....	14,205	71	75	104	174
Mortgage-backed securities available-for-sale.....	17,098	13,047	17,603	23,735	18,329
FHLB Stock.....	5,705	5,705	5,705	5,705	5,682
Cash and due from financial institutions, interest-bearing deposits in banks and fed funds sold.....	42,874	16,670	22,889	28,718	19,833
Deposits.....	498,572	466,735	431,061	411,665	319,570
FHLB advances.....	104,628	99,697	62,761	62,353	65,421
Shareholders' equity.....	74,841	74,547	79,365	74,642	72,817

	Year Ended September 30,				
	2008	2007	2006	2005	2004
	(In thousands, except per share data)				

SELECTED OPERATING DATA:

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Interest and dividend income.....	\$43,338	\$41,944	\$35,452	\$30,936	\$26,571
Interest expense.....	16,413	15,778	10,814	8,609	7,325
Net interest income.....	26,295	26,166	24,638	22,327	19,246
Provision for loan losses...	3,900	686	--	141	167
Net interest income after provision for loan losses..	23,025	25,480	24,638	22,186	19,079
Non-interest income.....	4,178	5,962	6,244	6,073	4,576
Non-interest expense.....	20,374	19,451	18,896	18,536	15,575
Income before income taxes..	6,829	11,991	11,986	9,723	8,080
Federal income taxes.....	2,824	3,828	3,829	3,105	2,492
Net income.....	\$ 4,005	\$ 8,163	\$ 8,157	\$ 6,618	\$ 5,588
Earnings per share (1):					
Basic.....	\$ 0.62	\$ 1.20	\$ 1.16	\$ 0.95	\$ 0.77
Diluted.....	\$ 0.61	\$ 1.17	\$ 1.12	\$ 0.91	\$ 0.73
Dividends per share (1).....	\$ 0.43	\$ 0.37	\$ 0.33	\$ 0.31	\$ 0.29
Dividend payout ratio.....	74.33%	32.86%	30.55%	35.01%	41.52%

(1) Have 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.

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	At September 30,				
	2008	2007	2006	2005	2004
OTHER DATA:					
Number of real estate loans outstanding.....	3,261	3,295	3,005	3,022	2,857
Deposit accounts.....	53,501	53,166	51,392	51,496	40,348
Full-service offices.....	21	21	21	21	16

	At or For the Year Ended September 30,				
	2008	2007	2006	2005	2004
KEY FINANCIAL RATIOS:					
Performance Ratios:					
Return on average assets (1).....	0.61%	1.34%	1.47%	1.23%	1.24%
Return on average equity (2).....	5.35	10.67	10.59	9.08	7.52
Interest rate spread (3)....	3.98	4.18	4.49	4.30	4.30
Net interest margin (4).....	4.41	4.69	4.91	4.60	4.67
Average interest-earning assets to average interest-bearing liabilities.....	115.70	118.01	119.20	116.56	120.68
Noninterest expense as a					

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percent of average total assets.....	3.10	3.20	3.41	3.44	3.46
Efficiency ratio (5).....	65.50	60.54	61.19	65.27	65.38
Book value per share (6)....	\$10.74	\$10.72	\$10.56	\$ 9.93	\$ 9.38
Book value per share (7)....	11.34	11.39	11.22	10.65	10.14
Tangible book value per share (6) (8).....	9.79	9.73	9.61	8.93	9.38
Tangible book value per share (7) (8).....	10.34	10.34	10.21	9.58	10.14
Asset Quality Ratios:					
Non-accrual and 90 days or more past due loans as a percent of total loans receivable, net.....	2.12%	0.29%	0.02%	0.75%	0.41%
Non-performing assets as a percent of total assets (9).....	1.83	0.23	0.02	0.62	0.40
Allowance for loan losses as a percent of total loans receivable, net (10).....	1.44	0.92	0.96	1.05	1.14
Allowance for losses as a percent of non-performing loans (11).....	67.14	321.95	5,152.50	140.09	276.77
Net charge-offs (recoveries) to average outstanding loans.....	0.12	--	(0.01)	0.01	0.02
Capital Ratios:					
Total equity-to-assets ratio.....	10.98%	11.56%	13.75%	13.50%	15.82%
Tangible equity-to-assets ratio.....	10.00	10.49	12.51	12.15	15.82
Average equity to average assets (12).....	11.47	12.58	13.90	13.53	16.52

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

Item 7. Management's Discussion and Analysis of Financial Condition and  
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Results of Operations  
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MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

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

Special Note Regarding Forward-Looking Statements

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

Critical Accounting Policies 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 two policies, that as a result of judgments, estimates and assumptions inherent in those policies, are critical to an understanding of the Company's Consolidated Financial Statements. These policies relate to the methodology for the determination of the allowance for loan losses and the valuation of mortgage servicing rights ("MSRs"). These policies and the judgments, estimates and assumptions are described in greater detail in subsequent sections of Management's Discussion and Analysis contained herein and in the notes to the Consolidated Financial Statements contained in Item 8 of this Form 10-K. In particular, Note 1 of the Notes to Consolidated Financial Statements, "Summary of Significant Accounting Policies," generally describes the Company's accounting policies. Management believes that the judgments, estimates and assumptions used in the preparation of the Company's Consolidated Financial Statements are appropriate given the factual circumstances at the time. However, given the sensitivity of the



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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.

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**Mortgage Servicing Rights.** Mortgage servicing rights are capitalized when acquired through the origination of loans that are subsequently sold with servicing rights retained and are amortized to servicing income on loans sold in proportion to and over the period of estimated net servicing income. The value of MSR's 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 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 MSR's 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 MSR's fair value is limited by the conditions existing and assumptions as of the date made. Those assumptions may not be appropriate if they are applied at different times.

### New Accounting Pronouncements

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

### Operating Strategy

The Company is a 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. The primary elements of the Bank's operating strategy include:

**Diversify Primary Market Area by Expanding Branch Office Network.** In an effort to lessen its dependence on the Grays Harbor County market whose economy has historically been tied to the timber and fishing industries, the Bank has opened branch offices in Pierce, King, Thurston and Kitsap Counties.

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Pierce, King, Thurston and Kitsap Counties contain the Olympia, Bremerton, and Seattle-Tacoma metropolitan areas and their economies are more diversified with the presence of government, aerospace and computer technology industries. In October 2004, the Bank continued its geographic diversification by acquiring two branches in Lewis County as part of a seven-branch acquisition. In August 2008, the Bank announced plans to open an additional full-service branch in Lewis County. The Bank's existing loan production office in Lewis County will be consolidated into the new facility, which is expected to open in 2009.

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

**Emphasize Residential Mortgage Lending.** The Bank has historically attempted to establish itself as a niche lender in its primary market areas by focusing a part of its lending activities on the origination of loans secured by one-to four-family residential dwellings, including loans for the construction of residential dwellings. In an effort to meet the credit needs of borrowers in its primary market areas, the Bank originates one- to four-family mortgage loans that do not qualify for sale in the secondary market under FHLMC guidelines. The Bank has also been an active participant in the secondary market, originating residential loans for sale to the FHLMC on a servicing retained basis. The Bank occasionally retains fixed-rate one- to four-family mortgage loans in its portfolio for yield and asset-liability management purposes.

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**Emphasize the Origination of Commercial Real Estate and Commercial Business Loans.** The Bank has hired additional commercial loan officers since 2006 for the purpose of increasing the Bank's origination of commercial real estate and commercial business loans.

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

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

### Market Risk and Asset and Liability Management

**General.** Market risk is the risk of loss from adverse changes in market prices and rates. The Company's market risk arises primarily from interest rate risk inherent in its lending, investment, deposit and borrowing

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activities. The Bank, like other financial institutions, is subject to interest rate risk to the extent that its interest-earning assets reprice differently than its interest-bearing liabilities. Management actively monitors and manages its interest rate risk exposure. Although the Bank manages other risks, such as credit quality and liquidity risk, in the normal course of business management considers interest rate risk to be its most significant market risk that could potentially have the largest material effect on the Bank's financial condition and results of operations. The Bank does not maintain a trading account for any class of financial instruments nor does it engage in hedging activities. 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 risk rate risk and balance sheet management services. Based on a rate shock analysis prepared by FIMAC, an immediate increase in interest rates of 200 basis points would increase the Bank's projected net interest income by approximately 5.7%, 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 7.0%, 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, 2008, adjustable-rate mortgage loans constituted \$216.1 million or 58.6%, of the Bank's total mortgage loan portfolio due after

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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 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, 2008, the construction and land development, and consumer loan portfolios amounted to \$186.3 million and \$59.3 million, or 30.5% and 9.7% 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, 2008.

Projected Interest Rate Scenario	Net Interest Income(1) (2)			Current Market Value		
	Estimated Value	\$ Change from Base	% Change from Base	Estimated Value	\$ Change from Base	% Change from Base
(Dollars in thousands)						
+300	\$26,633	\$ 2,059	8.38%	\$80,443	\$(7,750)	(8.79)%
+200	25,981	1,407	5.72	82,749	(5,444)	(6.17)
+100	25,330	756	3.07	85,849	(2,344)	(2.66)
BASE	24,574	--	--	88,193	--	--
-100	23,906	(668)	(2.72)	87,030	(1,163)	(1.32)
-200	22,844	(1,730)	(7.04)	84,869	(3,324)	(3.77)
-300	21,942	(2,632)	(10.71)	82,193	(6,000)	(6.80)

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(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 3.8% decrease in NPV and a 7.0% decrease in net interest income. In the event of a 200 basis point increase in interest rates, a 6.2% decrease in NPV and a 5.7% increase in net interest income would be expected. Based upon the modeling described above, the Bank's asset and liability structure generally results in decreases in net interest income in a declining interest rate scenario and increases in net interest income in a rising rate scenario. This structure also generally results in decreases in NPV in rising and declining rate scenarios.

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

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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, 2008 and September 30, 2007

The Company's total assets increased by \$37.1 million, or 5.7%, to \$681.9 million at September 30, 2008 from \$644.8 million at September 30, 2007, primarily attributable to a \$42.4 million increase in net loans receivable and a \$26.2 million increase in cash equivalents. These increases were partially offset by a \$32.7 million decrease in investment and mortgage-backed securities. This asset growth was primarily funded by a \$31.9 million increase in deposits and a \$4.9 million increase in FHLB advances.

The Company's capital increased by \$294,000, or 0.4%, to \$74.8 million at September 30, 2008 from \$74.5 million at September 30, 2007, primarily as a result of retained net income and proceeds from the exercise of stock options, reduced by the payment of cash dividends and share repurchases. The Company remains well capitalized with a total capital to risk-weighted assets ratio of 13.6% at September 30, 2008.

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

**Cash Equivalents:** Cash equivalents increased by \$26.2 million or 157.2% to \$42.9 million at September 30, 2008 from \$16.7 million at September 30, 2007. The increase was primarily reflected in a \$21.7 million increase in federal funds sold as the Company increased its liquidity position.

**Investment Securities and Mortgage-backed Securities and FHLB Stock:** Investment and mortgage-backed securities (including FHLB stock) decreased by \$32.7 million or 46.8% to \$37.0 million at September 30, 2008 from \$69.7 million at September 30, 2007, primarily as the result of the maturity or call of U.S. agency securities, the redemption of mutual funds, and regular amortization and prepayments on mortgage-backed securities. In June 2008, the Company redeemed its \$29.1 million investment in the AMF family of mutual funds for the underlying securities and cash, and recorded a loss of \$2.8 million. The Company used the proceeds from the security maturities and prepayments to fund loan growth rather than reinvesting into investment securities. 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."

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Loans Receivable and Loans Held for Sale, Net of Allowance for Loan Losses: Net loans receivable, including loans held for sale, increased by \$42.4 million or 8.2% to \$557.7 million at September 30, 2008 from \$515.3 million at September 30, 2007. The increase in the portfolio was primarily a result of a \$22.4 million increase in construction loans (net of the undisbursed portion of construction loans in process), an \$18.4 million increase in commercial real estate loans, a \$9.9 million increase in one- to four-family mortgage loans, and a \$2.9 million increase in commercial business loans. These increases were partially offset by a \$9.2 million decrease in multi-family loans.

Loan originations (including participation interests purchased) decreased by 12.7% to \$261.4 million for the year ended September 30, 2008 from \$299.4 million for the year ended September 30, 2007. The decrease in loan originations was primarily a result of lower demand for financing in the Bank's market areas due to a slowing economy and a tightening in the Bank's underwriting standards. The Bank sold \$45.3 million in fixed rate one- to four-family mortgage loans during the year ended September 30, 2008 compared to \$29.9 million for the fiscal year ended September 30, 2007. For additional information on loans, see "Item 1. Business - Lending Activities" and Note 4 of the Notes to Consolidated Financial Statements contained in "Item 8. Financial Statements and Supplementary Data."

Premises and Equipment: Premises and equipment increased by \$309,000 to \$16.9 million at September 30, 2008 from \$16.6 million at September 30, 2007. The increase was primarily as a result of the purchase of land for the Bank's new branch facility that will be constructed in Lewis County, and remodeling costs associated with several branch offices. These increases were partially offset by depreciation and the sale of a building in Grays Harbor County that previously served as a branch facility. For additional information on premises and equipment, see "Item 2. Properties"

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and Note 6 of the Notes to Consolidated Financial Statements contained in "Item 8. Financial Statements and Supplementary Data."

Other Real Estate Owned ("OREO"): OREO and other repossessed items totaled \$511,000 at September 30, 2008 and consisted of one single family residence in Pierce County and two vehicles. The Company did not have any OREO or other repossessed items at September 30, 2007. For additional information on OREOs, see "Item 1. Business - Lending Activities - Non-performing 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"): Goodwill and CDI decreased by \$249,000 to \$6.6 million at September 30, 2008 from \$6.9 million at September 30, 2007 due to scheduled amortization of CDI. The Company recorded goodwill and CDI in connection with the October 2004 acquisition of seven branches and related deposits. The Company performed its annual review of goodwill as of June 30, 2008 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."

Deposits: Deposits increased by \$31.9 million, or 6.8%, to \$498.6 million at September 30, 2008 from \$466.7 million at September 30, 2007, primarily due to a \$22.3 million increase in money market accounts, a \$10.1 million increase

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in N.O.W. checking accounts, and a \$2.5 million increase in certificates of deposit accounts. These increases were partially offset by a \$3.0 million decrease in non-interest bearing accounts. The increase in money market accounts was partially a result of a \$10.5 million short-term deposit by a commercial customer that was transferred out of the deposit base and into the Bank's Certificate of Deposit Registry Service ("CDARS") program in early October 2008. 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."

**FHLB Advances and Other Borrowings:** FHLB advances and other borrowings increased by \$5.1 million, or 5.1%, to \$105.4 million at September 30, 2008 from \$100.3 million at September 30, 2007 as the Bank used additional advances to fund loan portfolio growth. For additional information on borrowings, see "Item 1. Business - Deposit Activities and Other Sources of Funds - Borrowings" and Notes 10 and 11 of the Notes to Consolidated Financial Statements contained in "Item 8. Financial Statements and Supplementary Data."

**Shareholders' Equity:** Total shareholders' equity increased by \$294,000, or 0.4%, to \$74.8 million at September 30, 2008 from \$74.5 million at September 30, 2007, primarily as a result net income of \$4.0 million and proceeds from the exercise of stock options of \$857,000 and a \$323,000 net increase in the fair value of investment securities available for sale. These increases to shareholders' equity were partially offset by the payment of \$3.0 million in cash dividends to shareholders and share repurchases of \$1.9 million.

During the year ended September 30, 2008 the Company repurchased 144,950 shares of its common stock for \$1.9 million (an average price of \$13.26 per share.) The Company had 343,468 shares remaining to be purchased on its existing stock repurchase plan at September 30, 2008. Cumulatively, the Company has repurchased 7,783,934 shares (58.9%) of the 13,225,000 shares that were issued in its 1998 initial public offering, at an average price of \$8.98 per share. For additional information 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, 2008 and 2007

The Company's net income decreased by \$4.16 million, or 50.9%, to \$4.01 million for the year ended September 30, 2008 from \$8.16 million for the year ended September 30, 2007. The decrease was primarily as a result of increased provision for loan losses, decreased non-interest income due to a loss on the redemption of mutual funds, and increased non-interest expenses, which were partially offset by increased net interest income. Diluted earnings per share decreased by 47.9% to \$0.61 for the year ended September 30, 2008 from \$1.17 for the year ended September 30, 2007.

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The increased provision for loan losses was primarily a result of an increase in the level of non-performing loans, an increase in the level of performing loans classified as substandard under the Bank's loan grading system, loan portfolio growth, and uncertainties in the housing market in certain markets of the Pacific Northwest. Net charge-offs were \$647,000 during the year ended September 30, 2008, which was equivalent to 0.12% of the

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average outstanding loans.

The decreased non-interest income was primarily a result of a \$2.82 million loss on the sale of securities, as the Company redeemed its investment in the AMF family of mutual funds in June 2008. This loss was partially offset by increased income from service charges on deposit accounts and increased income from loan sales.

The increased non-interest expense was primarily a result of increased employee costs and increased deposit related expenses. The increased salary and employee 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 implemented during the year.

The increased net interest income was primarily a result of a larger interest earning asset base due to an increased loan portfolio. The increase in net interest income attributable to a larger interest earning asset base was, however, partially offset by a decrease in the Company's net interest margin.

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

**Net Income:** Net income for the year ended September 30, 2008 decreased by \$4.16 million, or 50.9%, to \$4.01 million, or \$0.61 per diluted share (\$0.62 per basic share) from \$8.16 million, or \$1.17 per diluted share (\$1.20 per basic share) for the year ended September 30, 2007. The \$0.56 decrease in diluted earnings per share for the year ended September 30, 2008 was primarily the result of a \$2.82 million (\$2.59 million net of income tax - \$0.39 per diluted share) charge from the redemption of the Company's investment in the AMF family of mutual funds, a \$3.21 million (\$2.12 million net of income tax - \$0.30 per diluted share) increase in the provision for loan losses, and a \$923,000 (\$609,000 net of income tax - \$0.08 per diluted share) increase in non-interest expense. These items were partially offset by a \$759,000 (\$501,000 net of income tax - \$0.07 per diluted share) increase in net interest income, a \$1.04 million (\$688,000 net of income tax - \$0.10 per diluted share) increase in non-interest income, excluding the mutual fund redemption charge, and a lower number of weighted average shares outstanding which increased diluted earnings per share by approximately \$0.04.

**Net Interest Income:** Net interest income increased by \$759,000, or 2.9%, to \$26.93 million for the year ended September 30, 2008 from \$26.17 million for the year ended September 30, 2007, primarily due to a larger interest earning asset base due to an increased loan portfolio. Total interest and dividend income increased by \$1.39 million to \$43.34 million for the year ended September 30, 2008 from \$41.94 million for the year ended September 30, 2007 as average total interest earning assets increased by \$52.84 million. The yield on interest earning assets decreased to 7.09% for the year ended September 30, 2008 from 7.51% for the year ended September 30, 2007. Total interest expense increased by \$635,000 to \$16.41 million for the year ended September 30, 2008 from \$15.78 million for the year ended September 30, 2007 as average interest bearing liabilities increased by \$55.09 million. The average rate paid on interest bearing liabilities decreased to 3.11% for the year ended September 30, 2008 from 3.33% for the year ended September 30, 2007.

The increase in net interest income attributable to a larger interest earning asset base was, however, partially offset by a compression of the Company's net interest margin. The net interest margin decreased 28 basis points to 4.41% for the year ended September 30, 2008 from 4.69% for the year ended September 30, 2007 as the yield on interest earnings assets decreased at



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a greater rate than funding costs were 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.

**Provision for Loan Losses:** The provision for loan losses increased by \$3.21 million, or 468.5%, to \$3.90 million for the year ended September 30, 2008 from \$686,000 for the year ended September 30, 2007. The increased

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provision for loan losses was primarily a result of an increase in non-performing loans, an increase in the level of performing loans classified as substandard under the Bank's loan grading system, loan portfolio growth, and uncertainties in the housing market in certain markets of the Pacific Northwest. The Bank had a net charge-off of \$647,000 for the year ended September 30, 2008 compared to a net charge-off of \$11,000 for the year ended September 30, 2007. The net charge-offs to average outstanding loans ratio was 0.12% for the year ended September 30, 2008 and 0.002% for the year ended September 30, 2007.

The Bank has established a comprehensive methodology for determining the provision for loan losses. On a quarterly basis the Bank performs an analysis taking into consideration pertinent factors underlying the quality of the loan portfolio. These factors include changes in the size and composition of the loan portfolio, historical loss experience for various loan segments, changes in economic conditions, delinquency rates, a detailed analysis of individual loans on non-accrual status, and other factors to determine the level of allowance for loan losses needed. Management's analysis, however, for the year ended September 30, 2008, placed a greater emphasis on the Bank's construction and land development portfolio and the effect of various factors such as geographic and loan type concentrations. The Bank also reviewed the national trend of declining home sales with potential housing market value depreciation. The allowance for loan losses increased \$3.25 million to \$8.05 million at September 30, 2008 from \$4.80 million at September 30, 2007. The increased level of the allowance for loan losses was primarily attributable to an increase in non-performing loans, an increase in the level of performing loans classified as substandard under the Bank's grading system, loan portfolio growth, and uncertainties in the housing market and economy.

Based on the comprehensive methodology, management deemed the allowance for loan losses of \$8.05 million at September 30, 2008 (1.42% of loans receivable and 67.1% of non-performing loans) adequate to provide for probable losses based on an evaluation of known and inherent risks in the loan portfolio at that date. While the Bank believes it has established its existing allowance for loan losses in accordance with GAAP, there can be no assurance that regulators, in reviewing the Bank's loan portfolio, will not request the Bank to increase significantly its allowance for loan losses. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is adequate or that substantial increases will not be necessary should the quality of any loans deteriorate. Any material increase in the allowance for loan losses would adversely affect the Bank's financial condition and results of operations. For additional information, see "Item 1. Business - Lending Activities - Allowance for Loan Losses."

**Non-interest Income:** Total non-interest income decreased by \$1.78 million, or 29.9%, to \$4.18 million for the year ended September 30, 2008 from \$5.96 million for the year ended September 30, 2007, primarily due to a \$2.82

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million loss on the redemption of investments in the AMF family of mutual funds.

Non-interest income, excluding the mutual fund redemption loss increased by \$1.04 million, or 17.4%, to \$7.0 million for the year ended September 30, 2008 from \$5.96 million from the year ended September 30, 2007. This increase was primarily a result of a \$717,000 increase in service charges on deposit accounts and a \$240,000 increase in income from loan sales (gain on sale of loans and servicing income on loans sold). The increase in service charges on deposit accounts was primarily a result of implementing a new automated overdraft decision system during the year and increasing the fee charged for overdrafts. The increase in income from loan sales was primarily a result of an increase in the dollar value of fixed rate one- to four-family mortgage loans sold during the year. The sale of fixed rate one-to four-family mortgage loans totaled \$45.3 million for the year ended September 30, 2008 compared to \$29.9 million for the year ended September 30, 2007.

Non-interest Expense: Total non-interest expense increased by \$923,000, or 4.7%, to \$20.37 million for the year ended September 30, 2008 from \$19.45 million for the year ended September 30, 2007. The increase was primarily attributable to a \$641,000 increase in salary and benefit expenses and a \$269,000 increase in deposit related expenses. Salary and benefit expenses increased primarily as a result of annual salary adjustments and increased health insurance expenses. Deposit related expenses increased primarily as a result of the expenses associated with several new deposit related programs implemented during the year and an increase in FDIC insurance expense recorded as the Bank's credit with the FDIC was fully depleted during the quarter ended June 30, 2008.

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The Company's efficiency ratio increased to 65.50% for the year ended September 30, 2008 from 60.54% for the year ended September 30, 2007. The efficiency ratio, excluding the mutual fund redemption loss, was 60.06% for the year ended September 30, 2008.

Provision for Income Taxes: The provision for income taxes decreased by \$1.01 million to \$2.82 million for the year ended September 30, 2008 from \$3.83 million for the year ended September 30, 2007 primarily as a result of lower income before taxes. The provision for income taxes for the year ended September 30, 2008 was also impacted by the \$2.82 million loss on the redemption of mutual funds. The redemption of the mutual funds resulted in a capital loss which can only be deducted for tax purposes to the extent that capital gains are realized within a three year carry back period and a five year carry forward period. The Company has estimated that it will have \$679,000 in capital gains during the allowable tax period to offset the capital loss. Therefore \$2.14 million of the \$2.82 million loss has been treated as non-deductible for tax purposes. The Company's effective tax rate was 41.35% (or 31.65% exclusive of the mutual fund redemption loss and associated tax impact) for the year ended September 30, 2008 and 31.92% for the year ended September 30, 2007.

Comparison of Operating Results for the Years Ended September 30, 2007 and 2006

The Company's net income was nearly identical at \$8.16 million for the years ended September 30, 2007 and 2006 as increased net interest income was offset by increased non-interest expense, increased provision for loan losses,

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and decreased non-interest income. Diluted earnings per share, however, increased by 4.5% to \$1.17 for the year ended September 30, 2007 from \$1.12 for the year ended September 30, 2006. The increased earnings per diluted share were primarily a result of a decrease in the weighted average number of shares outstanding as a result of share repurchases.

The increased net interest income was primarily a result of a larger interest earning asset base due to an increased loan portfolio. The increase in net interest income attributable to a larger interest earning asset base was, however, partially offset by a decrease in the Company's net interest margin.

The increased provision for loan losses was primarily the result of a larger loan portfolio and an increase in the level of loans classified as substandard. Net charge-offs remained low at only \$11,000 during the year ended September 30, 2007, which is equivalent to 0.002% of average outstanding loans.

The increased non-interest expense was primarily a result of increased employee costs and increased advertising expenses. The increased salary and employee benefit expenses were primarily because of a larger employee base and annual salary adjustments, and the increased advertising expenses were primarily the result of additional advertising campaigns.

The decreased non-interest income was primarily a result of decreased income from service charges on deposit accounts and decreased fee income from the sale of non-deposit investment products.

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

**Net Income:** Net income for the year ended September 30, 2007 increased by \$6,000 to \$8.16 million, or \$1.17 per diluted share (\$1.20 per basic share) from \$8.16 million, or \$1.12 per diluted share (\$1.16 per basic share) for the year ended September 30, 2006. The \$0.05 increase in diluted earnings per share for the year ended September 30, 2007 was primarily the result of a \$1.53 million (\$1.01 million net of income tax - \$0.14 per diluted share) increase in net interest income and a lower number of weighted average shares outstanding which increased diluted earnings per share by approximately \$0.05. These items were partially offset by a \$686,000 (\$439,000 net of income tax - \$0.06 per diluted share) increase in the provision for loan losses, a \$555,000 (\$366,000 net of income tax - \$0.05 per diluted share) increase in non-interest expense and a \$282,000 (\$186,000 net of income tax - \$0.03 per diluted share) decrease in non-interest income.

**Net Interest Income:** Net interest income increased by \$1.53 million to \$26.17 million for the year ended September 30, 2007 from \$24.64 million for the year ended September 30, 2006, primarily due to a larger interest

earning asset base due to an increased loan portfolio. Total interest and dividend income increased by \$6.49 million to \$41.94 million for the year ended September 30, 2007 from \$35.45 million for the year ended September 30, 2006 as average total interest earning assets increased by \$56.10 million. The yield on interest earning assets increased to 7.51% for the year ended September 30, 2007 from 7.06% for the year ended September 30, 2006. Total interest expense increased by \$4.96 million to \$15.78 million for the year

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ended September 30, 2007 from \$10.81 million for the year ended September 30, 2006 as average interest bearing liabilities increased by \$51.79 million. The average rate paid on interest bearing liabilities increased to 3.33% for the year ended September 30, 2007 from 2.57% for the year ended September 30, 2006.

The increase in net interest income attributable to a larger interest earning asset base was, however, partially offset by a compression of the Company's net interest margin. The net interest margin decreased 22 basis points to 4.69% for the year ended September 30, 2007 from 4.91% for the year ended September 30, 2006 as funding costs increased at a greater rate than yields increased on interest earning assets. This was primarily due to an increased reliance on wholesale funding (FHLB advances and brokered deposits) and increased competition for deposits in the Company's primary market areas, which increased overall funding costs. Also factoring into the decrease in this year's net interest margin was the collection of prepayment penalties and non-accrual interest last year which increased the net interest margin for the year ended September 30, 2006 by approximately 10 basis points.

**Provision for Loan Losses:** The provision for loan losses increased to \$686,000 for the year ended September 30, 2007 compared to no provision made during the year ended September 30, 2006. The provision for loan losses increased primarily due to an increase in the loan portfolio and an increase in the level of loans classified as substandard. The Bank had a net charge-off of \$11,000 for the year ended September 30, 2007 compared to a net recovery of \$23,000 for the year ended September 30, 2006. The net charge-offs (recoveries) to average outstanding loans ratio was 0.002% for the year ended September 30, 2007 and (0.006%) for the year ended September 30, 2006.

The Bank has established a comprehensive methodology for determining the provision for loan losses. On a quarterly basis the Bank performs an analysis taking into consideration pertinent factors underlying the quality of the loan portfolio. These factors include changes in the size and composition of the loan portfolio, historical loss experience for various loan segments, changes in economic conditions, delinquency rates, a detailed analysis of individual loans on non-accrual status, and other factors to determine the level of allowance for loan losses needed. The allowance for loan losses increased \$675,000 to \$4.80 million at September 30, 2007 from \$4.12 million at September 30, 2006. The increased level of the allowance for loan losses was primarily attributable to a larger loan portfolio (loans receivable and loans held for sale), which increased by \$90.7 million to \$515.3 million at September 30, 2007 from \$424.6 million at September 30, 2006. Also contributing to the increased allowance was an increase in the level of loans classified as substandard.

Based on the comprehensive methodology, management deemed the allowance for loan losses of \$4.80 million at September 30, 2007 (0.92% of loans receivable and 321.9% of non-performing loans) adequate to provide for probable losses based on an evaluation of known and inherent risks in the loan portfolio at that date. While the Bank believes it has established its existing allowance for loan losses in accordance with GAAP, there can be no assurance that regulators, in reviewing the Bank's loan portfolio, will not request the Bank to increase significantly its allowance for loan losses. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, there can be no assurance that the existing allowance for loan losses is adequate or that substantial increases will not be necessary should the quality of any loans deteriorate. Any material increase in the allowance for loan losses would adversely affect the Bank's financial condition and results of operations. For additional information, see "Item 1. Business - Lending Activities - Allowance for Loan Losses."

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Non-interest Income: Total non-interest income decreased by \$282,000 to \$5.96 million for the year ended September 30, 2007 from \$6.24 million for the year ended September 30, 2006, primarily due to a \$205,000 decrease in service charges on deposits and a \$166,000 decrease in fees from the sale of non-deposit investment products, and a \$30,000 decrease in gain on sale of loans. The decrease in income from service charges on deposits was primarily a result of a decrease in the number of customer overdrafts. The decrease in gross fees received from that sale of non-deposit investment products was primarily due to decreased sales and a change in the fee structure with the Bank's

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third-party vendor. These decreases were partially offset by a \$112,000 increase in ATM transaction fees and an \$80,000 increase in servicing income on loans sold.

Non-interest Expense: Total non-interest expense increased by \$555,000 to \$19.45 million for the year ended September 30, 2007 from \$18.90 million for the year ended September 30, 2006. Non-interest expense increased in the current year primarily due to a \$184,000 increase in salary and benefit expenses, a \$155,000 increase in advertising expenses, a \$69,000 increase in ATM expenses, a \$49,000 increase in premises and equipment expense and smaller increases in several other expense categories. The increased salary and benefit expenses were primarily due to a larger employee base and annual salary adjustments and the increased advertising expenses were a result of additional advertising campaigns. Also contributing to the increase in non-interest expense was a \$143,000 change in the other real estate operations expense category. This change was primarily due to larger gains on the sale of OREO properties that were included in this category during the 2006 fiscal year.

These increases to non-interest expense were partially offset by a \$143,000 decrease in professional fees. The decrease in professional fees was primarily a result of decreased consulting, legal, and audit related expenses.

The Company's efficiency ratio improved to 60.54% for the year ended September 30, 2007 from 61.19% for the year ended September 30, 2006.

Provision for Income Taxes: The provision for income taxes remained at \$3.83 million for the years ended September 30, 2007 and 2006. The Company's effective tax rate was 31.92% for the year ended September 30, 2007 and 31.95% for the year ended September 30, 2006.

### Average Balances, Interest and Average Yields/Cost

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

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

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	Year Ended September 30,							
	2008			2007			2006	
	Average Balance	Interest and Dividends	Yield/ Cost	Average Balance	Interest and Dividends	Yield/ Cost	Average Balance	Inter an Divid
	(Dollars in thousands)							
Interest-earning assets:								
Loans receivable (1) (2) ..	\$552,318	\$40,924	7.41%	\$477,029	\$38,386	8.04%	\$399,811	\$31,
Mortgage-backed and investment securities...	19,799	1,064	5.37	37,411	1,529	4.09	55,373	2,
FHLB stock and equity securities.....	29,201	1,123	3.85	37,347	1,692	4.53	36,882	1,
Federal funds sold.....	8,318	191	2.30	5,030	260	5.17	8,414	
Interest-bearing deposits.....	1,499	36	2.40	1,481	77	5.17	1,714	
	-----	-----		-----	-----		-----	-----
Total interest-earning assets.....	611,135	43,338	7.09	558,298	41,944	7.51	502,194	35,
Non-interest-earning assets.....	47,086			49,483			52,037	
	-----			-----			-----	
Total assets.....	\$658,221			\$607,781			\$554,231	
	=====			=====			=====	
Interest-bearing liabilities:								
Savings accounts.....	\$ 56,461	398	0.70	\$ 60,124	425	0.71%	\$ 62,255	
Money market accounts....	51,943	1,249	2.40	46,013	1,186	2.58	43,204	
NOW accounts.....	86,441	774	0.90	82,323	638	0.77	91,507	
Certificates of deposit..	224,493	9,342	4.16	199,046	9,043	4.55	168,578	6,
Short-term borrowings (3).....	14,321	615	4.29	35,206	1,954	5.55	4,664	
Long-term borrowings (4).....	94,537	4,035	4.27	50,393	2,532	5.02	51,109	2,
	-----	-----		-----	-----		-----	-----
Total interest bearing liabilities.....	528,196	16,413	3.11	473,105	15,778	3.33	421,317	10,
Non-interest bearing liabilities.....	55,150			58,179			55,870	
	-----			-----			-----	
Total liabilities.....	583,346			531,284			477,187	
Shareholders' equity.....	74,875			76,497			77,044	
	-----			-----			-----	
Total liabilities and shareholders'								

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equity.....	\$658,221 =====	\$607,781 =====	\$554,231 =====
Net interest income.....	\$26,925 =====	\$26,166 =====	\$24, =====
Interest rate spread.....	3.98% =====	4.18% =====	
Net interest margin (5)...	4.41% =====	4.69% =====	
Ratio of average interest-earning assets to average interest- bearing liabilities.....	115.70% =====	118.01% =====	

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- (1) Does not include interest on loans 90 days or more past due. Includes loans originated for Amortized net deferred loan fees, late fees, extension fees and prepayment penalties (2008, 2007, \$1,794; and 2006, \$2,137) included with interest and dividends.
  - (2) Average balance includes nonaccrual loans.
  - (3) Includes FHLB advances and PCBB advances with original maturities of less than one year and short-term borrowings-repurchase agreements.
  - (4) Includes FHLB advances with original maturities of one year or greater.
  - (5) Net interest income divided by total average interest earning assets.

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

Year Ended September 30, 2008 Compared to Year Ended September 30, 2007			Year Ended September 30, 2007 Compared to Year Ended September 30, 2006		
Increase (Decrease) Due to			Increase (Decrease) Due to		
Rate	Volume	Net Change	Rate	Volume	Net Change
-----	-----	-----	-----	-----	-----
(In thousands)					

Interest-earning assets:						
Loans receivable (1)...	\$ (3,201)	\$ 5,739	\$ 2,538	\$ 793	\$ 6,196	\$ 6,989
Investments and mortgage-backed						

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securities.....	391	(856)	(465)	(11)	(118)	(129)
FHLB stock and equity securities.....	(233)	(336)	(569)	2	(3)	(1)
Federal funds sold.....	(188)	119	(69)	(38)	(585)	(623)
Interest-bearing deposits.....	(42)	1	(41)	237	19	256
Total net change in income on interest-earning assets.....	(3,273)	4,667	1,394	983	5,509	6,492
Interest-bearing liabilities:						
Savings accounts.....	(1)	(26)	(27)	--	(17)	(17)
NOW accounts.....	103	33	136	(3)	(43)	(46)
Money market accounts..	(83)	146	63	424	51	475
Certificate accounts...	(798)	1,097	299	2,356	619	2,975
Short-term borrowings..	(370)	(969)	(1,339)	47	1,689	1,736
Long-term borrowings...	(430)	1,933	1,503	(123)	(36)	(159)
Total net change in expense on interest-bearing liabilities....	(1,579)	2,214	635	2,701	2,263	4,964
Net change in net interest income.....	\$(1,694)	\$2,453	\$ 759	\$(1,718)	\$3,246	\$1,528

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

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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, 2008, the Bank's regulatory liquidity ratio (net cash, and short-term and marketable assets, as a percentage of net deposits and short-term liabilities) was 9.77%. At September 30, 2008, the Bank maintained an uncommitted credit facility with the FHLB-Seattle that provided for immediately available advances up to an aggregate amount equal to 30% of total assets, limited by available collateral, under which \$104.6 million was outstanding. The Bank also maintained a \$10.0 million overnight borrowing line with PCBB. At September 30, 2008, the Bank did not have an outstanding balance on this borrowing line.

Liquidity management is both a short and long-term responsibility of the



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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, which includes construction and land development loans. During the years ended September 30, 2008, 2007 and 2006, the Bank originated \$223.9 million, \$235.7 million and \$215.8 million of mortgage loans, respectively. At September 30, 2008, the Bank had loan commitments totaling \$40.6 million and undisbursed loans in process totaling \$43.4 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, 2008 totaled \$175.8 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, 2008, 2007 and 2006, the Bank sold \$45.3 million \$29.9 million and \$26.4 million in fixed rate, one- to four-family mortgage loans, respectively. The Bank also sold \$17.0 million in participation loans during the year ended September 30, 2008. During the years ended September 30, 2008, 2007, and 2006, the Bank received \$176.1 million, \$164.9 million and \$177.0 million in principal repayments, respectively.

The Bank's liquidity has been impacted by increases in deposit levels. During the years ended September 30, 2008, 2007 and 2006, deposits increased by \$31.8 million, \$35.7 million and \$19.4 million, respectively.

Investment and mortgage-backed securities, federal funds sold, and interest bearing deposits in other banks decreased to \$60.2 million at September 30, 2008 from \$69.8 million at September 30, 2007.

Federally-insured state-chartered banks are required to maintain minimum levels of regulatory capital. Under current FDIC regulations, insured state-chartered banks generally must maintain (i) a ratio of Tier 1 leverage capital to total assets of at least 3.0% (4.0% to 5.0% for all but the most highly rated banks), (ii) a ratio of Tier 1 capital to risk weighted assets of at least 4.0% and (iii) a ratio of total capital to risk weighted assets of at least 8.0%. At September 30, 2008, the Bank was in compliance with all applicable capital requirements. 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, 2008, the Company's significant fixed and determinable contractual obligations, within the categories described below, by payment date or contractual maturity. These contractual obligations, except for the operating lease obligations are included in the Consolidated Balance Sheet. The payment amounts represent those amounts contractually due at September 30, 2008.

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Payments due by period					
	Within 1 year	After 1 year through 3 years	After 3 years through 5 years	After 5 years	Total
(In thousands)					
Contractual obligations					
Short-term debt obligations...	\$ 758	\$ --	\$ --	\$ --	\$ 758
Long-term debt obligations....	4,628	40,000	10,000	50,000	104,628
Operating lease obligations...	228	286	134	--	648
Capital lease obligations.....	6	--	--	--	6
Total contractual obligations.....	\$5,620	\$40,286	\$10,134	\$50,000	\$106,040
	=====	=====	=====	=====	=====

### 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

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

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### Item 8. Financial Statements and Supplementary Data

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#### 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

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permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

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

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, 2008. Management's assessment of the effectiveness of the Company's internal control over financial reporting has been audited by McGladrey & Pullen, LLP, an independent registered public accounting firm, as stated in their report which is included herein.

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McGladrey & Pullen  
Certified Public Accountants

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

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

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

We have audited Timberland Bancorp, Inc.'s internal control over financial reporting as of September 30, 2008, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Timberland Bancorp, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the

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circumstances. We believe that our audit provides a reasonable basis for our opinion.

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

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

In our opinion, Timberland Bancorp, Inc. maintained, in all material respects, effective internal control over financial reporting as of September 30, 2008, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the annual consolidated financial statements of Timberland Bancorp, Inc. and Subsidiary and our report dated December 8, 2008, expressed an unqualified opinion.

/s/McGladrey & Pullen, LLP

Seattle, Washington  
December 8, 2008

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### TIMBERLAND BANCORP, INC. AND SUBSIDIARY

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McGladrey & Pullen  
Certified Public Accountants

Report of Independent Registered Public Accounting Firm

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

We have audited the consolidated balance sheets of Timberland Bancorp, Inc. and Subsidiary as of September 30, 2008 and 2007, and the related consolidated statements of income, shareholders' equity, cash flows and comprehensive income for each of the three years in the period ended September 30, 2008. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits 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, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2008, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Timberland Bancorp, Inc. and Subsidiary's internal control over financial reporting as of September 30, 2008, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated December 8, 2008, expressed an unqualified opinion on the effectiveness of Timberland Bancorp, Inc. and Subsidiary's internal control over financial reporting.

/s/McGladrey & Pullen, LLP

Seattle, Washington  
December 8, 2008

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Consolidated Balance Sheets

(Dollars in Thousands)

Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

	2008	2007
<b>Assets</b>		
Cash equivalents:		
Cash and due from financial institutions	\$ 14,013	\$ 10,813
Interest-bearing deposits in other banks	3,431	2,082
Federal funds sold	25,430	3,775
	42,874	16,670
Investments and mortgage-backed securities - held to maturity (market value \$11,974 and \$70)	14,233	71
Investments and mortgage-backed securities - available for sale	17,098	63,898
Federal Home Loan Bank ("FHLB") stock (at cost)	5,705	5,705
Loans receivable, net of allowance for loan losses of \$8,050 and \$4,797	555,914	514,584
Loans held for sale	1,773	757
	557,687	515,341
Premises and equipment, net	16,884	16,575
Other real estate owned ("OREO") and other repossessed items	511	-
Accrued interest receivable	2,870	3,424
Bank owned life insurance ("BOLI")	12,902	12,415
Goodwill	5,650	5,650
Core deposit intangible ("CDI")	972	1,221
Mortgage servicing rights	1,306	1,051
Other assets	3,191	2,827
Total assets	\$681,883	\$644,848
<b>Liabilities and shareholders' equity</b>		
<b>Liabilities</b>		
Deposits:		
Demand, non-interest-bearing	\$ 51,955	\$ 54,962
Interest-bearing	446,617	411,773
Total deposits	498,572	466,735
FHLB advances	104,628	99,697
Other borrowings: repurchase agreements	758	595
Other liabilities and accrued expenses	3,084	3,274
Total liabilities	607,042	570,301
Commitments and contingencies (See Note 17)	-	-
<b>Shareholders' equity</b>		
Preferred stock, \$0.01 par value; 50,000,000 shares		

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authorized; none issued	- -	- -
Common stock, \$0.01 par value; 50,000,000 shares authorized;		
2008 - 6,967,579 shares issued and outstanding		
2007 - 6,953,360 shares issued and outstanding	70	70
Additional paid-in capital	8,602	9,923
Unearned shares issued to Employee Stock Ownership Plan ("ESOP")	(2,776)	(3,040)
Retained earnings	69,406	68,378
Accumulated other comprehensive loss	(461)	(784)
Total shareholders' equity	74,841	74,547
Total liabilities and shareholders' equity	\$681,883	\$644,848
See notes to consolidated financial statements.		

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Consolidated Statements of Income

(Dollars in Thousands, Except Per Share Amounts)

Timberland Bancorp, Inc. and Subsidiary

Years Ended September 30, 2008, 2007 and 2006

	2008	2007	2006
Interest and dividend income			
Loans receivable	\$40,924	\$38,386	\$31,397
Investments and mortgage-backed securities	1,064	1,529	2,152
Dividends from mutual funds and FHLB stock	1,123	1,692	1,436
Interest-bearing deposits in banks	227	337	467
Total interest and dividend income	43,338	41,944	35,452
Interest expense			
Deposits	11,763	11,292	7,905
FHLB advances - short term	593	1,905	169
FHLB advances - long term	4,035	2,532	2,691
Other borrowings	22	49	49
Total interest expense	16,413	15,778	10,814
Net interest income	26,925	26,166	24,638
Provision for loan losses	3,900	686	- -
Net interest income after provision for loan losses	23,025	25,480	24,638
Non-interest income			
Service charges on deposits	3,493	2,776	2,981
ATM transaction fees	1,251	1,138	1,026
BOLI net earnings	486	464	449
Gain on sale of loans, net	432	356	386
Loss on sale/redemption of mutual funds, net	(2,822)	- -	- -
Servicing income on loans sold	669	505	425
Escrow fees	9	92	120
Fee income from non-deposit investment sales	124	120	286
Other	536	511	571
Total non-interest income	4,178	5,962	6,244
Non-interest expense			
Salaries and employee benefits	11,569	10,928	10,744

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Premises and equipment	2,307	2,452	2,403
Advertising	897	843	688
OREO and other repossessed items expense (income)	(3)	(13)	(156)
ATM expenses	576	497	428
Postage and courier	514	478	486
Amortization of CDI	249	285	328
State and local taxes	622	571	564
Professional fees	678	650	793
Other	2,965	2,760	2,618
Total non-interest expense	20,374	19,451	18,896
Income before federal income taxes	6,829	11,991	11,986
Federal income taxes	2,824	3,828	3,829
Net income	\$ 4,005	\$ 8,163	\$ 8,157
Earnings per share			
Basic	\$ 0.62	\$ 1.20	\$ 1.16
Diluted	0.61	1.17	1.12

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, 2008, 2007 and 2006

	Common Shares	Stock Amount	Additional Paid-in Capital	Unearned Shares Issued to ESOP	Retained Earnings	Accumulat Other Compre- hensive Income (Loss)
Balance, September 30, 2005	7,519,874	\$ 38	\$22,040	(\$3,833)	\$57,268	(\$871)
Net income	--	--	--	--	8,157	--
Issuance of Management Recognition & Development Plan ("MRDP") shares	12,000	--	--	--	--	--
Repurchase of common stock	(217,200)	(1)	(3,700)	--	--	--
Exercise of stock options	200,678	1	1,827	--	--	--
Cash dividends (\$.33 per share)	--	--	--	--	(2,492)	--
Earned ESOP shares and tax effect	--	--	480	528	--	--
MRDP compensation expense	--	--	3	--	--	--
Stock option compensation exp.	--	--	50	--	--	--
Unrealized holding loss on securities available for sale, net of tax	--	--	--	--	--	(130)
Balance, September 30, 2006	7,515,352	\$ 38	\$20,700	(\$3,305)	\$62,933	(\$1,001)



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Net income	- -	- -	- -	- -	8,163	- -
Stock split	- -	36	- -	- -	(36)	- -
Issuance of MRDP shares	15,080	- -	- -	- -	- -	- -
Repurchase of common stock	(687,542)	(4)	(12,427)	- -	- -	- -
Exercise of stock options	110,470	- -	1,207	- -	- -	- -
Cash dividends (\$.37 per share)	- -	- -	- -	- -	(2,682)	- -
Earned ESOP shares and tax effect	- -	- -	354	265	- -	- -
MRDP compensation expense	- -	- -	64	- -	- -	- -
Stock option compensation exp.	- -	- -	25	- -	- -	- -
Unrealized holding gain on securities available for sale, net of tax	- -	- -	- -	- -	- -	217
Balance, September 30, 2007	6,953,360	\$ 70	\$ 9,923	(\$3,040)	\$68,378	(\$ 784)
Net income	- -	- -	- -	- -	4,005	- -
Issuance of MRDP shares	20,315	- -	- -	- -	- -	- -
Repurchase of common stock	(144,950)	(1)	(1,920)	- -	- -	- -
Exercise of stock options	138,854	1	856	- -	- -	- -
Cash dividends (\$.43 per share)	- -	- -	- -	- -	(2,977)	- -
Earned ESOP shares and tax effect	- -	- -	(409)	264	- -	- -
MRDP compensation expense	- -	- -	147	- -	- -	- -
Stock option compensation exp.	- -	- -	5	- -	- -	- -
Unrealized holding gain on securities available for sale, net of tax	- -	- -	- -	- -	- -	323
Balance, September 30, 2008	6,967,579	\$ 70	\$ 8,602	(\$2,776)	\$69,406	(\$ 461)

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, 2008, 2007 and 2006

	2008	2007	2006
Cash flows from operating activities			
Net income	\$ 4,005	\$ 8,163	\$ 8,157
Non-cash revenues, expenses, gains and losses included in net income:			
Depreciation	1,100	1,038	998
Deferred federal income taxes	(1,217)	(101)	226
Amortization of CDI	249	285	328
Earned ESOP shares	264	265	528
MRDP compensation expense	131	59	7
Stock option compensation expense	5	25	50
Stock option tax effect	15	464	607
Less stock option excess tax benefit	(11)	(354)	(494)

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Loss on redemption of mutual funds	2,600	- -	- -
Loss on sale of mutual funds	222	- -	- -
Write-down on securities held-to-maturity	4	- -	- -
Gain on sale of OREO and other repossessed items, net	(47)	(19)	(158)
Gain on sale of loans	(432)	(356)	(386)
Gain on sale of premises and equipment	(288)	(71)	(37)
Provision for loan losses	3,900	686	- -
Loans originated for sale	(45,853)	(27,845)	(26,153)
Proceeds from sale of loans held for sale	45,269	29,893	26,445
BOLI net earnings	(486)	(464)	(449)
Net change in accrued interest receivable and other assets, and other liabilities and accrued expenses	520	(275)	(1,906)
Net cash provided by operating activities	9,950	11,393	7,763
Cash flows from investing activities			
Net decrease in CDs held for investment	- -	100	100
Activity in securities held to maturity:			
Maturities and prepayments	579	3	27
Activity in securities/mutual funds available for sale:			
Maturities and prepayments	22,862	17,806	7,960
Proceeds from sales	6,929	- -	- -
Increase in loans receivable, net	(46,413)	(93,316)	(36,398)
Additions to premises and equipment	(1,495)	(1,135)	(1,924)
Proceeds from sale of OREO and other repossessed items	926	105	680
Proceeds from the disposition of premises and equipment	374	323	95
Net cash used by investing activities	(16,238)	(76,114)	(29,460)

(continued)

See notes to consolidated financial statements.

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Consolidated Statements of Cash Flows

(concluded) (Dollars in Thousands)

Timberland Bancorp, Inc. and Subsidiary  
Years Ended September 30, 2008, 2007 and 2006

	2008	2007	2006
Cash flows from financing activities			
Increase in deposits	\$ 31,837	\$ 35,674	\$ 19,396
Proceeds from FHLB advances - long term	50,000	60,000	10,000
Repayment of FHLB advances - long term	(15,069)	(24,064)	(30,592)
Net increase (decrease) in FHLB advances - short term	(30,000)	1,000	21,000
Net increase (decrease) in repurchase agreements	163	(352)	166
Proceeds from exercise of stock options	841	744	1,221
Earned ESOP shares and tax effect	(409)	354	480

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MRDP compensation tax effect	16	5	(4)
Stock option excess tax benefit	11	354	494
Repurchase of common stock	(1,921)	(12,431)	(3,701)
Payment of dividends	(2,977)	(2,682)	(2,492)
Net cash provided by financing activities	32,492	58,602	15,968
Net increase (decrease) in cash equivalents	26,204	(6,119)	(5,729)
Cash equivalents			
Beginning of year	16,670	22,789	28,518
End of year	\$ 42,874	\$ 16,670	\$ 22,789
Supplemental disclosures of cash flow information			
Income taxes paid	\$ 4,120	\$ 3,646	\$ 3,755
Interest paid	16,656	15,426	10,496
Supplemental disclosures of non-cash investing and financing activities			
Market value adjustment of securities held for sale, net of tax	\$ 323	\$ 217	(\$ 130)
Loans transferred to OREO and other repossessed items	1,404	71	28
Shares issued to MRDP	259	263	195
Loans to facilitate sale of OREO	257	- -	- -
Mutual funds redeemed for mortgage-backed securities	22,188	- -	- -

See notes to consolidated financial statements.

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Consolidated Statements of Comprehensive Income

(Dollars in Thousands)

Timberland Bancorp, Inc. and Subsidiary  
Years Ended September 30, 2008, 2007 and 2006

	2008	2007	2006
Comprehensive income			
Net income	\$4,005	\$8,163	\$8,157
Unrealized holding gain (loss) on securities available for sale, net of tax	323	217	(130)
Total comprehensive income	\$4,328	\$8,380	\$8,027

See notes to consolidated financial statements.

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

Note 1 - Summary of Significant Accounting Policies

Principles of Consolidation

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

Nature of Operations

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

Consolidated Financial Statement Presentation

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

Certain prior year amounts have been reclassified to conform to the 2008 presentation with no change to net income or shareholders' equity previously reported.

Stock Split

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

Segment Reporting

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

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

Note 1 - Summary of Significant Accounting Policies (continued)

#### Investments and Mortgage-Backed Securities - Available for Sale

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

Declines in the fair value of individual securities available for sale below their cost that are other than temporary would result in write-downs of the individual securities that are recognized in the statement of income as realized losses. Management evaluates individual securities for other than temporary impairment on a quarterly basis based on the securities' current credit quality, interest rates, term to maturity and management's intent and ability to hold the securities until the net book value is recovered. Management considers an investment security to be other than temporarily impaired if the decline in fair value is due to credit quality deterioration which management believes will affect repayment of the investment principal, or if for any other reason the Company does not have the ability and intent to hold the investment until the decline in fair value recovers.

#### Investments and Mortgage-Backed Securities - Held to Maturity

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

Declines in the fair value of individual securities held to maturity below

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their cost that are other than temporary would result in write-downs of the individual securities to their fair value. Management evaluates individual securities for other than temporary impairment on a quarterly basis based on the securities' current credit quality, interest rates, term to maturity and management's intent and ability to hold the securities until the net book value is recovered. Management considers an investment security to be other than temporarily impaired if the decline in fair value is due to credit quality deterioration which management believes will affect repayment of the investment principal, or if for any other reason the Company does not have the ability and intent to hold the investment until the decline in fair value recovers. Any other than temporary declines in fair value are recognized in the statement of income as realized losses.

In addition, the Company accounts for mortgage-backed securities in its portfolio that did not have a "AA" rating or higher at the time of acquisition in accordance with the Emerging Issues Task Force ("EITF") 99-20, Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets.

### Federal Home Loan Bank Stock

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

### Loans Held for Sale

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

(continued)

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

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

##### Loans Receivable

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

##### Troubled Debt Restructured Loans

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A troubled debt restructured loan is a loan 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, renewals and rewrites. A troubled debt restructured loan would generally be considered impaired.

### 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 terms of the loan agreement.

### 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 estimate the fair value of loan collateral and the existence of potential alternative sources of repayment. The allowance consists of specific, general and unallocated components. The specific component relates to loans that are deemed impaired. For such loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the recorded value of that loan. The general component covers non-classified loans and classified loans that are not evaluated individually for impairment and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio. The appropriateness of the allowance for losses on loans is estimated based upon these factors and trends identified by management at the time financial statements are prepared.

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

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Notes to Consolidated Financial Statements

Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

Note 1 - Summary of Significant Accounting Policies (continued)

Allowance for Loan Losses (continued)

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

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

Interest on Loans and Loan Fees

Interest on loans is accrued daily based on the principal amount outstanding. For impaired loans, accrual of interest is discontinued on a loan when management believes, after considering collection efforts and other factors that the borrower's financial condition is such that collection of interest is doubtful, and in no event when the loan is more than 90 days past due (based on contractual terms.) All interest accrued but not collected for loans that are placed on nonaccrual 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 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

Mortgage servicing rights are capitalized when acquired through the



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origination of loans that are subsequently sold with the servicing rights retained and are amortized to servicing income on loans sold in proportion to and over the period of estimated net servicing income. The value of mortgage servicing rights at the date of the sale of loans is determined based on the discounted present value of expected future cash flows using key assumptions for servicing income and costs and prepayment rates on the underlying loans. The estimated fair value is periodically evaluated for impairment by comparing actual cash flows and estimated future cash flows from the servicing assets to those estimated at the time servicing assets were originated. Fair values are estimated using discounted cash flows based on current market rates of interest. For purposes of measuring impairment, the rights must be stratified by one or more predominant risk characteristics of the underlying loans. The Company stratifies its capitalized mortgage servicing rights based on product type, interest rate and term of the underlying loans. The amount of impairment recognized is the amount, if any, by which the amortized cost of the rights for each stratum exceed their fair value.

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

Bank-owned life insurance 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, 2008 and 2007

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

#### Goodwill

Goodwill is initially recorded when the purchase price paid for an acquisition exceeds the estimated fair value of the net identified tangible and intangible assets acquired. Goodwill is presumed to have an indefinite useful life and is analyzed annually for impairment. An annual review is performed at the end of the third quarter of each fiscal year, or more frequently if indicators of potential impairment exist, to determine if the recorded goodwill is impaired. If the fair value of the reporting unit exceeds the recorded value of the reporting unit, goodwill is not considered impaired and no additional analysis is necessary. As of June 30, 2008 the fair value of the reporting unit exceeded the recorded value. As of September 30, 2008, there have been no events or changes in the circumstances that would indicate a potential impairment.

#### 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

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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.

### Other Real Estate Owned and Other Repossessed Items

Other real estate owned and other repossessed items consist of properties or assets acquired through or in lieu of foreclosure, and are recorded initially at the 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.

### 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.

(continued)

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## Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

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

#### Income Taxes

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

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

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In June 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109 ("FIN 48"). The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Company adopted the provisions of FIN 48 on October 1, 2007. As of September 30, 2008 the Company recorded a liability of \$25,000 for unrecognized taxes related to various state income tax matters. It is the Company's policy to record any penalties or interest arising from federal or state taxes as a component of non-interest expense.

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

### Employee Stock Ownership Plan

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

### Cash Equivalents and Cash Flows

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

### Advertising

Costs for advertising and marketing are expensed as incurred.

(continued)

## Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

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

#### Stock-Based Compensation

The Company accounts for stock based compensation in accordance with SFAS No.

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123(Revised), Share Based Payment, which requires measurement of the compensation cost for all stock-based awards based on the grant-date fair value and recognition of compensation cost over the service period of stock-based awards.

The fair value of stock options is determined using the Black-Scholes valuation model, which is consistent with the Company's valuation methodology previously utilized for options in footnote disclosure required under SFAS No. 123, Accounting for Stock-Based Compensation. The fair value of stock grants under the Management Recognition and Development Plan ("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.

### Earnings Per Share

Basic earnings per share exclude dilution and are computed by dividing net income by the weighted average number of common shares outstanding. Diluted earnings per share reflect the potential dilution that could occur if common shares were issued under the Company's stock option plans and MRDP unless such options are anti-dilutive.

### Recent Accounting Pronouncements

In February 2007, the FASB issued SFAS No. 159, The Fair Value Options for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 ("SFAS 159"). This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The Company adopted SFAS 159 on October 1, 2008 and does not expect it to have a material impact on the Company's Consolidated Financial Statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ("SFAS 157"), which defines fair value, establishes a framework for measuring fair value under Generally Accepted Accounting Principles ("GAAP"), and expands disclosures about fair value measurements. This Statement expands other accounting pronouncements that require or permit fair value measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company adopted SFAS 157 on October 1, 2008 and does not expect it to have a material impact on the Company's Consolidated Financial Statements.

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

(continued)

Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

Note 1 - Summary of Significant Accounting Policies (concluded)

Recent Accounting Pronouncements (concluded)

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

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 amount of the reserve requirement balance for the years ended September 30, 2008 and 2007 was approximately \$676,000 and \$679,000, respectively.

Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

Note 3 - Investments and Mortgage-Backed Securities

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

	Gross	Gross	
Amortized	Unrealized	Unrealized	Fair

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	Cost	Gains	Losses	Value
September 30, 2008				
Held to Maturity				
Mortgage-backed securities	\$14,205	\$ 8	(\$2,267)	\$11,946
U.S. agency securities	28	- -	- -	28
Total	\$14,233	\$ 8	(\$2,267)	\$11,974
Available for Sale				
Mortgage-backed securities	\$16,806	\$ 52	(\$696)	\$16,162
Mutual funds	1,000	- -	(64)	936
Total	\$17,806	\$ 52	(\$760)	\$17,098
September 30, 2007				
Held to Maturity				
Mortgage-backed securities	\$ 71	\$- -	(\$1)	\$ 70
Available for Sale				
Mortgage-backed securities	\$13,148	\$ 31	(\$131)	\$13,048
Mutual funds	32,938	- -	(1,063)	31,875
U.S. agency securities	19,000	- -	(25)	18,975
Total	\$65,086	\$ 31	(\$1,219)	\$63,898

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

Description of Securities	Less Than Fair Value	12 Months Unrealized Losses	12 Months Fair Value	or Longer Unrealized Losses	Total Fair Value	Unrealized Losses
Mutual funds	\$ - -	\$ - -	\$ 936	(\$64)	\$ 936	(\$64)
Mortgage-backed securities	25,011	(2,961)	117	(2)	25,128	(2,961)
U.S. agency securities	- -	- -	- -	- -	- -	- -
Total	\$25,011	(\$2,961)	\$1,053	(\$66)	\$26,064	(\$3,027)

(continued)

Notes to Consolidated Financial Statements

Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

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

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The Company has evaluated these securities and has determined that the decline in their value is temporary and is not related to any specific company event. 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 intent to hold the investments until the market value recovers.

Mortgage-backed and agency securities pledged as collateral for public fund deposits, federal treasury tax and loan deposits, FHLB collateral, retail repurchase agreements and other non-profit organization deposits totaled \$23,001,000 and \$31,869,000 at September 30, 2008 and 2007, respectively.

The contractual maturities of debt securities at September 30, 2008, are as follows (in thousands). Expected maturities may differ from scheduled maturities due to the prepayment of principal or call provisions. Maturities for mortgage-backed securities are based on the last payment due date.

	Held to Maturity		Available for Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due within one year	\$ - -	\$ - -	\$ - -	\$ - -
Due after one year to five years	15	15	635	576
Due after five to ten years	72	71	278	283
Due after ten years	14,146	11,888	15,893	15,303
Mutual funds	- -	- -	1,000	936
Total	\$14,233	\$11,974	\$17,806	\$17,098

There were no gross realized gains on sales of securities for the years ended September 30, 2008, 2007 and 2006. Gross realized losses on sale and redemption of mutual funds classified as available for sale were \$2,822,000 and gross realized losses on impaired securities held-to-maturity were \$4,000 for the year ended September 30, 2008. There were no gross realized losses on sales of securities for the years ended September 30, 2007 and 2006. During the quarter ended June 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.

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

Note 4 - Loans Receivable and Loans Held for Sale

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

	2008	2007
Mortgage loans:		
One- to four-family	\$110,526	\$101,677
Multi-family	25,927	35,157
Commercial	146,223	127,866
Construction and land development	186,344	186,261
Land	60,701	60,706
Total mortgage loans	529,721	511,667
Consumer loans:		
Home equity and second mortgage	48,690	47,269
Other	10,635	10,922
Total consumer loans	59,325	58,191
Commercial business loans	21,018	18,164
Total loans receivable	610,064	588,022
Less:		
Undisbursed portion of construction loans in process	43,353	65,673
Deferred loan origination fees	2,747	2,968
Allowance for loan losses	8,050	4,797
	54,150	73,438
Loans receivable, net	555,914	514,584
Loans held for sale (one- to four-family)	1,773	757
Total loans receivable and loans held for sale	\$557,687	\$515,341

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, 2008 and 2007. These loans were performing according to their terms at September 30, 2008 and 2007. Activity in related party loans during the years ended September 30 is as follows (in thousands):

	2008	2007
Balance, beginning of year	\$2,786	\$2,622
New loans	486	490
Repayments	(221)	(326)
Balance, end of year	\$3,051	\$2,786

(continued)



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

At September 30, 2008, 2007 and 2006, the Bank had impaired loans totaling approximately \$13,647,000, \$1,490,000 and \$80,000 respectively. At September 30, 2008, 2007 and 2006, no loans were 90 days or more past due and still accruing interest. Interest income recognized on impaired loans for the years ended September 30, 2008, 2007 and 2006 was \$41,000, \$58,000 and \$384,000 respectively. Interest income recognized on a cash basis on impaired loans for the years ended September 30, 2008, 2007 and 2006 was \$21,000, \$58,000 and \$384,000, respectively. The average investment in impaired loans for the years ended September 30, 2008, 2007 and 2006 was \$6,955,000, \$623,000 and \$1,938,000 respectively. The Bank had \$272,000 in trouble debt restructured loans that were included in impaired loans as of September 30, 2008. There were no trouble debt restructured loans as of September 30, 2007 and 2006. There were no commitments to lend additional funds on trouble debt restructured loans for the years ended September 30, 2008, 2007 and 2006.

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

	2008	2007	2006
Balance, beginning of year	\$4,797	\$4,122	\$4,099
Provision for loan losses	3,900	686	-
Loans charged off	(648)	(12)	(2)
Recoveries	1	1	25
Net recovery (charge-off)	(647)	(11)	23
Balance, end of year	\$8,050	\$4,797	\$4,122

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

	2008	2007	2006
Impaired loans without a valuation allowance	\$ 8,872	\$ 490	\$ 80
Impaired loans with a valuation allowance	4,775	1,000	-
	\$13,647	\$1,490	\$ 80
Valuation allowance related to impaired loans	\$ 790	\$ 75	\$-

### Note 5 - Loan Servicing

Loans serviced for the Federal Home Loan Mortgage Corporation and others are not included on the consolidated balance sheets. The principal amounts of those loans at September 30, 2008, 2007 and 2006 were \$175,619,000, \$161,565,000 and \$156,187,000, respectively.

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

	2008	2007	2006
Balance, at beginning of year	\$1,051	\$ 932	\$ 928
Additions	578	391	241
Amortization	(323)	(272)	(237)
Balance, end of year	\$1,306	\$1,051	\$ 932

(continued)

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## Notes to Consolidated Financial Statements

Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

## Note 5 - Loan Servicing (concluded)

At September 30, 2008, 2007 and 2006, the fair value of mortgage servicing rights totaled \$1,818,000, \$1,958,000 and \$1,891,000, respectively. The fair values for 2008, 2007, and 2006 were estimated using premium rates of 10.60%, 9.58% and 9.59%, and prepayment speed factors of 214, 194 and 204, respectively. There was no valuation allowance at September 30, 2008, 2007 or 2006.

## Note 6 - Premises and Equipment

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

	2008	2007
Land	\$ 4,333	\$ 3,760
Buildings and improvements	14,229	14,260
Furniture and equipment	5,899	6,302
Property held for future expansion	111	40
Construction and purchases in progress	299	160
	24,871	24,522
Less accumulated depreciation	7,987	7,947
Total premises and equipment	\$16,884	\$16,575

The Bank leases premises under operating leases. Rental expense of leased premises was \$241,000, \$242,000, and \$207,000 for September 30, 2008, 2007 and 2006, 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):

2009	\$228
2010	219
2011	67
2012	67
2013	67
Thereafter	--
Total minimum payments required	\$648

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, 2008 and 2007

## Note 7 - Other Real Estate Owned and Other Repossessed Items

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

	2008	2007
Real estate acquired through foreclosure	\$ 508	- -
Items acquired through repossession	3	- -
 Total other real estate owned and other repossessed items	 \$ 511	 - -

## 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 \$972,000 and \$1,221,000 at September 30, 2008 and 2007, respectively. Amortization expense related to the core deposit intangible for the years ended September 30, 2008, 2007 and 2006 was \$249,000, \$285,000 and \$328,000, respectively.

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

2009	\$217
2010	190
2011	167
2012	148
2013	131
Thereafter	119
 Total	 \$972

## Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

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### Note 9 - Deposits

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

	2008	2007
Non-interest-bearing	\$ 51,955	\$ 54,962
NOW checking	90,468	80,372
Savings	56,391	56,412
Money market accounts	70,379	48,068
Certificates of deposit	203,420	202,844
Certificates of deposit - brokered	25,959	24,077
 Total deposits	 \$498,572	 \$466,735

Certificates of deposit of \$100,000 or greater totaled \$73,107,000 and \$67,316,000 at September 30, 2008 and 2007, respectively.

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

2009	\$175,817
2010	46,407
2011	1,629
2012	1,576
2013	3,554
Thereafter	396
 Total	 \$229,379

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

	2008	2007	2006
NOW checking	\$ 774	\$ 638	\$ 684
Savings	398	425	442
Money market accounts	1,250	1,186	711
Certificates of deposit	8,480	8,818	6,068
Certificates of deposit - brokered	861	225	-
 Total	 \$11,763	 \$11,292	 \$7,905

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

#### Note 10 - Other Borrowings - Repurchase Agreements

Other borrowings at September 30, 2008 and 2007 consisted of overnight

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repurchase agreements with customers totaling \$758,000 and \$595,000, respectively.

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

	2008	2007
Average daily balance during the period	\$ 943	\$1,019
Average daily interest rate during the period	2.12%	4.61%
Maximum month-end balance during the period	\$1,884	\$4,460
Weighted average rate at end of period	1.05%	4.42%
Securities underlying the agreements at the end of period:		
Recorded value	\$1,614	\$1,701
Fair value	1,614	1,701

The securities underlying the agreements at September 30, 2008 were under the Company's control in safekeeping at third-party financial institutions.

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

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

	2008	2007
Short-term	\$ - -	\$30,000
Long-term	104,628	69,697
 Total	 \$104,628	 \$99,697

The long-term borrowings mature at various dates through September 2017 and bear interest at rates ranging from 3.49% to 5.54%. Advances totaling \$4,628,000 have monthly payments aggregating \$6,000 plus interest. Under the Advances, Security and Deposit Agreement, virtually all of the Bank's assets, not otherwise encumbered, are pledged as collateral for advances. Principal reductions due for future years ending September 30 are as follows (in thousands):

2009		\$ 4,628
2010		20,000
2011		20,000
2012		10,000
2013		- -
Thereafter		50,000
		\$104,628

(continued)

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

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

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

The Bank also maintains a short-term \$10,000,000 overnight borrowing line with Pacific Coast Banker's Bank. The borrowing line may be reduced or withdrawn at any time. As of September 30, 2008 and 2007, the Bank did not have any outstanding advances on this borrowing line.

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

	2008	2007
Average daily balance during the period	\$13,378	\$34,187
Average daily interest rate during the period	4.44%	5.58%
Maximum month-end balance during the period	\$42,600	\$72,750
Weighted average rate at end of the period	- -	5.19%

Note 12 - Other Liabilities and Accrued Expenses

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

	2008	2007
Accrued deferred compensation and profit sharing plans payable	\$ 454	\$ 605
Accrued interest payable on deposits, FHLB advances and other borrowings	1,135	1,378
Accounts payable and accrued expenses - other	1,495	1,291
 Total other liabilities and accrued expenses	 \$3,084	 \$3,274

Note 13 - Federal Income Taxes

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

	2008	2007	2006
Current	\$4,041	\$3,929	\$3,603
Deferred	(1,217)	(101)	226
 Total federal income taxes	 \$2,824	 \$3,828	 \$3,829

(continued)

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

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

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

	2008	2007
Prepaid federal income taxes	\$ 525	\$1,154
Net deferred tax assets	1,945	884
Total	\$2,470	\$2,038

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

	2008	2007
<b>Deferred Tax Assets</b>		
Accrued interest on loans	\$ 5	\$ 1
Accrued vacation	115	106
Deferred compensation	54	69
Unearned ESOP shares	450	438
Allowance for loan losses	2,822	1,679
CDI	226	189
Unearned MRDP shares	61	26
Net unrealized securities losses	248	404
Capital loss carry-forward	928	-
Stock option compensation expense	21	20
Total deferred tax assets	4,930	2,932
<b>Deferred Tax Liabilities</b>		
FHLB stock dividends	906	906
Depreciation	262	243
Goodwill	527	396
Certificate of deposit valuation	21	23
Mortgage servicing rights	457	368
Prepaid expenses	122	112
Total deferred tax liabilities	2,295	2,048
Valuation allowance for capital loss on sale of securities	(690)	-
Net deferred tax assets	\$1,945	\$ 884

The Company has a capital loss carry forward in the amount of \$2,643,000 that will expire in 2013.

## Notes to Consolidated Financial Statements

Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

## Note 13 - Federal Income Taxes (concluded)

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

	2008		2007		2006	
	Amount	Percent	Amount	Percent	Amount	Percent
Taxes at statutory rate	\$2,390	35.0%	\$4,197	35.0%	\$4,195	35.0%
BOLI income	(170)	(2.5)	(162)	(1.4)	(157)	(1.3)
Non-deductible capital loss	750	11.0	- -	- -	- -	- -
Dividends on ESOP	(136)	(2.0)	(123)	(1.0)	(114)	(1.0)
Other - net	(10)	(0.1)	(84)	(0.7)	(95)	(0.8)
Federal income taxes	\$2,824	41.4%	\$3,828	31.9%	\$3,829	31.9%

## 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 \$389,000, \$351,000, and \$326,000 were used to service the debt during the years ended September 30, 2008, 2007 and 2006, respectively. As of September 30, 2008, 164,229 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 \$359,000, \$375,000, and \$411,000 for the years ended September 30, 2008, 2007 and 2006, respectively. The balance of



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the loan at September 30, 2008 was \$4,063,000.

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

	2008	2007	2006
Unallocated s	370,294	405,562	440,830
Shares released for allocation	523,477	518,066	542,216
Total ESOP shares	893,771	923,628	983,046

The approximate fair market value of the Bank's unallocated shares at September 30, 2008, 2007 and 2006, was \$2,796,000, \$6,347,000 and \$7,737,000, respectively. Compensation expense recognized under the ESOP was \$7,000, \$274,000 and \$683,000 for the years ended September 30, 2008, 2007 and 2006, respectively.

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

Note 14 - Employee Stock Ownership and 401(k) Plan ("KSOP") (concluded)

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 per the plan. Bank contributions totaled \$422,000, \$371,000 and \$558,000 for the years ended September 30, 2008, 2007 and 2006, respectively.

Note 15 - Stock Compensation Plans

Stock Options Plans

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Under the Company's stock option plans (1999 Stock Option Plan and 2003 Stock Option Plan), the Company may 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. The options vest over a ten-year period, which may be accelerated if the Company meets certain performance criteria. Generally, options vest in annual installments of 10% on each of the ten anniversaries from the date of grant and if the Company meets three of four established performance criteria the vesting is accelerated to 20% for that year. These four performance criteria are: (i) generating a return on assets which exceeds that of the median of all thrifts in the 12th FHLB District having assets within \$250 million of the Company; (ii) generating an efficiency ratio which is less than that of the median of all thrifts in the 12th FHLB District having assets within \$250 million of the Company; (iii) generating a net interest margin which exceeds the median of all thrifts in

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the 12th FHLB District having assets within \$250 million of the Company; and (iv) increasing the Company's earnings per share over the prior fiscal year. The Company performs the accelerated vesting analysis in February of each year based on the results of the most recently completed fiscal year. At September 30, 2008, options for 279,416 shares are available for future grant under these plans.

The Company uses the Black-Scholes option pricing model to estimate the fair value of stock-based awards with the weighted average assumptions noted in the following table. The risk-free interest rate is based on the U.S. Treasury rate of a similar term as the stock option at the particular grant date. The expected life is based on historical data, vesting terms, and estimated exercise dates. The expected dividend yield is based on the most recent quarterly dividend on an annualized basis. The expected volatility is based on historical volatility of the Company's stock price. There were no options granted during the fiscal years ended September 30, 2008, 2007 or 2006.

Stock option activity is summarized in the following table:

	Number of Shares	Weighted Average Exercise Price
Outstanding September 30, 2005	724,822	\$ 6.93
Options exercised	(200,678)	6.09
Outstanding September 30, 2006	524,144	7.26
Options exercised	(110,470)	6.73
Options forfeited	(1,000)	7.60
Outstanding September 30, 2007	412,674	7.39
Options exercised	(138,854)	6.06
Outstanding September 30, 2008	273,820	8.07

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

#### Note 15 - Stock Compensation Plans (continued)

The total fair value of shares that vested during the years ended September 30, 2008, 2007 and 2006 was \$30,000, \$52,000 and \$65,000, respectively.

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

	2008	2007	2006
Proceeds from options exercised	\$ 842	\$ 744	\$1,221
Related tax benefit recognized	15	463	607
Intrinsic value of options exercised	531	1,231	1,785

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Additional information regarding options outstanding at September 30, 2008, 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)
\$ 6.00	104,956	\$ 6.00	0.3	104,956	\$ 6.00	0.3
7.45	56,638	7.45	2.7	56,638	7.45	2.7
7.85 - 7.98	6,000	7.91	3.6	6,000	7.91	3.6
9.52	56,680	9.52	4.4	51,012	9.52	4.4
11.46 - 11.63	49,546	11.51	5.3	49,546	11.51	5.3
	273,820	\$ 8.07	2.6	268,152	\$ 8.04	2.6

The aggregate intrinsic value of all options outstanding at September 30, 2008 was \$168,000. At September 30, 2008, there were 5,668 unvested options, all of which are assumed to vest, with an aggregate intrinsic value of \$0. The aggregate intrinsic value of all options that were exercisable at September 30, 2008 was \$168,000.

### Management Recognition and Development Plan ("MRDP")

In November 1998, the Board of Directors adopted the MRDP. In January 1999, shareholders approved the adoption of the MRDP for the benefit of employees, officers and directors of the Company. The objective of the MRDP is to retain personnel of experience and ability in key positions by providing them with a proprietary interest in the Company.

The MRDP allows for the issuance to participants of up to 529,000 shares of the Company's common stock. Shares issued may be purchased in the open market or may be issued from authorized and unissued shares. Awards under the MRDP are made in the form of restricted shares of common stock that are subject to restrictions on the transfer of ownership 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.

(continued)

### Notes to Consolidated Financial Statements

Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

Note 15 - Stock Compensation Plans (continued)

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

	2008	2007	2006
Shares granted	20,315	15,080	12,000
Weighted average grant date fair value	\$12.76	\$17.44	\$16.22
Shares vested	5,416	2,400	- -
Aggregate vesting date fair value	\$46,000	\$39,000	\$ - -

A summary of unvested MRDP shares as of September 30, 2008 and changes during the year ended September 30, 2008, were as follows:

	Shares	Weighted Average Grant Date Fair Value
Unvested shares, beginning of period	24,680	\$16.97
Shares granted	20,315	12.76
Shares vested	(5,416)	16.90
Unvested shared, end of period	39,579	14.82

At September 30, 2008, there were 39,579 unvested MRDP shares with an aggregate grant date fair value of \$586,000 and there were 71,751 shares available for future grant under the MRDP.

### Expense for Stock Compensation Plans

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

	2008	2007	2006
Stock options	\$ 5	\$ 25	\$ 50
MRDP stock grants	147	66	8
Less: related tax benefit recognized	(53)	(31)	(20)
	\$ 99	\$ 60	\$ 38

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### Notes to Consolidated Financial Statements

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 Timberland Bancorp, Inc. and Subsidiary  
 September 30, 2008 and 2007

#### Note 15 - Stock Compensation Plans (concluded)

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

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thousands):

	Stock		Total Awards
	Stock Options	Grants (MRDP)	
2009	\$ 3	\$143	\$146
2010	--	143	143
2011	--	137	137
2012	--	84	84
2013	--	11	11
	\$ 3	\$518	\$521

Note 16 - Deferred Compensation Plans

The Bank has a deferred compensation/non-competition arrangement with its former chief executive officer, which provides monthly payments of \$2,000 per month upon retirement. Payments under this agreement began in March 2004 and will continue until his death, at which time payments will continue to his surviving spouse until the earlier of her death or for 60 months. The present value of the payments as of September 30, 2008 and 2007, \$129,000 and \$153,000, respectively, has been accrued for under the agreement and is included in other liabilities on the 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. The Company accrues interest on the liability at a rate of 1.00% over the Bank's one-year CD rate. The liability accrued for under the plan as of September 30, 2008 and 2007 was \$10,000 and is included in other liabilities on the consolidated balance sheets.

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 on the consolidated balance sheets.

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

	2008	2007
Undisbursed portion of construction loans in process (see Note 4)	\$43,353	\$65,673
Undisbursed lines of credit	25,343	20,522
Commitments to extend credit	15,281	35,784

(continued)

Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

Note 17 - Commitments and Contingencies (continued)

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

In April 2007, the Bank and the Company entered into employment agreements with the Chief Executive Officer and the Chief Financial Officer. The employment agreements provide for a severance payment and other benefits if the officers are involuntarily terminated following a change in control of the Company or the Bank. The maximum value of the severance benefits under the employment agreements is 2.99 times the officer's average annual compensation during the five-year period prior to the effective date of the change in control.

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

Note 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, 2008, the Bank had \$580,184,000 (including \$43,353,000 of undisbursed construction loan proceeds) in loans secured by real estate, which represents 94.8% 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, 2008, 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 maintains loan-to-value ratios of no greater than 90% on real estate loans.

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

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

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.

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

At September 30, 2008, the most recent notification from the Bank's regulator categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category.

(continued)

Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

Note 19 - Regulatory Matters (concluded)

Restrictions on Retained Earnings

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

	Actual Amount	Ratio	Capital Adequacy Purposes Amount	Ratio	To be Well Capitalized Under Prompt Corrective Action Provisions Amount	Ratio
September 30, 2008						
Tier 1 capital						
(to average assets):						
Consolidated	\$68,615	10.3%	\$26,709	4.0%	N/A	N/A
Timberland Bank	61,326	9.2	26,649	4.0	\$33,311	5.0%
Tier 1 capital						
(to risk-weighted assets):						
Consolidated	68,615	12.4	22,189	4.0	N/A	N/A
Timberland Bank	61,326	11.1	22,192	4.0	33,288	6.0
Total capital (to risk-weighted assets):						
Consolidated	75,563	13.6	44,378	8.0	N/A	N/A
Timberland Bank	68,275	12.3	44,384	8.0	55,480	10.0
September 30, 2007						
Tier 1 capital						
(to average assets):						
Consolidated	\$67,397	10.7%	\$25,116	4.0%	N/A	N/A
Timberland Bank	59,308	9.5	25,058	4.0	\$31,323	5.0%
Tier 1 capital						
(to risk-weighted assets):						
Consolidated	67,397	12.7	21,172	4.0	N/A	N/A
Timberland Bank	59,308	11.2	21,154	4.0	31,731	6.0
Total capital						
(to risk-weighted assets):						
Consolidated	72,194	13.6	42,344	8.0	N/A	N/A
Timberland Bank	64,105	12.1	42,308	8.0	52,885	10.0



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

At the time of conversion of the Bank from a Washington-chartered mutual savings bank to a Washington-chartered stock savings bank, the Bank established a liquidation account in an amount equal to its retained earnings of \$23,866,000 as of June 30, 1997, the date of the latest statement of financial condition used in the final conversion prospectus. The liquidation account 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. 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, 2008 and 2007

#### Note 20 - Condensed Financial Information - Parent Company Only

##### Condensed Balance Sheets - September 30 (In Thousands)

	2008	2007
<b>Assets</b>		
Cash and due from financial institutions	\$ 280	\$ 73
Interest-bearing deposits in banks	2,903	1,253
Investments and mortgage-backed securities (available for sale)	-	2,064
Loan receivable from Bank	4,063	4,293
Investment in Bank	67,552	66,434
Other assets	1,345	1,906
<b>Total assets</b>	<b>\$76,143</b>	<b>\$76,023</b>
<b>Liabilities and shareholders' equity</b>		
Loan payable to Bank	\$ -	\$ 1,400
Accrued expenses	1,302	76
Shareholders' equity	74,841	74,547
<b>Total liabilities and shareholders' equity</b>	<b>\$76,143</b>	<b>\$76,023</b>

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

	2008	2007	2006
<b>Operating income</b>			
Interest-bearing deposits in banks	\$ 22	\$ 26	\$ 27
Interest on loan receivable from Bank	359	375	411

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Dividends on investments	65	108	91
Loss on sale of investment securities available for sale ("AFS")	(171)	- -	- -
Dividends from Bank	3,850	12,823	4,500
Total operating income	4,125	13,332	5,029
Non-operating income	- -	- -	3
Operating expenses	589	633	465
Income before income taxes and equity in undistributed income of Bank	3,536	12,699	4,567
Income taxes (benefit)	(193)	(166)	(91)
Income before equity in undistributed income of Bank	3,729	12,865	4,658
Equity in undistributed income of bank (dividends in excess of income of Bank)	276	(4,702)	3,499
Net income (continued)	\$4,005	\$8,163	\$8,157

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

Note 20 - Condensed Financial Information - Parent Company Only (concluded)

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

	2008	2007	2006
Cash flows from operating activities			
Net income	\$ 4,005	\$ 8,163	\$ 8,157
Adjustments to reconcile net income to net cash provided:			
(Equity in undistributed income of Bank)			
dividends in excess of income of Bank	(276)	4,702	(3,499)
ESOP shares earned	264	265	528
MRDP compensation expense	131	59	7
Stock option compensation expense	5	25	50
Stock option tax effect	15	464	607
Less stock option excess tax benefit	(11)	(354)	(494)
Loss on sale of securities AFS	171	- -	- -
Other, net	1,764	(256)	(462)
Net cash provided by operating activities	6,068	13,068	4,894
Cash flows from investing activities			
Investment in Bank	(562)	(698)	(1,062)
Proceeds from sale of securities AFS	1,959	- -	- -
Principal repayments on loan receivable from Bank	230	214	525
Net cash provided by (used in) investing			

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activities	1,627	(484)	(537)
Cash flows from financing activities			
Increase (decrease) in borrowings from Bank	(1,400)	1,400	- -
Proceeds from exercise of stock options	841	744	1,221
Repurchase of common stock	(1,920)	(12,431)	(3,701)
Payment of dividends	(2,977)	(2,682)	(2,492)
ESOP tax effect	(409)	354	480
MRDP compensation tax effect	16	5	(4)
Stock option tax effect	11	354	494
Net cash used in financing activities	(5,838)	(12,256)	(4,002)
Net increase in cash	1,857	328	355
Cash equivalents			
Beginning of year	1,326	998	643
End of year	\$ 3,183	\$ 1,326	\$ 998

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

Note 21 - Earnings Per Share Disclosures

Basic earnings per share are computed by dividing net income applicable to common stock by the weighted average number of common shares outstanding during the period, without considering any dilutive items. Diluted earnings per share are computed by dividing net income applicable to common stock by the weighted average number of common shares and common stock equivalents for items that are dilutive, net of shares assumed to be repurchased using the treasury stock method at the average share price for the Company's common stock during the period. Common stock equivalents arise from assumed conversion of outstanding stock options and from assumed vesting of shares awarded but not released under the Company's MRDP. In accordance with Statement of Position 93-6, Employers' Accounting for Employee Stock Ownership Plans, issued by the American Institute of Certified Public Accountants, shares owned by the Bank's ESOP that have not been allocated are not considered to be outstanding for the purpose of computing earnings per share. Information regarding the calculation of basic and diluted earnings per share for the years ended September 30 is as follows (dollars in thousands, except per share amounts):

	2008	2007	2006
Basic EPS Computation			
Numerator - net income	\$4,005	\$8,163	\$8,157
Denominator - weighted average common shares outstanding	6,475,385	6,775,822	7,032,662
Basic EPS	\$0.62	\$1.20	\$1.16

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Diluted EPS Computation			
Numerator - net income	\$4,005	\$8,163	\$8,157
Denominator - weighted average common			
shares outstanding	6,475,385	6,775,822	7,032,662
Effect of dilutive stock options	95,107	204,636	249,090
Effect of dilutive MRDP shares	- -	1,649	144
Weighted average common shares outstanding-assuming dilution	6,570,492	6,982,107	7,281,896
Diluted EPS	\$0.61	\$1.17	\$1.12

For the year ended September 30, 2008, options to purchase 40,443 shares of common stock were outstanding but not included in the computation of diluted earnings per 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. There were no options to purchase shares of common stock excluded from the computation of diluted earnings per share for the years ended September 30, 2007 and 2006.

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

Note 22 - Accumulated Other Comprehensive Income (Loss)

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

	Before-Tax Amount	Tax (Benefit) Expense	Net-of-Tax Amount
2008			
Unrealized holding losses arising during the year	(\$2,329)	(\$58)	(\$2,271)
Reclassification adjustment for losses included in net income	2,826	232	2,594
Net unrealized gains	\$ 497	\$174	\$ 323
2007			
Unrealized holding gains arising during the year	\$ 329	\$112	\$ 217
Net unrealized gains	\$ 329	\$112	\$ 217
2006			

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Unrealized holding losses arising during the year	(\$196)	(\$66)	(\$130)
Net unrealized losses	(\$196)	(\$66)	(\$130)

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

#### Note 23 - Fair Value of Financial Instruments

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

**Cash and Due from Financial Institutions, Interest-Bearing Deposits in Banks, and Federal Funds Sold** The recorded amount is a reasonable estimate of fair value.

**Investments and Mortgage-Backed Securities**

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

**Federal Home Loan Bank Stock**

The recorded value of stock holdings approximates fair value.

**Loans Receivable and Loans Held for Sale**

Fair value of loans is estimated for portfolios of loans with similar financial characteristics. Fair value is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers for the same remaining maturities. Prepayments are based on the historical experience of the Bank. Loans held for sale has been based on quoted market prices.

**Deposits**

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

**Federal Home Loan Bank Advances**

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

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### Other Borrowings: Repurchase Agreements

The recorded value of repurchase agreements approximates fair value.

### Accrued Interest

The recorded amounts of accrued interest approximate fair value.

### Mortgage Servicing Rights ("MSRs")

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

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## Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

### Note 23 - Fair Value of Financial Instruments (concluded)

#### Off-Balance-Sheet Instruments

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

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

	2008 Recorded Amount	Estimated Fair Value	2007 Recorded Amount	Estimated Fair Value
<b>Financial Assets</b>				
Cash and due from financial institutions and interest-bearing deposits in banks	\$ 17,444	\$ 17,444	\$ 12,895	\$ 12,895
Federal funds sold	25,430	25,430	3,775	3,775
Investments and mortgage-backed securities	31,331	29,072	63,969	63,968
FHLB stock	5,705	5,705	5,705	5,705
Loans receivable and loans held for sale	557,687	558,379	515,341	510,924
Accrued interest receivable	2,870	2,870	3,424	3,424
Mortgage servicing rights	1,306	1,818	1,051	1,958
<b>Financial Liabilities</b>				
Deposits	\$498,572	\$498,806	\$466,735	\$466,648

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FHLB advances - short term	-	-	30,000	30,000
FHLB advances - long term	104,628	105,958	69,697	69,556
Other borrowings: repurchase agreements	758	758	595	595
Accrued interest payable	1,135	1,135	1,378	1,378

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

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### Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

#### Note 24 - Stock Repurchase Plan

The Company repurchased 144,950 shares of stock during the year ended September 30, 2008. The Company had 343,468 shares remaining to be purchased on its existing stock repurchase plan at September 30, 2008.

#### Note 25 - Subsequent Events

On October 29, 2008, the Company's board of directors approved a dividend in the amount of \$0.11 per share to be paid on November 26, 2008 to shareholders of record as of November 13, 2008.

#### Note 26 - Selected Quarterly Financial Data (Unaudited)

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

	September 30, 2008	June 30, 2008	March 31, 2008	December 31, 2007
Interest and dividend income	\$10,567	\$10,368	\$10,926	\$11,477
Interest expense	(3,732)	(3,868)	(4,255)	(4,558)
Net interest income	6,835	6,500	6,671	6,919

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Provision for loan losses	(1,500)	(500)	(700)	(1,200)
Non-interest income	2,019	(893)	1,555	1,497
Non-interest expense	(5,397)	(4,919)	(5,207)	(4,851)
Income before income taxes	1,957	188	2,319	2,365
Federal income taxes	607	733	734	750
Net income	\$ 1,350	\$ (545)	\$ 1,585	\$ 1,615
Basic earnings per share	\$ 0.208	\$ (0.085)	\$ 0.246	\$ 0.248
Diluted earnings per share	0.207	(0.084)	0.242	0.242

(continued)

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Notes to Consolidated Financial Statements

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Timberland Bancorp, Inc. and Subsidiary  
September 30, 2008 and 2007

Note 26 - Selected Quarterly Financial Data (Unaudited) (concluded)

	September 30, 2007	June 30, 2007	March 31, 2007	December 31, 2006
Interest and dividend income	\$11,197	\$10,814	\$10,168	\$9,765
Interest expense	(4,453)	(4,156)	(3,680)	(3,489)
Net interest income	6,744	6,658	6,488	6,276
Provision for loan losses	(270)	(260)	(156)	- -
Non-interest income	1,557	1,501	1,424	1,480
Non-interest expense	(4,854)	(4,761)	(4,939)	(4,897)
Income before income taxes	3,177	3,138	2,817	2,859
Federal income taxes	1,022	1,000	901	905
Net income	\$ 2,155	\$ 2,138	\$ 1,916	\$ 1,954
Basic earnings per share	\$ 0.330	\$ 0.318	\$ 0.279	\$ 0.279
Diluted earnings per share	0.322	0.309	0.270	0.270

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Item 9. Changes in and Disagreements with Accountants on Accounting and

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Financial Disclosure  
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Not applicable.

Item 9A. Controls and Procedures  
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(a) Evaluation of Disclosure Controls and Procedures: An evaluation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act")) was carried out under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and several other members of the Company's senior management as of the end of the period covered by this annual report. The Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures in effect as of September 30, 2008, are effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Act is (i) accumulated and communicated to the Company's management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

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

Item 9B. Other Information  
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None.

PART III

Item 10. Directors and Executive Officers of the Registrant  
-----

The information contained under the section captioned "Proposal I - Election of Directors" is included in the Company's Definitive Proxy Statement for the 2009 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."

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Compliance with Section 16(a) of the Exchange Act

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

Audit Committee Financial Expert

The Company has a separately designated standing Audit Committee, composed of Directors Mason, Robbel and Smith. Each member of the Audit Committee is "independent" as defined in the Nasdaq Stock Market listing standards. The Company's Board of Directors has designated Director Robbel as the Audit Committee financial expert, as defined in the SEC's Regulation S-K. Directors Mason, Robbel and Smith 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, 2008. 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  
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The information contained under the sections captioned "Executive Compensation" and "Directors' Compensation" is included in the Company's Proxy Statement and is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and  
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Related Stockholder Matters  
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- (a) Security Ownership of Certain Beneficial Owners.

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

(b) Security Ownership of Management.

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

(c) Changes In Control.

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

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(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, 2008.

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.....	--	\$ --	71,751
1999 Stock Option Plan.....	261,688	7.90	3,678
2003 Stock Option Plan.....	12,132	11.63	275,738
Equity compensation plans not approved by security holders.....	--	--	--
Total.....	273,820	\$ 8.07	351,167

Item 13. Certain Relationships and Related Transactions, and Director Independence

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

### Item 14. Principal Accounting Fees and Services

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

## PART IV

### Item 15. Exhibits, Financial Statement Schedules

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#### (a) Exhibits

- 3.1 Articles of Incorporation of the Registrant (1)
- 3.2 Amended and Restated Bylaws of the Registrant (2)
- 3.3 Amendment to Bylaws(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)

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- 21 Subsidiaries of the Registrant
- 23 Consent of Accountants
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
- 32 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act

- 
- (1) Filed as an exhibit to the Registrant's Registration Statement on Form S-1 (333-35817).
  - (2) Incorporated by reference to the Registrant's Current Report on Form 8-K dated December 18, 2007.
  - (3) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended September 30, 2002.
  - (4) Incorporated by reference to the Registrant's Quarterly Report on Form

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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 9, 2008

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.

Table with 3 columns: SIGNATURES, TITLE, DATE. Rows include Michael R. Sand (President, Chief Executive Officer and Director), Clarence E. Hamre (Chairman of the Board), Dean J. Brydon (Chief Financial Officer), Andrea M. Clinton (Director), and David A. Smith (Director).

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-----  
David A. Smith

/s/ Jon C. Parker                      Director    December 9, 2008  
-----

Jon C. Parker

/s/ James C. Mason                      Director    December 9, 2008  
-----

James C. Mason

/s/ Ronald A. Robbel                      Director    December 9, 2008  
-----

Ronald A. Robbel

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EXHIBIT INDEX

Exhibit No. -----	Description of Exhibit -----
21	Subsidiaries of the Registrant
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31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
32	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act

Exhibit 21

Subsidiaries of the Registrant

Parent  
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Timberland Bancorp, Inc.

Subsidiaries	Percentage of Ownership	Jurisdiction or State of Incorporation
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Timberland Bank	100%	Washington
Timberland Service Corporation (1)	100%	Washington
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(1) This corporation is a wholly-owned subsidiary of Timberland Bank.

Exhibit 23

Consent of Accountants

McGladrey & Pullen  
Certified Public Accountants

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in Registration Statements No. 333-32386 and No. 333-116163 on Form S-8 of Timberland Bancorp, Inc. of our reports dated December 8, 2008, relating to the consolidated financial statements and the effectiveness of internal control over financial reporting of Timberland Bancorp, Inc. which appear in this Form 10-K for the year ended September 30, 2008.

/s/McGladrey & Pullen, LLP

Seattle, Washington  
December 8, 2008

Exhibit 31.1

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

I, Michael R. Sand, certify that:

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

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

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

Date: December 9, 2008

/s/ Michael R. Sand

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



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

I, Dean J. Brydon, certify that:

- 1 I have reviewed this Annual Report on Form 10-K of Timberland Bancorp, Inc.;
- 2 Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
- 3 Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- 4 The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- 5 The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to

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record, process, summarize and report financial information; and

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

Date: December 9, 2008

/s/ Dean J. Brydon

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

Exhibit 32

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

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

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

/s/ Michael R. Sand

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

/s/ Dean J. Brydon

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

Dated: December 9, 2008