TIMBERLAND BANCORP INC
Form 10-Q
August 11, 2014
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2014
OR
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the Transition Period from $\qquad$ to $\qquad$ .

Commission file number 0-23333
TIMBERLAND BANCORP, INC.
(Exact name of registrant as specified in its charter)

Washington
(State or other jurisdiction of incorporation or organization)

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

> 91-1863696
(IRS Employer Identification No.)

## 98550

(Zip Code)
(360) 533-4747
(Registrant's telephone number, including area code)
Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No

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

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

Large accelerated filer $\qquad$ Accelerated Filer
Non-accelerated filer __ Smaller reporting company _X_

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

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

CLASS
Common stock, $\$ .01$ par value

SHARES OUTSTANDING AT JULY 31, 2014
7,045,936

## INDEX

PART I. FINANCIAL INFORMATION ..... Page
Item 1. Financial Statements (unaudited)
Condensed Consolidated Balance Sheets ..... 
Condensed Consolidated Statements of Income ..... 5
Condensed Consolidated Statements of Comprehensive Income ..... 7
Condensed Consolidated Statements of Shareholders' Equity ..... $\underline{8}$
Condensed Consolidated Statements of Cash Flows ..... $\underline{9}$
Notes to Unaudited Condensed Consolidated Financial Statements ..... 11
Item 2. Management's Discussion and Analysis of Financial Condition and Results of ..... $\underline{39}$
Item 3. Quantitative and Qualitative Disclosures About Market Risk ..... $\underline{49}$
Item 4. Controls and Procedures ..... 49
PART II. OTHER INFORMATION
Item 1. Legal Proceedings ..... $\underline{50}$
Item Risk Factors ..... $\underline{50}$
1A.
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds ..... 50
Item 3. Defaults Upon Senior Securities ..... $\underline{50}$
Item 4. Mine Safety Disclosures ..... $\underline{50}$
Item 5. Other Information ..... $\underline{50}$
Item 6. Exhibits ..... 51
SIGNATURES
Certifications
Exhibit 32Exhibit 101

## PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (unaudited)
TIMBERLAND BANCORP, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS
June 30, 2014 and September 30, 2013
(Dollars in thousands, except per share amounts)
(Unaudited)

|  | $\begin{aligned} & \text { June 30, } \\ & 2014 \end{aligned}$ | $\begin{aligned} & \text { September 30, } \\ & 2013 \end{aligned}$ |
| :---: | :---: | :---: |
| Assets |  |  |
| Cash and cash equivalents: |  |  |
| Cash and due from financial institutions | \$13,500 | \$ 12,879 |
| Interest-bearing deposits in banks | 50,467 | 81,617 |
| Total cash and cash equivalents | 63,967 | 94,496 |
| Certificates of deposit ("CDs") held for investment (at cost which approximates fair value) | 32,336 | 30,042 |
| Mortgage-backed securities ("MBS") and other investments - held to maturity, at amortized cost (estimated fair value $\$ 6,285$ and $\$ 3,533$ ) | 5,417 | 2,737 |
| MBS and other investments - available for sale | 2,928 | 4,101 |
| Federal Home Loan Bank of Seattle ("FHLB") stock | 5,299 | 5,452 |
| Loans receivable | 566,757 | 557,329 |
| Loans held for sale | 1,501 | 1,911 |
| Less: Allowance for loan losses | (10,563 | ) $(11,136$ |
| Net loans receivable | 557,695 | 548,104 |
| Premises and equipment, net | 17,867 | 17,764 |
| Other real estate owned ("OREO") and other repossessed assets, net | 11,172 | 11,720 |
| Accrued interest receivable | 1,922 | 1,972 |
| Bank owned life insurance ("BOLI") | 17,494 | 17,102 |
| Goodwill | 5,650 | 5,650 |
| Core deposit intangible ("CDI") | 32 | 119 |
| Mortgage servicing rights ("MSRs"), net | 1,812 | 2,266 |
| Other assets | 4,040 | 4,123 |
| Total assets | \$727,631 | \$745,648 |
| Liabilities and shareholders' equity |  |  |
| Liabilities: |  |  |
| Deposits: |  |  |
| Non-interest-bearing demand | \$92,995 | \$87,657 |
| Interest-bearing | 505,637 | 520,605 |
| Total deposits | 598,632 | 608,262 |
| FHLB advances | 45,000 | 45,000 |
| Other liabilities and accrued expenses | 2,669 | 2,698 |
| Total liabilities | 646,301 | 655,960 |
| See notes to unaudited condensed consolidated financial statements |  |  |

TIMBERLAND BANCORP, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS (continued)
June 30, 2014 and September 30, 2013
(Dollars in thousands, except per share amounts)
(Unaudited)

| June 30, | September 30, |
| :--- | :--- |
| 2014 | 2013 |

Shareholders' equity
Fixed Rate Cumulative Perpetual Preferred Stock. Series A, \$0.01 par value; 1,000,000
shares authorized; redeemable at $\$ 1,000$ per share; 12,065 shares issued and
\$— \$11,936 outstanding - September 30, 2013
Common stock, $\$ .01$ par value; $50,000,000$ shares authorized;
7,045,936 shares issued and outstanding - June 30, 2014 7,045,036 shares issued and $10,710 \quad 10,570$ outstanding - September 30, 2013
Unearned shares issued to Employee Stock Ownership Plan ("ESOP") (1,256 ) (1,454)
Retained earnings 68,998
Accumulated other comprehensive loss (364) (362
$\begin{array}{lll}\text { Total shareholders' equity } & 89,330 & 89,688\end{array}$
$\begin{array}{ll}\text { Total liabilities and shareholders' equity } & \$ 727,631\end{array}$
See notes to unaudited condensed consolidated financial statements

4

TIMBERLAND BANCORP, INC. AND SUBSIDIARY CONDENSED CONSOLIDATED STATEMENTS OF INCOME
For the three and nine months ended June 30, 2014 and 2013
(Dollars in thousands, except per share amounts)
(Unaudited)

|  | Three Months Ended June 30, |  | Nine Months Ended June 30, |  |
| :---: | :---: | :---: | :---: | :---: |
| Interest and dividend income |  |  |  |  |
| Loans receivable | \$7,238 | \$7,422 | \$21,811 | \$22,231 |
| MBS and other investments | 66 | 69 | 190 | 216 |
| Dividends from mutual funds and FHLB stock | 6 | 5 | 21 | 22 |
| Interest-bearing deposits in banks | 87 | 79 | 268 | 247 |
| Total interest and dividend income | 7,397 | 7,575 | 22,290 | 22,716 |
| Interest expense |  |  |  |  |
| Deposits | 498 | 609 | 1,562 | 1,987 |
| FHLB advances | 466 | 467 | 1,399 | 1,399 |
| Total interest expense | 964 | 1,076 | 2,961 | 3,386 |
| Net interest income | 6,433 | 6,499 | 19,329 | 19,330 |
| Provision for loan losses | - | 1,385 | - | 2,760 |
| Net interest income after provision for loan losses | 6,433 | 5,114 | 19,329 | 16,570 |
| Non-interest income |  |  |  |  |
| Recoveries (Other than temporary impairment "OTTI") on MBS and other investments | (38 | ) (1 | ) 49 | (9 |
| Adjustment for portion recorded as (transferred from) other comprehensive income (loss) before taxes | 29 | (2 | 29 | (30 |
| Net recoveries (OTTI) on MBS and other investments | (9 | ) (3 | ) 78 | (39 |
| Loss on sale of MBS and other investments, net | - | - | (32 | ) - |
| Service charges on deposits | 921 | 882 | 2,795 | 2,657 |
| ATM and debit card interchange transaction fees | 611 | 526 | 1,769 | 1,562 |
| BOLI net earnings | 134 | 144 | 392 | 431 |
| Gain on sales of loans, net | 241 | 579 | 714 | 2,054 |
| Escrow fees | 45 | 55 | 111 | 135 |
| Valuation recovery on MSRs | - | - | - | 475 |
| Fee income from non-deposit investment sales | 14 | 19 | 58 | 92 |
| Other | 159 | 170 | 439 | 498 |
| Total non-interest income, net | 2,116 | 2,372 | 6,324 | 7,865 |

See notes to unaudited condensed consolidated financial statements

TIMBERLAND BANCORP, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (continued)
For the three and nine months ended June 30, 2014 and 2013
(Dollars in thousands, except per share amounts)
(Unaudited)

|  | Three Months Ended June 30, |  | Nine Months Ended June 30, |  |
| :---: | :---: | :---: | :---: | :---: |
| Non-interest expense |  |  |  |  |
| Salaries and employee benefits | \$3,325 | \$3,176 | \$ 10,138 | \$9,376 |
| Premises and equipment | 754 | 739 | 2,094 | 2,154 |
| Advertising | 187 | 184 | 537 | 533 |
| OREO and other repossessed assets, net | 240 | 313 | 795 | 1,107 |
| ATM and debit card processing | 207 | 219 | 791 | 636 |
| Postage and courier | 122 | 107 | 329 | 342 |
| Amortization of CDI | 29 | 33 | 87 | 98 |
| State and local taxes | 123 | 170 | 361 | 466 |
| Professional fees | 196 | 202 | 590 | 636 |
| Federal Deposit Insurance Corporation ("FDIC") insurance | 158 | 157 | 479 | 526 |
| Other insurance | 34 | 39 | 113 | 133 |
| Loan administration and foreclosure | 129 | 91 | 377 | 278 |
| Data processing and telecommunications | 399 | 319 | 1,058 | 911 |
| Deposit operations | 146 | 157 | 569 | 450 |
| Other | 381 | 331 | 1,107 | 1,152 |
| Total non-interest expense | 6,430 | 6,237 | 19,425 | 18,798 |
| Income before federal income taxes | 2,119 | 1,249 | 6,228 | 5,637 |
| Provision for federal income taxes | 685 | 373 | 2,024 | 1,774 |
| Net income | 1,434 | 876 | 4,204 | 3,863 |
| Preferred stock dividends | - | (151 | (136 | ) (559 ) |
| Preferred stock discount accretion | - | (47 | (70 | ) (236 |
| Discount on redemption of preferred stock | - | - | - | 255 |
| Net income to common shareholders | \$ 1,434 | \$678 | \$3,998 | \$3,323 |
| Net income per common share |  |  |  |  |
| Basic | \$0.21 | \$0.10 | \$0.58 | \$ 0.49 |
| Diluted | \$0.20 | \$0.10 | \$0.57 | \$0.48 |
| Weighted average common shares outstanding |  |  |  |  |
| Basic | 6,857,149 | 6,818,752 | 6,855,811 | 6,816,772 |
| Diluted | 7,033,713 | 6,902,497 | 7,015,155 | 6,870,751 |
| Dividends paid per common share | \$0.04 | \$0.03 | \$0.11 | \$0.06 |

See notes to unaudited condensed consolidated financial statements

TIMBERLAND BANCORP, INC. AND SUBSIDIARY CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the three and nine months ended June 30, 2014 and 2013
(Dollars in thousands)
(Unaudited)

|  | Three Months Ended June 30, |  |  | Nine Months Ended June 30, |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Comprehensive income: |  |  |  |  |  |
| Net income | \$1,434 | \$876 |  | \$4,204 | \$3,863 |
| Unrealized holding gain (loss) on securities available for sale, net of tax | (8) | 82 |  | (59 | 55 |
| Change in OTTI on securities held to maturity, net of tax: |  |  |  |  |  |
| Additional amount recognized (recovered) related to credit loss for which OTTI was previously recognized | 11 | (1 | ) | 11 | 17 |
| Amount reclassified to credit loss for previously recorded market loss | 8 | - |  | 8 | 3 |
| Accretion of OTTI securities held to maturity, net of tax | 14 | 15 |  | 38 | 38 |
| Total comprehensive income | \$1,459 | \$972 |  | \$4,202 | \$3,976 |

See notes to unaudited condensed consolidated financial statements

7

TIMBERLAND BANCORP, INC. AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
For the nine months ended June 30, 2014 and the year ended September 30, 2013
(Dollars in thousands, except per share amounts)
(Unaudited)


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

See notes to unaudited condensed consolidated financial statements
8

TIMBERLAND BANCORP, INC. AND SUBSIDIARY CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
For the nine months ended June 30, 2014 and 2013
(Dollars in thousands)
(Unaudited)

|  | Nine Months Ended June 30, |  |  |
| :---: | :---: | :---: | :---: |
| Cash flows from operating activities |  |  |  |
| Net income | \$4,204 |  | \$3,863 |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |  |  |
| Provision for loan losses | - |  | 2,760 |
| Depreciation | 886 |  | 810 |
| Deferred federal income taxes | - |  | 522 |
| Amortization of CDI | 87 |  | 98 |
| Earned ESOP shares | 198 |  | 198 |
| MRDP compensation expense | 2 |  | 32 |
| Stock option compensation expense | 76 |  | 37 |
| Gain on sales of OREO and other repossessed assets, net | (185 | ) | (261 |
| Provision for OREO losses | 491 |  | 759 |
| Gain on sale of premises and equipment | (5 | ) | (7 |
| BOLI net earnings | (392 | ) | (431 |
| Gain on sales of loans, net | (714 | ) | (2,054 |
| Decrease in deferred loan origination fees | (23 | ) | (272 |
| Net OTTI (recoveries) on MBS and other investments | (78 | ) | 39 |
| Loss on sale of MBS and other investments, net | 32 |  | - |
| Valuation recovery on MSRs | - |  | (475 |
| Loans originated for sale | (22,177 | ) | (73,559 |
| Proceeds from sales of loans | 23,301 |  | 74,607 |
| Decrease in other assets, net | 559 |  | 1,327 |
| Decrease in other liabilities and accrued expenses, net | (29 | ) | (377 |
| Net cash provided by operating activities | 6,233 |  | 7,616 |
| Cash flows from investing activities |  |  |  |
| Net increase in CDs held for investment | (2,294 | ) | (3,259 |
| Proceeds from sale of MBS and other investments available for sale | 856 |  | - |
| Proceeds from maturities and prepayments of MBS and other investments available for sale | 288 |  | 666 |
| Purchase of MBS and other investments held to maturity | (3,003 | ) | - |
| Proceeds from maturities and prepayments of MBS and other investments held to maturity | 424 |  | 506 |
| Redemption of FHLB stock | 153 |  | 153 |
| Increase in loans receivable, net | $(14,834$ | ) | (13,461 |
| Additions to premises and equipment | (1,021 |  | (967 |
| Proceeds from sale of premises and equipment | 37 |  | 7 |
| Proceeds from sale of OREO and other repossessed assets | 5,098 |  | 2,661 |
| Net cash used in investing activities | $(14,296$ |  | (13,694 |

See notes to unaudited condensed consolidated financial statements
9

TIMBERLAND BANCORP, INC. AND SUBSIDIARY CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
For the nine months ended June 30, 2014 and 2013
(Dollars in thousands)
(Unaudited)
$\left.\begin{array}{lll} & \begin{array}{c}\text { Nine Months Ended } \\ \text { June } 30, \\ \\ \text { Cash flows from financing activities } \\ \text { Decrease in deposits, net }\end{array} & 2014\end{array}\right)$

See notes to unaudited condensed consolidated financial statements

10

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

## (1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation: The accompanying unaudited condensed consolidated financial statements for Timberland Bancorp, Inc. ("Company") were prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and with instructions for Form 10-Q and, therefore, do not include all disclosures necessary for a complete presentation of financial condition, results of operations, and cash flows in conformity with GAAP. However, all adjustments which are, in the opinion of management, necessary for a fair presentation of the interim condensed consolidated financial statements have been included. All such adjustments are of a normal recurring nature. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended September 30, 2013 ("2013 Form 10-K"). The unaudited condensed consolidated results of operations for the nine months ended June 30, 2014 are not necessarily indicative of the results that may be expected for the entire fiscal year ending September 30, 2014.
(b) Principles of Consolidation: The unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Timberland Bank ("Bank"), and the Bank's wholly-owned subsidiary, Timberland Service Corp. All significant intercompany transactions and balances have been eliminated in consolidation.
(c) Operating Segment: The Company has one reportable operating segment which is defined as community banking in western Washington under the operating name, "Timberland Bank."
(d) The preparation of condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.
(e) Certain prior period amounts have been reclassified to conform to the June 30, 2014 presentation with no change to net income or total shareholders' equity previously reported.

## (2) PREFERRED STOCK SOLD IN TROUBLED ASSET RELIEF PROGRAM ("TARP") CAPITAL PURCHASE PROGRAM ("CPP")

On December 23, 2008, the Company received $\$ 16.64$ million from the U.S. Treasury Department ("Treasury") as a part of the Treasury's CPP, which was established as part of the TARP. The Company sold 16,641 shares of Fixed Rate Cumulative Perpetual Preferred Stock, Series A ("Series A Preferred Stock"), with a liquidation value of $\$ 1,000$ per share and a related warrant to purchase 370,899 shares of the Company's common stock at an exercise price of $\$ 6.73$ per share (subject to anti-dilution adjustments) at any time through December 23, 2018. The Series A Preferred Stock paid a $5.0 \%$ dividend for the first five years, after which the rate was scheduled to increase to $9.0 \%$ if the preferred shares were not redeemed by the Company.

On November 13, 2012, the Company's outstanding 16,641 shares of Series A Preferred Stock were sold by the Treasury as part of its efforts to manage and recover its investments under the TARP. While the sale of the shares of Series A Preferred Stock to new owners did not result in any proceeds to the Company and did not change the Company's capital position or accounting for these securities, it did eliminate restrictions put in place by the Treasury on TARP recipients.

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On June 12, 2013, the Treasury sold, to private investors, the warrant to purchase up to 370,899 shares of the Company's common stock. The sale of the warrant to new owners did not result in any proceeds to the Company and did not change the Company's capital position or accounting for the warrant.

During the year ended September 30, 2013 the Company purchased and retired 4,576 shares of its Series A Preferred Stock for $\$ 4.32$ million; a $\$ 255,000$ discount from the liquidation value. The discount from the liquidation value on the repurchased shares was recorded as an increase to retained earnings. On December 20, 2013, the Company redeemed the remaining 12,065 shares of its Series A Preferred Stock at the liquidation value of $\$ 12.07$ million.

11
(3) MBS AND OTHER INVESTMENTS

MBS and other investments have been classified according to management's intent and are as follows as of June 30, 2014 and September 30, 2013 (dollars in thousands):

| Amortized | Gross | Gross | Estimated |
| :--- | :--- | :--- | :--- |
| Cost | Unrealized | Unrealized | Fair Value |

June 30, 2014
Held to Maturity
MBS:

| U.S. government agencies | $\$ 1,053$ | $\$ 29$ | $\$(2)$ | $) \$ 1,080$ |
| :--- | :--- | :--- | :--- | :--- |
| Private label residential | 1,348 | 853 | $(5$ | $)$ |
| U.S. agency securities | 3,016 | 1 | $(8)$ | 3,009 |
| Total | $\$ 5,417$ | $\$ 883$ | $\$(15$ | $)$ |

Available for Sale
MBS:

| U.S. government agencies | $\$ 1,866$ | $\$ 102$ | $\$(1)$ | $)$ |
| :--- | :--- | :--- | :--- | :--- |
| Mutual funds | 1,000 | - | $(39$ | $)$ |
| Total | $\$ 2,866$ | $\$ 102$ | $\$(40$ | $)$ |

September 30, 2013
Held to Maturity
MBS:

| U.S. government agencies | $\$ 1,202$ | $\$ 31$ | $\$(2$ | $)$ |
| :--- | :--- | :--- | :--- | :--- |
| Private label residential | $1,521,231$ |  |  |  |
| U.S. agency securities | 14 | 781 | $(15$ | $)$ |
| Total | $\$ 2,737$ | 1 | - | 15 |
| Tota | $\$ 813$ | $\$(17$ | $)$ |  |

Available for Sale
MBS:
U.S. government agencies

Private label residential
Mutual funds
Total

| $\$ 2,144$ | $\$ 87$ | $\$(2$ | $)$ |
| :--- | :--- | :--- | :--- |
| 804 | 120 | $(10$ | $) 92,229$ |
| 1,000 | - | $(42$ | $) 958$ |
| $\$ 3,948$ | $\$ 207$ | $\$(54$ | $)$ |

12

The following table summarizes the estimated fair value and gross unrealized losses for all securities and the length of time these unrealized losses existed as of June 30, 2014 (dollars in thousands):

| Less Than 12 Months |  |  |
| :--- | :--- | :--- |
| Estimated | Gross |  |
| Fair | Unrealized | Qty |
| Value | Losses |  |


| 12 Months or Longer |  |  |
| :--- | :--- | :--- |
| Estimated | Gross |  |
| Fair | Unrealized | Qty |
| Value | Losses |  |

Total

| Estimated | Gross |
| :--- | :--- |
| Fair | Unrealized |
| Value | Losses |

Held to Maturity
MBS:
$\left.\begin{array}{llllllllll}\begin{array}{ll}\text { U.S. government } \\ \text { agencies }\end{array} & \$ 14 & \$- & 1 & \$ 81 & \$(2 & ) & 10 & \$ 95 & \$(2) \\ \begin{array}{l}\text { Private label }\end{array} & 9 & - & 1 & 156 & (5 & ) & 12 & 165 & (5\end{array}\right)$

Available for
Sale
MBS:

| U.S. government agencies | \$21 | \$- | 1 | \$40 | \$(1 |  | 2 | \$61 | \$(1 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Mutual Funds | - | - | - | 961 | (39 | ) | 1 | 961 | (39 |
| Total | \$21 | \$- | 1 | \$1,001 | \$(40 |  | 3 | \$1,022 | \$(40 |

The following table summarizes the estimated fair value and gross unrealized losses for all securities and the length of time the unrealized losses existed as of September 30, 2013 (dollars in thousands):

| Less Than 12 Months |  |  |
| :--- | :--- | :--- |
| Estimated | Gross |  |
| Fair | Unrealized | Qty |
| Value | Losses |  |

Held to Maturity
MBS:
$\left.\begin{array}{llllllllll}\begin{array}{l}\text { U.S. government } \\ \text { agencies }\end{array} & \$ 3 & \$- & 6 & \$ 88 & \$(2 & ) & 4 & \$ 91 & \$(2) \\ \begin{array}{l}\text { Private label }\end{array} & 80 & (4 & ) & 4 & 239 & (11 & ) & 14 & 319\end{array}\right)(15 \quad)$

Available for
Sale
MBS:
$\left.\begin{array}{llllllllll}\begin{array}{llll}\text { U.S. government } \\ \text { agencies }\end{array} & \$ 96 & \$(2 & ) & 3 & \$- & \$- & 1 & \$ 96 & \$(2) \\ \begin{array}{l}\text { Private label } \\ \text { residential }\end{array} & - & - & - & 108 & (10 & ) & 2 & 108 & (10\end{array}\right)$

During the three months ended June 30, 2014 and 2013, the Company recorded net recoveries (OTTI) through earnings on residential MBS of $(\$ 9,000)$ and $(\$ 3,000)$, respectively. During the nine months ended June 30, 2014 and 2013, the Company
recorded net recoveries (OTTI) through earnings of $\$ 78,000$ and $(\$ 39,000)$ respectively. The Company provides for the bifurcation of OTTI into (i) amounts related to credit losses which are recognized through earnings, and (ii) amounts related to all other factors which are recognized as a component of other comprehensive income.

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

The following table presents a summary of the significant inputs utilized to measure management's estimate of the credit loss component on OTTI securities as of June 30, 2014 and September 30, 2013:
$\left.\begin{array}{llllllll} & \begin{array}{l}\text { Range } \\ \text { Minimum }\end{array} & & \text { Maximum }\end{array} \begin{array}{l}\text { Weighted } \\ \text { Average }\end{array}\right\}$

The following tables present the recoveries (OTTI) for the three and nine months ended June 30, 2014 and 2013 (dollars in thousands):

Total recoveries (OTTI)
Adjustment for portion recorded as (transferred from) other comprehensive income (loss) before taxes (1)
Net recoveries (OTTI) recognized in earnings (2)

| Three Months Ended June | Three Months Ended |  |  |
| :--- | :--- | :--- | :--- |
| 30, 2014 |  | June 30, 2013 |  |
| Held To | Available | Held To | Available |
| Maturity | For Sale | Maturity | For Sale |
| $\$(38$ | $)$ | $\$-$ | $\$-$ |
| 29 | - | $(2$ | $\$(1$ |
| 29 | $)$ | - |  |
| $\$(9$ | $\$-$ | $\$(2$ | $)$ |

## Total recoveries (OTTI)

Adjustment for portion recorded as (transferred from) other comprehensive income (loss) before taxes (1)
Net recoveries (OTTI) recognized in earnings (2)
(1) Represents OTTI related to all other factors.
(2) Represents net recoveries (OTTI) related to credit losses.

The following table presents a roll-forward of the credit loss component of held to maturity and available for sale debt securities that have been written down for OTTI with the credit loss component recognized in earnings and the remaining impairment loss related to all other factors recognized in other comprehensive income for the nine months ended June 30, 2014 and 2013 (dollars in thousands):

## Beginning balance of credit loss

Nine Months Ended June 30,
20142013

Additions:
Credit losses for which OTTI was
not previously recognized
Additional increases to the amount
related to credit loss for which OTTI
\$2,084
\$2,703
was previously recognized
Subtractions:
Realized losses previously recorded
as credit losses
Recovery of prior credit loss
Ending balance of credit loss

| $(535$ | $)(571$ |
| :--- | :--- |
| 90 | - |
| $\$ 1,654$ | $\$ 2,176$ |

There was no realized loss on sale of securities for the three months ended June 30, 2014 and there was a $\$ 32,000$ realized loss on sale of securities for the nine months ended June 30, 2014. There was no realized loss on sale of securities for the three and nine months ended June 30, 2013. During the three months ended June 30, 2014, the Company recorded a net $\$ 40,000$ realized loss (as a result of the securities being deemed worthless) on 12 held to maturity residential MBS, of which the entire amount had been recognized previously as a credit loss. During the nine months ended June 30, 2014, the Company recorded a net $\$ 445,000$ realized loss (as a result of securities being deemed worthless) on 15 held to maturity residential MBS and six available for sale MBS, of which the entire amount had been recognized previously as a credit loss. During the three months ended June 30, 2013, the Company recorded a $\$ 188,000$ realized loss (as a result of the securities being deemed worthless) on 12 held to maturity residential MBS and six available for sale residential MBS, of which the entire amount had been recognized previously as a credit loss. During the nine months ended June 30, 2013, the Company recorded a $\$ 571,000$ realized loss (as a result of securities being deemed worthless) on 17 held to maturity residential MBS and six available for sale MBS, of which the entire amount had been recognized previously as a credit loss.

The amortized cost of residential mortgage-backed and agency securities pledged as collateral for public fund deposits, federal treasury tax and loan deposits, FHLB collateral, retail repurchase agreements and other non-profit organization deposits totaled $\$ 6.39$ million and $\$ 4.54$ million at June 30, 2014 and September 30, 2013, respectively.

The contractual maturities of debt securities at June 30, 2014 were as follows (dollars in thousands). Expected maturities may differ from scheduled maturities as a result of the prepayment of principal or call provisions.

|  | Held to Maturity |  | Available for Sale |  |
| :--- | :--- | :--- | :--- | :--- |
|  | Amortized | Estimated | Amortized | Estimated |
|  | Cost | Fair | Fair |  |
|  | $\$-$ | Value |  | Value |
| Due within one year | 3,022 | $\$-$ | $\$-$ | $\$-$ |
| Due after one year to five years | 10 | 3,015 | 22 | 21 |
| Due after five to ten years | 2,385 | 10 | 34 | 35 |
| Due after ten years | $\$ 5,417$ | $\$ 6,285$ | 1,810 | 1,911 |
| Total |  |  | $\$ 1,866$ | $\$ 1,967$ |

## (4) GOODWILL

The Company performed its fiscal year 2014 goodwill impairment test during the quarter ended June 30, 2014 with the assistance of a third-party firm specializing in goodwill impairment valuations for financial institutions. The third-party
analysis was conducted as of May 31, 2014 and concluded that the recorded value of goodwill as of May 31, 2014 was not impaired.

The goodwill impairment test involves a two-step process. Step one of the goodwill impairment test estimates the fair value of the reporting unit. If the estimated fair value of the Company's sole reporting unit, the Bank, under step one exceeds the recorded value of the reporting unit, goodwill is not considered impaired and no further analysis is necessary. If the estimated fair value of the Company's sole reporting unit is less than the recorded value, then a step two test, which calculates the fair value of assets and liabilities to calculate an implied value of goodwill, is performed.

Step one of the goodwill impairment test estimated the fair value of the reporting unit utilizing a discounted cash flow income approach analysis, a public company market approach analysis, a merger and acquisition market approach analysis and a trading price market approach analysis in order to derive an enterprise value for the Company.

The discounted cash flow income approach analysis uses a reporting unit's projection of estimated operating results and cash flows and discounts them using a rate that reflects current market conditions. The projection uses management's estimates of economic and market conditions over the projected period including growth rates in loans and deposits, estimates of future expected changes in net interest margins and cash expenditures. Key assumptions used by the Company in its discounted cash flow model (income approach) included an annual loan growth rate that ranged from $3.00 \%$ to $5.10 \%$, an annual deposit growth rate that ranged from $2.80 \%$ to $4.00 \%$ and a return on assets that ranged from $0.70 \%$ to $1.00 \%$. In addition to the above projections of estimated operating results, key assumptions used to determine the fair value estimate under the approach were the discount rate of $13.6 \%$ and the residual capitalization rate of $10.6 \%$. The discount rate used was the cost of equity capital. The cost of equity capital was based on the capital asset pricing model ("CAPM"), modified to account for a small stock premium. The small stock premium represents the additional return required by investors for small stocks based on the Stocks, Bonds, Bill and Inflation 2013 Yearbook. Beyond the approximate five-year forecast period, residual free cash flows were estimated to increase at a constant rate into perpetuity. These cash flows were converted to a residual value using an appropriate residual capitalization rate. The residual capitalization rate was equal to the discount rate minus the expected long-term growth rate of cash flows. Based on historical results, the economic climate, the outlook for the industry and management's expectations, a long-term growth rate of $3.0 \%$ was estimated.

The public company market approach analysis estimates the fair value by applying cash flow multiples to the reporting unit's operating performance. The multiples were derived from comparable publicly traded companies with operating and investment characteristics similar to those of the Company. Key assumptions used by the Company included the selection of comparable public companies and performance ratios. In applying the public company analysis, the Company selected eight publicly traded institutions based on similar lines of business, markets, growth prospects, risks and firm size. The performance ratios included price to earnings (last twelve months), price to earnings (current year to date), price to book value, price to tangible book value and price to deposits.

The merger and acquisition market approach analysis estimates the fair value by using merger and acquisition transactions involving companies that are similar in nature to the Company. Key assumptions used by the Company included the selection of comparable merger and acquisition transactions and the valuation ratios to be used. The analysis used banks located in Washington or Oregon that were acquired after January 1, 2012. The valuation ratios from these transactions for price to earnings and price to tangible book value were then used to derive an estimated fair value of the Company.

The trading price market approach analysis used the closing market price at May 30, 2014 of the Company's common stock, traded on the NASDAQ Global Market to determine the market value of total equity capital.

A key assumption used by the Company in the public company market approach analysis and the trading price market approach analysis was the application of a control premium. The Company's common stock is thinly traded and therefore management believes reflects a discount for illiquidity. In addition, the trading price of the Company's common stock reflects a minority interest value. To determine the fair market value of a majority interest in the Company's stock, premiums were calculated and applied to the indicated values. Therefore, a control premium was applied to the results of the public company market approach analysis and the trading price market approach analysis because the initial value conclusion was based on minority interest transactions. Merger and acquisition studies were analyzed to conclude that the difference between the acquisition price and a company's stock price prior to acquisition indicates, in part, the price effect of a controlling interest. Based on the evaluation of mergers and acquisition studies, a control premium of $25 \%$ was used.

The results of the Company's step one test indicated that the the reporting unit's fair value was more than its recorded value and therefore step two of the analysis was not necessary.

A significant amount of judgment is involved in determining if an indicator of goodwill impairment has occurred. Such indicators may include, among others: a significant decline in the expected future cash flows; a sustained, significant decline in the Company's stock price and market capitalization; a significant adverse change in legal factors or in the business climate; adverse assessment or action by a regulator; and unanticipated competition. Key assumptions used in the annual goodwill impairment test are highly judgmental and include: selection of comparable companies, amount of control premium, projected cash flows and discount rate applied to projected cash flows. Any change in these indicators or key assumptions could have a significant negative impact on the Company's financial condition, impact the goodwill impairment analysis or cause the Company to perform a goodwill impairment analysis more frequently than once per year.

As of June 30, 2014, management believes that there have been no events or changes in the circumstances that would indicate a potential impairment of goodwill. No assurances can be given, however, that the Company will not record an impairment loss on goodwill in the future.

17

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

Loans receivable and loans held for sale consisted of the following at June 30, 2014 and September 30, 2013 (dollars in thousands):

(1) Includes loans held for sale.

Construction and Land Development Loan Portfolio Composition
The following table sets forth the composition of the Company's construction and land development loan portfolio at June 30, 2014 and September 30, 2013 (dollars in thousands):

\left.|  | June 30, |  | September 30, |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :---: |
|  | 2014 |  | 2013 |  |  |  |$\right]$

Allowance for Loan Losses
The following tables set forth information for the three and nine months ended June 30, 2014 and 2013 regarding activity in the allowance for loan losses (dollars in thousands):

|  | Three Months Ended June 30, 2014 |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
|  | Beginning <br> Allowance | Provision /(Credit) | Chargeoffs | Recoveries | Ending <br> Allowance |
| Mortgage loans: |  |  |  |  |  |
| One-to four-family | \$1,751 | \$213 | \$356 | \$42 | \$1,650 |
| Multi-family | 433 | (31 | - | - | 402 |
| Commercial | 5,168 | (4 | ) - | - | 5,164 |
| Construction - custom and owner/builder | 348 | (15 | ) - | - | 333 |
| Construction - speculative one- to four-family | 46 | 10 | - | - | 56 |
| Construction - commercial | 25 | 13 | - | - | 38 |
| Construction - multi-family | - | (110 | ) - | 125 | 15 |
| Land | 1,568 | (83 | ) 5 | 4 | 1,484 |
| Consumer loans: |  |  |  |  |  |
| Home equity and second mortgage | 868 | (7 | ) - | - | 861 |
| Other | 194 | (4 | ) 2 | 2 | 190 |
| Commercial business loans | 348 | 18 | - | 4 | 370 |
| Total | \$10,749 | \$- | \$363 | \$177 | \$ 10,563 |


| Mortgage loans: |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| One-to four-family | \$ 1,449 | \$987 | \$979 | \$ 193 | \$ 1,650 |
| Multi-family | 749 | (347 | ) - | - | 402 |
| Commercial | 5,275 | 348 | 463 | 4 | 5,164 |
| Construction - custom and owner/builder | 262 | 71 | - | - | 333 |
| Construction - speculative one- to four-family 96 |  | (40 | ) - | - | 56 |
| Construction - commercial | 56 | (18 | ) - | - | 38 |
| Construction - multi-family | - | (236 | ) - | 251 | 15 |
| Construction - land development | - | (287 | ) - | 287 | - |
| Land | 1,940 | (607 | ) 260 | 411 | 1,484 |
| Consumer loans: |  |  |  |  |  |
| Home equity and second mortgage | 782 | 100 | 28 | 7 | 861 |
| Other | 200 | (8) | ) 4 | 2 | 190 |
| Commercial business loans | 327 | 37 | 14 | 20 | 370 |
| Total | \$ 11,136 | \$- | \$ 1,748 | \$ 1,175 | \$ 10,563 |

Mortgage loans:

| One-to four-family | $\$ 1,846$ | $\$ 1$ | $\$ 3$ | $\$ 19$ | $\$ 1,863$ |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Multi-family | 815 | $(1)$ | - | - | 814 |
| Commercial | 4,497 | 179 | 11 | 3 | 4,668 |
| Construction - custom and owner/builder | 284 | $(29)$ | 26 | - | 229 |
| Construction - speculative one- to four-family 41 | $(58)$ | - | - | 83 |  |
| Construction - commercial | 85 | 5 | - | - | 90 |
| Construction - land development | 12 | $(2)$ | 10 | - | - |
| Land | 2,197 | 1,311 | 1,543 | 1 | 1,966 |
| Consumer loans: |  |  |  |  |  |
| Home equity and second mortgage | 781 | $(2)$ | - | 5 | 784 |
| Other 239 <br> Commercial business loans 216 | $(21)$ | 8 | - | 233 |  |
| Total | $\$ 11,313$ | $\$ 1,385$ | $\$ 1,601$ | $\$ 29$ | $\$ 11,126$ |


| Mortgage loans: |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| One-to four-family | \$ 1,558 | \$792 | \$527 | \$40 | \$ 1,863 |
| Multi-family | 1,156 | (227) | 116 | 1 | 814 |
| Commercial | 4,247 | 1,035 | 667 | 53 | 4,668 |
| Construction - custom and owner/builder | 386 | (131) | 26 | - | 229 |
| Construction - speculative one- to four-famil | 1128 | (45) | - | - | 83 |
| Construction - commercial | 429 | (339) | - | - | 90 |
| Construction - land development | - | (130) | 16 | 146 | - |
| Land | 2,392 | 1,821 | 2,250 | 3 | 1,966 |
| Consumer loans: |  |  |  |  |  |
| Home equity and second mortgage | 759 | 204 | 184 | 5 | 784 |
| Other | 254 | (7) | 14 | - | 233 |
| Commercial business loans | 516 | (213) | - | 93 | 396 |
| Total | \$ 11,825 | \$2,760 | \$3,800 | \$341 | \$11,126 |

The following tables presents information on the loans evaluated individually for impairment and collectively evaluated for impairment in the allowance for loan losses at June 30, 2014 and September 30, 2013 (dollars in thousands):

|  | Allowance for Loan Losses |  |  | Recorded Investment in Loans |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Individually <br> Evaluated <br> for <br> Impairment | Collectively <br> Evaluated <br> for <br> Impairment | Total | Individually <br> Evaluated <br> for <br> Impairment | Collectively <br> Evaluated <br> for <br> Impairment | Total |
| June 30, 2014 <br> Mortgage loans: |  |  |  |  |  |  |
| One- to four-family | \$798 | \$852 | \$ 1,650 | \$7,520 | \$92,565 | \$ 100,085 |
| Multi-family | 50 | 352 | 402 | 3,326 | 43,751 | 47,077 |
| Commercial | 1,423 | 3,741 | 5,164 | 17,440 | 282,267 | 299,707 |
| Construction - custom and owner/builder | - | 333 | 333 | - | 28,982 | 28,982 |
| Construction - speculative oneto four-family | - | 56 | 56 | - | 1,445 | 1,445 |
| Construction - commercial | - | 38 | 38 | - | 1,520 | 1,520 |
| Construction - multi-family | - | 15 | 15 | - | 285 | 285 |
| Land | 383 | 1,101 | 1,484 | 5,446 | 22,996 | 28,442 |
| Consumer loans: |  |  |  |  |  |  |
| Home equity and second mortgage | 193 | 668 | 861 | 670 | 31,162 | 31,832 |
| Other | - | 190 | 190 | 8 | 5,221 | 5,229 |
| Commercial business loans | - | 370 | 370 | - | 25,341 | 25,341 |
| Total | \$2,847 | \$7,716 | \$ 10,563 | \$34,410 | \$535,535 | \$569,945 |

September 30, 2013
Mortgage loans:

| One- to four-family | \$600 | \$849 | \$ 1,449 | \$8,984 | \$95,314 | \$ 104,298 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Multi-family | 334 | 415 | 749 | 5,184 | 45,924 | 51,108 |
| Commercial | 1,763 | 3,512 | 5,275 | 19,510 | 271,787 | 291,297 |
| Construction - custom and owner/builder | - | 262 | 262 | - | 22,788 | 22,788 |
| Construction - speculative one- to four-family | 88 | 8 | 96 | 687 | 236 | 923 |
| Construction - commercial | - | 56 | 56 | - | 2,239 | 2,239 |
| Construction - multi-family | - | - | - | 143 | 1 | 144 |
| Construction - land development |  | - | - | 515 | - | 515 |
| Land | 234 | 1,706 | 1,940 | 2,391 | 28,753 | 31,144 |
| Consumer loans: |  |  |  |  |  |  |
| Home equity and second mortgage | 57 | 725 | 782 | 679 | 32,335 | 33,014 |
| Other | - | 200 | 200 | 6 | 5,975 | 5,981 |
| Commercial business loans | - | 327 | 327 | - | 17,499 | 17,499 |
| Total | \$3,076 | \$8,060 | \$ 11,136 | \$38,099 | \$522,851 | \$560,950 |

## Credit Quality Indicators

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

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

Special Mention: Special mention loans are defined as those loans deemed by management to have some potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in the deterioration of the payment prospects of the loan. Assets in this category do not expose the Company to sufficient risk to warrant a substandard classification.

Substandard: Substandard loans are defined as those loans that are inadequately protected by the current net worth and paying capacity of the obligor, or of the collateral pledged. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the repayment of the debt. If the weakness or weaknesses are not corrected, there is the distinct possibility that some loss will be sustained.

Loss: Loans in this classification are considered uncollectible and of such little value that continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this loan even though partial recovery may be realized in the future.

The following table lists the loan credit risk grades utilized by the Company that serve as credit quality indicators at June 30, 2014 and September 30, 2013 (dollars in thousands):

| Loan Grades |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| June 30, 2014 | Pass | Watch | Special <br> Mention | Substandard | Total |
| Mortgage loans: |  |  |  |  |  |
| One- to four-family | \$91,467 | \$1,835 | \$880 | \$5,903 | \$ 100,085 |
| Multi-family | 38,171 | 1,704 | 6,435 | 767 | 47,077 |
| Commercial | 271,593 | 3,179 | 18,622 | 6,313 | 299,707 |
| Construction - custom and owner/builder | 28,982 | - | - | - | 28,982 |
| Construction - speculative one- to four-family | 1,445 | - | - | - | 1,445 |
| Construction - commercial | 1,520 | - | - | - | 1,520 |
| Construction - multi-family | 285 | - | - | - | 285 |
| Land | 19,628 | 115 | 2,492 | 6,207 | 28,442 |
| Consumer loans: |  |  |  |  |  |
| Home equity and second mortgage | 29,938 | 729 | 326 | 839 | 31,832 |
| Other | 5,182 | 39 | - | 8 | 5,229 |
| Commercial business loans | 25,140 | 106 | 95 | - | 25,341 |
| Total | \$513,351 | \$7,707 | \$28,850 | \$20,037 | \$569,945 |
| September 30, 2013 |  |  |  |  |  |
| Mortgage loans: |  |  |  |  |  |
| One- to four-family | \$91,291 | \$4,032 | \$769 | \$8,206 | \$ 104,298 |
| Multi-family | 41,863 | 132 | 8,337 | 776 | 51,108 |
| Commercial | 262,502 | 3,309 | 12,522 | 12,964 | 291,297 |
| Construction - custom and owner/builder | 22,788 | - | - | - | 22,788 |
| Construction - speculative one- to four-family | 236 | 687 | - | - | 923 |
| Construction - commercial | 2,239 | - | - | - | 2,239 |
| Construction - multi-family | - | - | - | 144 | 144 |
| Construction - land development | - | - | - | 515 | 515 |
| Land | 20,627 | 5,101 | 1,129 | 4,287 | 31,144 |
| Consumer loans: |  |  |  |  |  |
| Home equity and second mortgage | 31,096 | 782 | 55 | 1,081 | 33,014 |
| Other | 5,937 | 39 | - | 5 | 5,981 |
| Commercial business loans | 17,029 | 366 | 104 | - | 17,499 |
| Total | \$495,608 | \$ 14,448 | \$22,916 | \$27,978 | \$560,950 |

The following tables present an age analysis of past due status of loans by category at June 30, 2014 and September 30, 2013 (dollars in thousands):

|  |  |  | Past Due |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| 30-59 | 60-89 |  | 90 Days |  |  |  |
| Days | Days | Accrual | or More | Past Due | Current | Loans |
| Past Due | Past Due |  | and Still Accruing |  |  |  |

June 30, 2014
Mortgage loans:

| One- to four-family \$- | \$ 163 | \$4,873 | \$- | \$5,036 | \$95,049 | \$ 100,085 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Multi-family | - | - | - | - | 47,077 | 47,077 |
| Commercial | 812 | 1,631 | - | 2,443 | 297,264 | 299,707 |
| Construction - custom and owner/builder | - | - | - | - | 28,982 | 28,982 |
| Construction - speculative one- to four- family | - | - | - | - | 1,445 | 1,445 |
| Construction - commercial - | - | - | - | - | 1,520 | 1,520 |
| Construction - multi-family- | - | - | - | - | 285 | 285 |
| Land 48 | - | 5,204 | - | 5,252 | 23,190 | 28,442 |
| Consumer loans: |  |  |  |  |  |  |
| Home equity and second mortgage | - | 371 | 150 | 521 | 31,311 | 31,832 |
| Other | - | 8 | - | 8 | 5,221 | 5,229 |
| Commercial business loans - | - | - | - | - | 25,341 | 25,341 |
| Total \$48 | \$975 | \$ 12,087 | \$150 | \$13,260 | \$556,685 | \$569,945 |

September 30, 2013
Mortgage loans:

| One- to four-family $\quad \$ 14$ | \$1,218 | \$6,985 | \$- | \$8,217 | \$96,081 | \$ 104,298 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Multi-family | - | - | - | - | 51,108 | 51,108 |
| Commercial | 2,537 | 3,435 | - | 5,972 | 285,325 | 291,297 |
| Construction - custom and owner/ builder | - | - | - | - | 22,788 | 22,788 |
| Construction - speculative one- to four- family | - | - | - | - | 923 | 923 |
| Construction - commercial - | - | - | - | - | 2,239 | 2,239 |
| Construction - multi-family- | - | 144 | - | 144 | - | 144 |
| Construction - land development | - | 515 | - | 515 | - | 515 |
| Land | - | 2,146 | 284 | 2,430 | 28,714 | 31,144 |
| Consumer loans: |  |  |  |  |  |  |
| Home equity and second mortgage 101 | 20 | 380 | 152 | 653 | 32,361 | 33,014 |
| Other | 39 | 5 | - | 45 | 5,936 | 5,981 |
| Commercial business loans 83 | 15 | - | - | 98 | 17,401 | 17,499 |
| Total \$199 | \$3,829 | \$13,610 | \$436 | \$ 18,074 | \$542,876 | \$560,950 |

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

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

The following is a summary of information related to impaired loans as of June 30, 2014 and for the three and nine months then ended (in thousands):

| Unpaid |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Principal | Unpaid |  |  |  | QTD YTD |  |
| Recorded | QTD | YTD | QTD | YTD | Cash | Cash |
|  | Related Average | Average | Interest | Interest | Basis | Basis |
| InvestmentBalance | Allowancecorded | Recorded | Income | Income | Interest | Interest |
| Plus | Allowance Investment | Investment | Recogniz | Recogniz | dncome | Income |
|  | (1) | (2) | (1) | (2) | Recogn | Recognized |
| Off) |  |  |  |  | (1) | (2) |

With no related
allowance recorded:
Mortgage loans:

| One- to four-family | \$ 2,635 | \$ 3,300 | \$ - | \$ 2,749 | \$ 3,767 | \$ - | \$ - | \$ - | \$ - |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Multi-family | - | 857 | - | - | 158 | - | - | - | - |
| Commercial | 9,047 | 12,342 | - | 9,077 | 7,704 | 151 | 267 | 122 | 210 |
| Construction - custom and owner/builder |  | - | - | - | 15 | - | - | - | - |
| Construction speculative one- to four-family | - | - | - | - | - | - | - | - | - |
| Construction -multi-family | - | 338 | - | - | 115 | - | - | - | - |
| Construction - land development | - | - | - | - | 244 | - | - | - | - |
| Land | 1,039 | 1,819 | - | 1,003 | 1,080 | 3 | 9 | 2 | 7 |
| Consumer loans: |  |  |  |  |  |  |  |  |  |
| Home equity and second mortgage | 185 | 389 | - | 211 | 251 | - | - | - | - |
| Other | 8 | 8 | - | 10 | 7 | - | - | - | - |
| Commercial business loans | - | 14 | - | 53 | 22 | - | - | - | - |
| Subtotal | 12,914 | 19,067 | - | 13,103 | 13,363 | 154 | 276 | 124 | 217 |

With an allowance
recorded:
Mortgage loans:

| One- to four-family | 4,885 | 4,903 | 798 | 4,925 | 4,336 | 39 | 109 | 31 | 81 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Multi-family | 3,326 | 3,326 | 50 | 3,675 | 4,580 | 45 | 175 | 34 | 132 |
| Commercial | 8,393 | 8,393 | 1,423 | 8,425 | 10,370 | 117 | 440 | 90 | 347 |
| Construction - custom | - | - | - | - | - | - | - | - |  |
| and owner/builder |  |  |  |  |  |  |  |  |  |
| Construction - <br> speculative one- to <br> four-family | - | - | - | - | 413 | - | 11 | - | 7 |
| Construction - <br> multi-family | - | - | - | - | - | - | - | - | - |
| Construction - land <br> development | - | - | - | - | - | - | - | - | - |
| Land | 4,407 | 4,407 | 383 | 4,477 | 3,225 | 6 | 12 | 6 | 12 |


| Consumer loans: |  |  |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Home equity and second mortgage | 485 | 485 | 193 | 488 | 375 | 4 | 12 | 3 | 9 |
| Other | - | - | - |  | - | - | - | - | - |
| Commercial business | - | - | - |  | - | - | - | - | - |
| Subtotal | 21,496 | 21,514 | 2,847 | 21,990 | 23,299 | 211 | 759 | 164 | 588 |

Total
Mortgage loans:

| One- to four-family | \$7,520 | \$8,203 | \$798 | \$7,674 | \$8,103 | \$39 | \$109 | \$31 | \$81 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Multi-family | 3,326 | 4,183 | 50 | 3,675 | 4,738 | 45 | 175 | 34 | 132 |
| Commercial | 17,440 | 20,735 | 1,423 | 17,502 | 18,074 | 268 | 707 | 212 | 557 |
| Construction - custom and owner/builder | - | - | - | - | 15 | - | - | - | - |
| Construction speculative one- to four-family | - | - | - | - | 413 | - | 11 | - | 7 |
| Construction -multi-family | - | 338 | - | - | 115 | - | - | - | - |
| Construction - land development | - | - | - | - | 244 | - | - | - | - |
| Land | 5,446 | 6,226 | 383 | 5,480 | 4,305 | 9 | 21 | 8 | 19 |
| Consumer loans: |  |  |  |  |  |  |  |  |  |
| Home equity and second mortgage | 670 | 874 | 193 | 699 | 626 | 4 | 12 | 3 | 9 |
| Other | 8 | 8 | - | 10 | 7 | - | - | - | - |
| Commercial business loans | - | 14 | - | 53 | 22 | - | - | - | - |
| Total | \$34,410 | \$40,581 | \$2,847 | \$35,093 | \$36,662 | \$365 | \$1,035 | \$288 | \$805 |

(1)For the three months ended June 30, 2014
(2)For the nine months ended June 30, 2014

26

The following is a summary of information related to impaired loans as of and for the year ended September 30, 2013 (in thousands):

|  | Unpaid |  | YTD | YTD | YTD Cash |
| :--- | :--- | :--- | :--- | :--- | :--- |
| Recorded | Principal | Related | Average | Interest | Basis |
| Investment | Recorded | Income | Interest |  |  |
|  | Balance (Loan | Allowance | Recome |  |  |
|  | Balance Plus |  | Investment | Recognized | Income |
|  | Charge Off) |  | (1) | (1) | (1) |

With no related allowance
recorded:
Mortgage loans:

| One- to four-family | $\$ 5,342$ | $\$ 5,775$ | $\$-$ | $\$ 2,661$ | $\$ 18$ | $\$ 13$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Multi-family | - | 982 | - | 473 | 3 | 3 |
| Commercial | 4,879 | 8,005 | - | 8,781 | 322 | 267 |
| Construction - custom and <br> owner/builder | - | - | - | 97 | - | - |
| Construction - speculative one- to <br> four-family | - | - | - | 65 | - | - |
| Construction - multi-family | 143 | 608 | - | 293 | - | - |
| Construction - land development <br> Land | 515 | 3,279 | - | 534 | - | - |
| Consumer loans: | 1,188 | 2,133 | - | 3,519 | 9 | 8 |
| Home equity and second mortgage | 380 | 556 | - | 266 | - | - |
| Other | 6 | 6 | - | 8 | - | - |
| Commercial business loans | - | 33 | - | - | - | - |
| Subtotal | 12,453 | 21,377 | - | 16,697 | 352 | 291 |

With an allowance recorded:
Mortgage loans:

| One- to four-family | 3,642 | 3,726 | 600 | 4,397 | 91 | 68 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Multi-family | 5,184 | 5,184 | 334 | 5,960 | 301 | 230 |
| Commercial | 14,631 | 15,297 | 1,763 | 9,052 | 526 | 420 |
| Construction - custom and owner/builder | - | - | - | 60 | - | - |
| Construction - speculative one- to four-family | 687 | 687 | 88 | 695 | 29 | 16 |
| Construction - multi-family | - | - | - | - | - | - |
| Construction - land development | - | - | - | - | - | - |
| Land | 1,203 | 1,226 | 234 | 1,962 | 27 | 27 |
| Consumer loans: |  |  |  |  |  |  |
| Home equity and second mortgage | 299 | 299 | 57 | 352 | 16 | 12 |
| Other | - | - | - | - | - | - |
| Subtotal | 25,646 | 26,419 | 3,076 | 22,478 | 990 | 773 |
| Total |  |  |  |  |  |  |
| Mortgage loans: |  |  |  |  |  |  |
| One- to four-family | 8,984 | 9,501 | 600 | 7,058 | 109 | 81 |
| Multi-family | 5,184 | 6,166 | 334 | 6,433 | 304 | 233 |
| Commercial | 19,510 | 23,302 | 1,763 | 17,833 | 848 | 687 |
| Construction - custom and | - | - | - | 157 | - |  |

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| Construction - speculative one- to <br> four-family | 687 | 687 | 88 | 760 | 29 | 16 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Construction - multi-family | 143 | 608 | - | 293 | - | - |
| Construction - land development | 515 | 3,279 | - | 534 | - | - |
| Land <br> Consumer loans: | 2,391 | 3,359 | 234 | 5,481 | 36 | 35 |
| Home equity and second mortgage <br> Other 679 | 855 | 57 | 618 | 16 | 12 |  |
| Commercial business loans 6 6 <br> Total - 33 | - | 8 | - | - |  |  |

(1) For the year ended September 30, 2013

27

The following table sets forth information with respect to the Company's non-performing assets at June 30, 2014 and September 30, 2013 (dollars in thousands):

|  | $\begin{aligned} & \text { June } 30, \\ & 2014 \end{aligned}$ |  | $\begin{aligned} & \text { September } \\ & 30, \\ & 2013 \end{aligned}$ |
| :---: | :---: | :---: | :---: |
| Loans accounted for on a non-accrual basis: |  |  |  |
| Mortgage loans: |  |  |  |
| One- to four-family | \$4,873 |  | \$6,985 |
| Commercial | 1,631 |  | 3,435 |
| Construction - multi-family | - |  | 144 |
| Construction - land development | - |  | 515 |
| Land | 5,204 |  | 2,146 |
| Consumer loans: |  |  |  |
| Home equity and second mortgage | 371 |  | 380 |
| Other | 8 |  | 5 |
| Commercial business loans | - |  | - |
| Total loans accounted for on a non-accrual basis | 12,087 |  | 13,610 |
| Accruing loans which are contractually past due 90 days or more | 150 |  | 436 |
| Total of non-accrual and 90 days past due loans | 12,237 |  | 14,046 |
| Non-accrual investment securities | 1,162 |  | 2,187 |
| OREO and other repossessed assets, net | 11,172 |  | 11,720 |
| Total non-performing assets (1) | \$24,571 |  | \$27,953 |
| Troubled debt restructured loans on accrual status (2) | \$16,524 |  | \$18,573 |
| Non-accrual and 90 days or more past due loans as a percentage of loans receivable | 2.15 | \% | 2.51 |
| Non-accrual and 90 days or more past due loans as a percentage of total assets | 1.68 | \% | 1.88 |
| Non-performing assets as a percentage of total assets | 3.38 | \% | 3.75 |
| Loans receivable (3) | \$568,258 |  | \$559,240 |
| Total assets | \$727,631 |  | \$745,648 |

(1) Does not include troubled debt restructured loans on accrual status.
(2) Does not include troubled debt restructured loans totaling $\$ 2.9$ million and $\$ 4.0$ million reported as non-accrual loans at June 30, 2014 and September 30, 2013, respectively.
(3) Includes loans held for sale and before the allowance for loan losses.

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

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consider. The loan terms which have been modified or restructured due to a borrower's financial difficulty include but are not limited to: a reduction in the stated interest rate; an extension of the maturity at an interest rate below current market; a reduction in the face amount of
the debt; a reduction in the accrued interest; or re-aging, extensions, deferrals and renewals. Troubled debt restructured loans are considered impaired loans and are individually evaluated for impairment. Troubled debt restructured loans can be classified as either accrual or non-accrual. Troubled debt restructured loans are classified as non-performing loans unless they have been performing in accordance with their modified terms for a period of at least six months. The Company had $\$ 19.44$ million in troubled debt restructured loans included in impaired loans at June 30, 2014 and had no commitments to lend additional funds on these loans. The Company had $\$ 22.60$ million in troubled debt restructured loans included in impaired loans at September 30, 2013 and had $\$ 1,000$ in commitments to lend additional funds on these loans. The allowance for loan losses allocated to troubled debt restructured loans at June 30, 2014 and September 30, 2013 was $\$ 1.72$ million and $\$ 2.37$ million, respectively.

The following table sets forth information with respect to the Company's troubled debt restructured loans by interest accrual status as of June 30, 2014 and September 30, 2013 (dollars in thousands):

Mortgage loans:

| One- to four-family | $\$ 2,647$ | $\$ 193$ | $\$ 2,840$ |
| :--- | :--- | :--- | :--- |
| Multi-family | 3,327 | - | 3,327 |
| Commercial | 10,009 | 1,495 | 11,504 |
| Land | 242 | 1,075 | 1,317 |
| Consumer loans: |  |  |  |
| Home equity and second mortgage <br> Total | 299 | 152 | 451 |

## Mortgage loans:

| One- to four-family | $\$ 1,999$ | $\$ 198$ | $\$ 2,197$ |
| :--- | :--- | :--- | :--- |
| Multi-family | 5,184 | - | 5,184 |
| Commercial | 10,160 | 1,574 | 11,734 |
| Construction - speculative one- to four-family | 687 | - | 687 |
| Construction - land development | - | 515 | 515 |
| Land | 244 | 1,564 | 1,808 |
| Consumer loans: |  |  |  |
| Home equity and second mortgage | 299 | 180 | 479 |
| Total | $\$ 18,573$ | $\$ 4,031$ | $\$ 22,604$ |

The following table sets forth information with respect to the Company's troubled debt restructured loans by portfolio segment that occurred during the nine months ended June 30, 2014 and the year ended September 30, 2013 (dollars in thousands):

June 30, 2014
$\left.\begin{array}{llll} & \begin{array}{l}\text { Pre-Modification }\end{array} \begin{array}{l}\text { Post- } \\ \text { Nodification }\end{array} & \begin{array}{l}\text { End of } \\ \text { Number of } \\ \text { Contracts }\end{array} & \begin{array}{l}\text { Outstanding } \\ \text { Recorded } \\ \text { Investment }\end{array}\end{array} \begin{array}{l}\text { Outstanding } \\ \text { Recorded } \\ \text { Investment }\end{array}\right)$

September 30, 2013

One-to four-family (2)
Commercial (1)
Total
Number of

Contracts \begin{tabular}{lll}

Pre-Modification \& \begin{tabular}{l}
Post- <br>
Outstanding <br>
Recorded <br>
Investment

 \& 

Outstanding <br>
Recorded
\end{tabular}

 

End of <br>
Period <br>
Balance
\end{tabular}

(1)Modifications were a result of a reduction in the stated interest rate.
(2) Modifications were a result of a combination of changes (i.e., a reduction in the stated interest rate and an extension of the maturity at an interest rate below current market).

## (6) NET INCOME PER COMMON SHARE

Basic net income per common share is computed by dividing net income to common shareholders by the weighted average number of common shares outstanding during the period, without considering any dilutive items. Diluted net income per common share is computed by dividing net income to common shareholders by the weighted average number of common shares and common stock equivalents for items that are dilutive, net of shares assumed to be repurchased using the treasury stock method at the average share price for the Company's common stock during the period. The dividend and related accretion for the amount of the Company's Series A Preferred Stock outstanding for the respective period was deducted from net income and the discount on the redemption of Series A Preferred Stock was added to net income in computing net income to common shareholders. Common stock equivalents arise from the assumed conversion of outstanding stock options and the outstanding warrant to purchase common stock. Shares owned by the Bank's ESOP that have not been allocated are not considered to be outstanding for the purpose of computing basic and diluted net income per common share. At June 30, 2014 and 2013, there were 187,807 and 225,070 shares, respectively, that had not been allocated under the Bank's ESOP.

Information regarding the calculation of basic and diluted net income per common share for the three and nine months ended June 30, 2014 and 2013 is as follows (dollars in thousands, except per share amounts):

| Three Months Ended | Nine Months Ended |  |
| :--- | :--- | :--- |
| June 30, | June 30, |  |
| 2014 2013 | 2014 |  |
| (In thousands, except for per share data) |  |  |


| Basic net income per common share computation |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Numerator - net income | \$ 1,434 | \$876 |  | \$4,204 | \$3,863 |
| Preferred stock dividends | - | (151 | ) | (136 | ) (559 |
| Preferred stock discount accretion | - | (47 | ) | (70 | ) (236 |
| Discount on redemption of preferred stock | - | - |  | - | 255 |
| Net income to common shareholders | \$ 1,434 | \$678 |  | \$3,998 | \$3,323 |
| Denominator - weighted average common shares outstanding | 6,857,149 | 6,818,752 |  | 6,855,811 | 6,816,772 |
| Basic net income per common share | \$0.21 | \$0.10 |  | \$0.58 | \$ 0.49 |
| Diluted net income per common share computation |  |  |  |  |  |
| Numerator - net income | \$ 1,434 | \$876 |  | \$4,204 | \$3,863 |
| Preferred stock dividends | - | (151 | ) | (136 | ) (559 |
| Preferred stock discount accretion | - | (47 | ) | (70 | ) (236 |
| Discount on redemption of preferred stock | - | - |  | - | 255 |
| Net income to common shareholders | \$ 1,434 | \$678 |  | \$3,998 | \$3,323 |
| Denominator - weighted average common shares outstanding | 6,857,149 | 6,818,752 |  | 6,855,811 | 6,816,772 |
| Effect of dilutive stock options (1) | 38,582 | 18,458 |  | 36,070 | 13,035 |
| Effect of dilutive stock warrant | 137,982 | 65,287 |  | 123,274 | 40,944 |
| Weighted average common shares and common stock equivalents | 7,033,713 | 6,902,497 |  | 7,015,155 | 6,870,751 |
| Diluted net income per common share | \$0.20 | \$0.10 |  | \$0.57 | \$ 0.48 |

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(1) For the three and nine months ended June 30, 2014, average options to purchase 126,000 and 131,489 shares of common stock, respectively, were outstanding but not included in the computation of diluted net income per common share because their effect would have been anti-dilutive. For the three and nine months ended June 30, 2013, options to purchase 56,546 and

131,152 shares of common stock, respectively, were outstanding but not included in the computation of diluted net income per common share because their effect would have been anti-dilutive.

## (7) STOCK PLANS AND STOCK BASED COMPENSATION

## Stock Option Plans

Under the Company's stock option plans (the 1999 Stock Option Plan and the 2003 Stock Option Plan), the Company was able to grant options for up to a combined total of $1,622,500$ shares of common stock to employees, officers and directors. Shares issued may be purchased in the open market or may be issued from authorized and unissued shares. The exercise price of each option equals the fair market value of the Company's common stock on the date of grant. Generally, options vest in $20 \%$ annual installments on each of the five anniversaries from the date of the grant. At June 30, 2014, there were no options for shares available for future grant under the 2003 Stock Option Plan or the 1999 Stock Option Plan.

Activity under the plans for the nine months ended June 30, 2014 and 2013 is as follows:

|  | Nine Months Ended |  | Nine Months Ended |  |
| :--- | :--- | :--- | :--- | :--- |
|  | June 30, 2014 |  | June 30, 2013 |  | Weighted

The aggregate intrinsic value of options outstanding at June 30, 2014 was $\$ 693,000$.
At June 30, 2014, there were 190,000 unvested options with an aggregate grant date fair value of $\$ 464,000$, all of which the Company assumes will vest. The aggregate intrinsic value of unvested options at June 30, 2014 was $\$ 477,000$. There were 14,600 options with an aggregate grant date fair value of $\$ 26,000$ that vested during the nine months ended June 30, 2014.

At June 30, 2013, there were 99,500 unvested options with an aggregate grant date fair value of $\$ 208,000$. There were 8,800 options with an aggregate grant date fair value of $\$ 13,000$ that vested during the nine months ended June 30 , 2013.

The Company uses the Black-Scholes option pricing model to estimate the fair value of stock-based awards with the weighted average assumptions noted in the following table. The risk-free interest rate is based on the U.S. Treasury rate of a similar term as the stock option at the particular grant date. The expected life is based on historical data, vesting terms and estimated exercise dates. The expected dividend yield is based on the most recent quarterly dividend on an annualized basis in effect at the time the options were granted, adjusted, if appropriate for management's expectations regarding future dividends. The expected volatility is based on historical volatility of the Company's stock price. There were 135,000 options granted during the nine months ended June 30, 2014 with an aggregate grant date fair value of $\$ 349,000$. There were 29,000 options granted during the nine months ended June 30, 2013 with an aggregate grant date fair value of $\$ 69,000$.

The weighted average assumptions used for options granted during the nine months ended June 30, 2014 and 2013 were:

32

|  | 2014 |  | 2013 | $\%$ |
| :--- | :--- | :--- | :--- | :--- |
| Expected volatility | 39 | $\%$ | 45 | $\%$ |
| Expected term (in years) | 5 | 5 | $\%$ |  |
| Expected dividend yield | 2.51 | $\%$ | - | $\%$ |
| Risk free interest rate | 1.41 | $\%$ | 0.76 | $\%$ |
| Grant date fair value per share | $\$ 2.59$ |  | $\$ 2.37$ |  |

## Stock Grant Plan

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

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

No MRDP shares were granted during the nine months ended June 30, 2014 or 2013. At June 30, 2014, no shares were available for future awards under the MRDP.

At June 30, 2014, there were no unvested MRDP shares. There were 3,254 MRDP shares that vested during the nine months ended June 30, 2014 with an aggregate grant date fair value of $\$ 23,000$.

At June 30, 2013, there were 3,248 unvested MRDP shares with an aggregated grant date fair value of $\$ 23,000$. There were 6,213 MRDP shares that vested during the nine months ended June 30,2013 with an aggregated grant date fair value of $\$ 62,000$. At June 30, 2013, no shares were available for future awards under the MRDP.

Expense for Stock Compensation Plans
Compensation expense for all stock-based plans were as follows:

|  | Nine Months Ended June 30, <br> 2014 <br> (Dollars in thousands) |  | 2013 |  |
| :--- | :--- | :--- | :--- | :--- |
|  | Stock | Stock | Stock | Stock |
|  | Options | Grants | Options | Grants |
| Compensation expense | $\$ 76$ | $\$ 2$ | $\$ 37$ | $\$ 32$ |
| Related tax benefit recognized | $\$-$ | $\$-$ | $\$ 13$ | $\$ 11$ |

As of June 30, 2014, the compensation expense yet to be recognized for stock-based awards that have been awarded but not vested for the years ending September 30 is as follows (dollars in thousands):

|  | Stock | Stock | Total |
| :--- | :--- | :--- | :--- |
|  | Options | Grants | Awards |
| Remainder of 2014 | $\$ 28$ | $\$-$ | $\$ 28$ |
| 2015 | 106 | - | 106 |
| 2016 | 106 | - | 106 |
| 2017 | 98 | - | 98 |
| 2018 | 67 | - | 67 |
| 2019 | 9 | - | 9 |

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Total
\$414
\$—
\$414

33
(8) FAIR VALUE MEASUREMENTS

GAAP requires disclosure of estimated fair values for financial instruments. Such estimates are subjective in nature, and significant judgment is required regarding the risk characteristics of various financial instruments at a discrete point in time. Therefore, such estimates could vary significantly if assumptions regarding uncertain factors were to change. In addition, as the Company normally intends to hold the majority of its financial instruments until maturity, it does not expect to realize many of the estimated amounts disclosed. The disclosures also do not include estimated fair value amounts for certain items which are not defined as financial instruments but which may have significant value. The Company does not believe that it would be practicable to estimate a representational fair value for these types of items as of June 30, 2014 and September 30, 2013. Because GAAP excludes certain items from fair value disclosure requirements, any aggregation of the fair value amounts presented would not represent the underlying value of the Company.

Accounting guidance regarding fair value measurements defines fair value and establishes a framework for measuring fair value in accordance with GAAP. Fair value is the exchange price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date. The following definitions describe the levels of inputs that may be used to measure fair value:

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

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

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

The Company used the following methods and significant assumptions to estimate fair value on a recurring basis:
MBS and Other Investments Available for Sale
The estimated fair value of MBS and other investments are based upon the assumptions market participants would use in pricing the security. Such assumptions include quoted market prices (Level 1), market prices of similar securities or observable inputs (Level 2).

Mutual Funds
The estimated fair value of mutual funds are based upon quoted market price assumptions (Level 1).
The following table summarizes the balances of assets and liabilities measured at estimated fair value on a recurring basis at
June 30, 2014 (dollars in thousands):
Estimated Fair Value
$\begin{array}{llll}\text { Level } 1 & \text { Level } 2 & \text { Level } 3 & \text { Total }\end{array}$
Available for Sale Securities
MBS:

| U.S. government agencies | $\$-$ | $\$ 1,967$ | $\$-$ | $\$ 1,967$ |
| :--- | :--- | :--- | :--- | :--- |
| Mutual funds | 961 | - | - | 961 |
| Total | $\$ 961$ | $\$ 1,967$ | $\$-$ | $\$ 2,928$ |

There were no transfers among Level 1, Level 2 and Level 3 during the three and nine months ended June 30, 2014.

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The following table summarizes the balances of assets and liabilities measured at estimated fair value on a recurring basis at September 30, 2013 (dollars in thousands):

Estimated Fair Value
$\begin{array}{llll}\text { Level } 1 & \text { Level } 2 & \text { Level } 3 & \text { Total }\end{array}$

| Available for Sale Securities |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- |
| MBS: | $\$-$ | $\$ 2,229$ | $\$-$ | $\$ 2,229$ |
| U.S. government agencies | - | 914 | - | 914 |
| Private label residential | 958 | - | - | 958 |
| Mutual funds | $\$ 958$ | $\$ 3,143$ | $\$-$ | $\$ 4,101$ |

There were no transfers between Level 1, Level 2 and Level 3 during the year ended September 30, 2013.
The Company may be required, from time to time, to measure certain financial assets and financial liabilities at fair value on a nonrecurring basis in accordance with GAAP. These include assets that are measured at the lower of cost or market value that were recognized at fair value below cost at the end of the period.

The Company uses the following methods and significant assumptions to estimate fair value on a non-recurring basis:
Impaired Loans: A loan is considered to be impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. The specific reserve for collateral dependent impaired loans was based on the estimated fair value of the collateral less estimated costs to sell, if applicable. The estimated fair value of collateral was determined based primarily on appraisals. In some cases, adjustments were made to the appraised values due to various factors including age of the appraisal, age of comparables included in the appraisal, and known changes in the market and in the collateral. Such adjustments may be significant and typically result in a Level 3 classification of the inputs for determining fair value. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

MBS and Other Investments Held to Maturity: The estimated fair value of MBS and other investments are based upon the assumptions market participants would use in pricing the security. Such assumptions include quoted market prices (Level 1), market prices of similar securities or observable inputs (Level 2) and unobservable inputs such as dealer quotes, discounted cash flows or similar techniques (Level 3).

OREO and Other Repossessed Assets, net: The Company's OREO and other repossessed assets are initially recorded at estimated fair value less estimated costs to sell. This amount becomes the property's new basis. Estimated fair value was generally determined by management based on a number of factors, including third-party appraisals of estimated fair value in an orderly sale. Estimated costs to sell were based on standard market factors. The valuation of OREO and other repossessed assets is subject to significant external and internal judgment (Level 3).

MSRs: The fair value of the MSRs was determined using a third-party model, which incorporates the expected life of the loans, estimated cost to service the loans, servicing fees received and other factors. The estimated fair value is calculated by stratifying the MSRs based on the predominant risk characteristics that include the underlying loan's interest rate, cash flows of the loan, origination date and term (Level 3).

The following table summarizes the balances of assets measured at estimated fair value on a non-recurring basis at June 30, 2014, and the total losses resulting from these estimated fair value adjustments for the nine months ended June 30, 2014 (dollars in thousands):

|  | Estimated Fair Value <br> Level 1 |  | Level 2 | Level 3 |
| :--- | :--- | :--- | :--- | :--- | Total Losses

[^0]The following table summarizes the balances of assets and liabilities measured at estimated fair value on a non-recurring basis at September 30, 2013 and the total losses resulting from these estimated fair value adjustments for the year ended September 30, 2013 (dollars in thousands):

Estimated Fair Value
$\begin{array}{llll}\text { Level } 1 & \text { Level } 2 & \text { Level } 3 & \text { Total Losses }\end{array}$
Impaired loans:
Mortgage Loans:

| One-to four-family | $\$-$ | $\$-$ | $\$ 3,042$ | $\$ 769$ |
| :--- | :--- | :--- | :--- | :--- |
| Multi-family | - | - | 4,850 | - |
| Commercial | - | - | 12,868 | 667 |
| Construction - speculative one-to four-family | - | - | 599 | - |
| Land | - | - | 969 | 2,307 |
| Consumer loans: | - | - | 242 |  |
| Home equity and second mortgage | - | - | 22,570 | 3,927 |
| Total impaired loans (1) | - |  |  |  |
| MBS - held to maturity (2): | - | - | 18 | 45 |
| Private label residential | $\$-$ | $\$ 83$ | $\$ 34,290$ | $\$ 6,036$ |

[^1]
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The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis as of June 30, 2014 (dollars in thousands):

|  | Estimated <br> Fair Value | Valuation <br> Technique(s) | Unobservable Input(s) <br> Appraised value of underlying <br> collateral less selling costs | Range |
| :--- | :--- | :--- | :--- | :--- |

The following methods and assumptions were used by the Company in estimating fair value of its other financial instruments:

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

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

MBS and Other Investments: See descriptions above.
FHLB Stock: No ready market exists for this stock, and it has no quoted market value. However, redemption of this stock has historically been at par value. During the three months ended June 30, 2014, 1,530 shares of FHLB stock were redeemed from the Company at par value. Accordingly, par value is deemed to be a reasonable estimate of fair value.

Loans Receivable, Net: The fair value of loans was estimated using a discounted cash flow analysis and comparable market statistics. A discounted cash flow analysis was used to estimate the fair value of loans graded pass. The fair value of loans graded watch, special mention and substandard was estimated using comparable market statistics that approximated sales of similarly rated loans.

Loans Held for Sale: The estimated fair value is based on quoted market prices obtained from the Federal Home Loan Mortgage Corporation.

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

FHLB Advances: The estimated fair value of FHLB advances is computed by discounting the future cash flows of the borrowings at a rate which approximates the current offering rate of the borrowings with a comparable remaining life.

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

The estimated fair values of financial instruments were as follows as of June 30, 2014 and September 30, 2013 (dollars in thousands):

|  | June 30, 2014 |  | Fair Value Measurements Using: |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- | :---: | :---: |
|  | Recorded <br> Amount | Total | Level 1 | Level 2 | Level 3 |  |  |
| Financial Assets |  |  |  |  |  |  |  |
| Cash and cash equivalents | $\$ 63,967$ | $\$ 63,967$ | $\$ 63,967$ | $\$-$ | $\$-$ |  |  |
| CDs held for investment | 32,336 | 32,336 | 32,336 | - | - |  |  |
| MBS and other investments | 8,345 | 9,213 | 961 | 8,212 | 40 |  |  |
| FHLB stock | 5,299 | 5,299 | 5,299 | - | - |  |  |
| Loans receivable, net | 556,194 | 544,485 | - | - | 544,485 |  |  |
| Loans held for sale | 1,501 | 1,552 | 1,552 | - | - |  |  |
| Accrued interest receivable | 1,922 | 1,922 | 1,922 | - | - |  |  |
|  |  |  |  |  |  |  |  |
| Financial Liabilities |  |  |  |  |  |  |  |
| Deposits: |  |  |  |  |  |  |  |
| Non-interest-bearing demand | $\$ 92,995$ | $\$ 92,995$ | $\$ 92,995$ | $\$-$ | $\$-$ |  |  |
| Interest-bearing | 505,637 | 506,392 | 345,394 | - | 160,998 |  |  |
| Total deposits | 598,632 | 599,387 | 438,389 | - | 160,998 |  |  |
| FHLB advances | 45,000 | 47,702 | - | 47,702 | - |  |  |
| Accrued interest payable | 294 | 294 | 294 | - | - |  |  |

September 30, 2013
Fair Value Measurements Using:
Recorded
$\begin{array}{lllll}\text { Amount } & \text { Total } & \text { Level } 1 & \text { Level } 2 & \text { Level } 3\end{array}$
Financial Assets
Cash and cash equivalents
CDs held for investment
MBS and other investments
FHLB stock
Loans receivable, net
Loans held for sale
Accrued interest receivable

| $\$ 94,496$ | $\$ 94,496$ | $\$ 94,496$ | $\$-$ | $\$-$ |
| :--- | :--- | :--- | :--- | :--- |
| 30,042 | 30,042 | 30,042 | - | - |
| 6,838 | 7,634 | 973 | 6,661 | - |
| 5,452 | 5,452 | 5,452 | - | - |
| 546,193 | 534,364 | - | - | 534,364 |
| 1,911 | 1,973 | 1,973 | - | - |
| 1,972 | 1,972 | 1,972 | - | - |

Financial Liabilities
Deposits:
Non-interest-bearing demand
Interest-bearing
Total deposits
FHLB advances
Accrued interest payable

| $\$ 87,657$ | $\$ 87,657$ | $\$ 87,657$ | $\$-$ | $\$-$ |
| :--- | :--- | :--- | :--- | :--- |
| 520,605 | 522,021 | 346,455 | - | 175,566 |
| 608,262 | 609,678 | 434,112 | - | 175,566 |
| 45,000 | 48,445 | - | 48,445 | - |
| 320 | 320 | 320 | - | - |

## (9) RECENT ACCOUNTING PRONOUNCEMENTS

In July 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standard Update ("ASU") No. 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exits. The guidance clarifies when it is appropriate for an unrecognized tax benefit, or portion of an unrecognized tax benefit, to be presented in the financial statements as a reduction to a deferred tax asset. ASU 2013-11 is effective prospectively for annual periods, and interim periods within those years, beginning after December 15, 2013. Adoption of ASU 2013-11 is not expected to have a material impact on the Company's condensed consolidated financial statements.

In January 2014, the FASB issued ASU No. 2014-04, Receivables - Troubled Debt Restructurings by Creditors. The guidance clarifies when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of the residential real estate property collateralizing a consumer mortgage loan such that the loan should be derecognized and the real estate property recognized. ASU 2014-04 is effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. The guidance can be adopted using a modified retrospective transition method or a prospective transition method. Adoption of ASU 2014-04 is not expected to have a material impact on the Company's condensed consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers. This guidance implements a common revenue standard that clarifies the principles for recognizing revenue. The core principle of ASU No. 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply the following steps: (i) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract and (v) recognize revenue when (or as) the entity satisfies a performance obligation. ASU No. 2014-09 is effective for annual and interim reporting periods within those annual periods, beginning after December 15, 2016. Adoption of the new guidance is not expected to have a material impact on the Company's condensed consolidated financial statements.

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

As used in this Form 10-Q, the terms "we," "our" and "Company" refer to Timberland Bancorp, Inc. and its consolidated subsidiaries, unless the context indicates otherwise. When we refer to "Bank" in this Form 10-Q, we are referring to Timberland Bank, a wholly-owned subsidiary of Timberland Bancorp, Inc. and the Bank's wholly-owned subsidiary, Timberland Service Corporation.

The following analysis discusses the material changes in the condensed consolidated financial condition and results of operations of the Company at and for the three and nine months ended June 30, 2014. This analysis as well as other sections of this report contains certain "forward-looking statements."

Certain matters discussed in this Quarterly Report on Form 10-Q may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 concerning our future operations. These statements relate to our financial condition, results of operations, plans, objectives, future performance or business. Forward-looking statements are not statements of historical fact, are based on certain assumptions and often include the words "believes," "expects," "anticipates," "estimates," "forecasts," "intends," "plans," "targets," "potentially," "p "projects," "outlook" or similar expressions or future or conditional verbs such as "may," "will," "should," "would" and
"could." Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, assumptions and statements about future economic performance and projections of financial items. These forward-looking statements are subject to known and unknown risks, uncertainties and other factors that could cause actual results to differ materially from the results anticipated or implied by our forward-looking statements, including, but not limited to: the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs and changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets which may lead to increased losses and non-performing assets in our loan portfolio, and may result in our allowance for loan losses not being adequate to cover actual losses, and require us to materially increase our loan loss reserves; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, and the relative differences between short and long term interest rates, deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes, land and other properties and fluctuations in real estate values in our market

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areas; secondary market conditions for loans and our ability to sell loans in the secondary market; results of examinations of us by the Board of Governors of the Federal Reserve System ("Federal Reserve") and of our bank subsidiary by the FDIC, the Washington State Department of Financial Institutions, Division of Banks or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, institute an informal or formal enforcement action against us or our bank subsidiary which could require us to increase our allowance for loan losses, write-down assets, change our regulatory capital position or affect our ability to borrow funds or maintain or increase deposits or impose additional requirements and restrictions on us, any of which could adversely affect our liquidity and earnings; legislative or regulatory changes that adversely affect our business including changes in regulatory policies and principles, or the interpretation of regulatory capital or other rules, including as a result of Basel III; the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act and implementing regulations; our ability to attract and retain deposits; increases in premiums for deposit insurance; our ability to control operating costs and expenses; the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation; difficulties in reducing risk associated with the loans on our consolidated balance sheet; staffing fluctuations in response to product demand or the implementation of corporate strategies that affect our work force and potential associated charges; the failure or security breach of computer systems on which we depend; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; our ability to implement our business strategies; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we may acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; our ability to manage loan delinquency rates; increased competitive pressures among financial services companies; changes in consumer spending, borrowing and savings habits; the availability of resources to address changes in laws, rules, or regulations or to respond to regulatory actions; our ability to pay dividends on our common and preferred stock; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the FASB, including additional guidance and interpretation on accounting issues and details of the implementation of new accounting methods; the economic impact of war or any terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations; pricing, products and services; and other risks detailed in our reports filed with the Securities and Exchange Commission, including our 2013 Form 10-K.

Any of the forward-looking statements that we make in this Form 10-Q and in the other public statements we make are based upon management's beliefs and assumptions at the time they are made. We do not undertake and specifically disclaim any obligation to publicly update or revise any forward-looking statements included in this report or to update the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise. We caution readers not to place undue reliance on any forward-looking statements. These risks could cause our actual results for fiscal 2014 and beyond to differ materially from those expressed in any forward-looking statements by, or on behalf of us, and could negatively affect the Company's financial condition and results of operations as well as its stock price performance.

## Overview

Timberland Bancorp, Inc., a Washington corporation, is the holding company for Timberland Bank. The Bank opened for business in 1915 and serves consumers and businesses across Grays Harbor, Thurston, Pierce, King, Kitsap and Lewis counties, Washington with a full range of lending and deposit services through its 22 branches (including its main office in Hoquiam). At June 30, 2014, the Company had total assets of $\$ 727.63$ million and total shareholders' equity of $\$ 81.33$ million. The Company's business activities generally are limited to passive investment activities and oversight of its investment in the Bank. Accordingly, the information set forth in this report relates primarily to the Bank's operations.

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

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

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Net income is also affected by non-interest income and non-interest expenses. For the three and nine month period ended June 30, 2014, non-interest income consisted primarily of service charges on deposit accounts, gain on sale of loans, ATM and debit card interchange transaction fees, an increase in the cash surrender value of BOLI and other operating income. Non-interest income is reduced by net OTTI losses on MBS and other investments and losses on the sale of MBS and other investments. Non-interest expenses consisted primarily of salaries and employee benefits, premises and equipment, advertising, ATM and debit card processing expenses, OREO and other repossessed asset expenses, postage and courier expenses, professional fees, deposit insurance premiums, other insurance premiums, state and local taxes, loan administration and foreclosure expenses, deposit operation expenses and data processing expenses and telecommunication expenses. Non-interest income and non-interest expenses are affected by the growth of our operations and growth in the number of loan and deposit accounts.

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

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

Critical Accounting Policies and Estimates
The Company has identified several accounting policies that as a result of judgments, estimates and assumptions inherent in those policies, are critical to an understanding of the Company's Condensed Consolidated Financial Statements. Critical accounting policies and estimates are discussed in the Company's 2013 Form 10-K under Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operation - Critical Accounting Policies and Estimates." That discussion highlights estimates the Company makes that involve uncertainty or potential for substantial change. There have been no material changes in the Company's critical accounting policies and estimates as previously disclosed in the Company's 2013 Form 10-K.

Comparison of Financial Condition at June 30, 2014 and September 30, 2013
The Company's total assets decreased by $\$ 18.02$ million, or $2.4 \%$, to $\$ 727.63$ million at June 30, 2014 from $\$ 745.65$ million at September 30, 2013. The decrease in total assets was primarily due to a decrease in total cash and cash equivalents, which was partially offset by increases in net loans receivable, CDs held for investment and MBS and other investments.

Net loans receivable increased by $\$ 9.59$ million, or $1.7 \%$, to $\$ 557.70$ million at June 30, 2014 from $\$ 548.10$ million at September 30, 2013. The increase was primarily due to increases in construction, in particular custom and owner/builder loans, commercial real estate loans and commercial business loans. These increases were partially offset by decreases in one-to four-family loans, multi-family loans, land loans and consumer loans.

Total deposits decreased by $\$ 9.63$ million, or $1.6 \%$, to $\$ 598.63$ million at June 30, 2014 from $\$ 608.26$ million at September 30, 2013. The decrease was primarily a result of decreases in certificates of deposit accounts and money market accounts balances, which was partially offset by increases in non-interest bearing accounts, savings accounts and N.O.W. checking accounts.

Shareholders' equity decreased by $\$ 8.36$ million, or $9.3 \%$, to $\$ 81.33$ million at June 30, 2014 from $\$ 89.69$ million at September 30, 2013. The decrease in shareholders' equity was primarily a result of the redemption of 12,065 shares of Series A Preferred Stock for $\$ 12.07$ million and the payment of dividends on common and preferred stock totaling $\$ 883,000$. These decreases to shareholders' equity were partially offset by net income of $\$ 4.20$ million for the nine months ended June 30, 2014.

A more detailed explanation of the changes in significant balance sheet categories follows:
Cash and Cash Equivalents and CDs Held for Investment: Cash and cash equivalents and CDs held for investment decreased by $\$ 28.24$ million, or $22.7 \%$, to $\$ 96.30$ million at June 30, 2014 from $\$ 124.54$ million at September 30, 2013. The decrease was primarily due to a $\$ 31.15$ million, or $38.2 \%$, decrease in interest-bearing deposits in banks, which was partially offset by a $\$ 2.29$ million increase in CDs held for investment and a $\$ 621,000$ increase in cash and due from financial institutions. The decrease in interest-bearing deposits in banks was primarily due to funding the redemption of Series A Prefe

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rred Stock for $\$ 12.07$ million, a $\$ 9.59$ million increase in net loans receivable and a $\$ 9.63$ million decrease in total deposits.

MBS (Mortgage-backed Securities) and Other Investments: MBS and other investments increased by $\$ 1.51$ million, or $22.0 \%$, to $\$ 8.35$ million at June 30, 2014 from $\$ 6.84$ million at September 30, 2013, primarily due to the purchase of $\$ 3.00$ million of U.S. government agency securities, which was partially offset by the sale of $\$ 747,000$ in private label residential MBS and scheduled amortization and prepayments on MBS. For additional information on MBS and other investments, see Note 3 of the Notes to Unaudited Condensed Consolidated Financial Statements contained in "Item 1, Financial Statements."

Loans: Net loans receivable increased by $\$ 9.59$ million, or $1.7 \%$, to $\$ 557.70$ million at June 30, 2014 from $\$ 548.10$ million at September 30, 2013. The increase in the portfolio was primarily a result of an $\$ 8.56$ million increase in construction and land development loans, an $\$ 8.41$ million increase in commercial real estate loans and a $\$ 7.84$ million increase in commercial business loans. These increases in net loans receivable were partially offset by a $\$ 4.21$ million decrease in one-to four-family loans, a $\$ 4.03$ million decrease in multi-family loans, a $\$ 2.70$ million decrease in land loans and a $\$ 1.93$ million decrease in consumer loans. Net loans receivable was also impacted by a $\$ 573,000$ decrease in the allowance for loan losses and a $\$ 2.94$ million increase in the undisbursed portion of construction loans in process.

Loan originations decreased $\$ 39.31$ million, or $23.9 \%$, to $\$ 125.39$ million for the nine months ended June 30, 2014 from $\$ 164.70$ million for the nine months ended June 30, 2013. The Company continued to sell longer-term fixed rate loans for asset liability management purposes and to generate non-interest income. Sales of fixed rate one- to four-family mortgage loans decreased $\$ 51.31$ million, or $68.8 \%$, to $\$ 23.30$ million for the nine months ended June 30 , 2014 compared to $\$ 74.61$ million for the nine months ended June 30, 2013. The decrease in loan originations and loans sold was primarily due to a reduction of $\$ 51.38$ million in loans originated for sale as refinance demand for single family loans decreased.

For additional information, see Note 5 of the Notes to Unaudited Condensed Consolidated Financial Statements contained in "Item 1, Financial Statements."

Premises and Equipment: Premises and equipment increased by $\$ 103,000$, or $0.6 \%$, to $\$ 17.87$ million at June 30, 2014 from $\$ 17.76$ million at September 30, 2013. The increase was primarily due to several remodeling projects at branch offices and several technology related initiatives.

OREO (Other Real Estate Owned): OREO and other repossessed assets decreased by $\$ 548,000$, or $4.7 \%$, to $\$ 11.17$ million at June 30, 2014 from $\$ 11.72$ million at September 30, 2013. The decrease was primarily due to the disposition of 20 OREO properties totaling $\$ 5.72$ million and OREO fair value write-downs of $\$ 491,000$, partially offset by the addition of $\$ 5.67$ million in OREO properties and other repossessed assets. At June 30, 2014, total OREO and other repossessed assets consisted of 50 individual properties and one vehicle. The properties consisted of 26 land parcels totaling $\$ 4.25$ million, five commercial real estate properties totaling $\$ 3.22$ million, 18 single-family homes totaling $\$ 3.55$ million and one multi-family property of $\$ 142,000$.

Goodwill and CDI: The recorded amount of goodwill of $\$ 5.65$ million at June 30, 2014 was unchanged from September 30, 2013. The recorded amount of the CDI decreased $\$ 87,000$, or $73.1 \%$, to $\$ 32,000$ at June 30, 2014 from $\$ 119,000$ at September 30, 2013. The decrease was due to scheduled amortization of the CDI.

Deposits: Deposits decreased by $\$ 9.63$ million, or $1.6 \%$, to $\$ 598.63$ million at June 30, 2014 from $\$ 608.26$ million at September 30, 2013. The decrease was primarily a result of a $\$ 13.91$ million decrease in certificates of deposit accounts and a $\$ 4.64$ million decrease in money market accounts. These decreases were partially offset by increases of $\$ 5.34$ million in non-interest bearing balances, $\$ 2.38$ million in savings accounts and $\$ 1.20$ million in N.O.W.
checking accounts.
FHLB Advances: The Company has short- and long-term borrowing lines with the FHLB with total credit available on the lines equal to $25 \%$ of the Bank's total assets, limited by available collateral. Borrowings are considered short-term when the original maturity is less than one year. At June 30, 2014 FHLB advances and other borrowings consisted of long-term FHLB advances with scheduled maturities at various dates in fiscal 2017 and bear interest at rates ranging from $3.69 \%$ to $4.34 \%$. A portion of these advances may be called by the FHLB at a date earlier than the scheduled maturity date. FHLB advances remained unchanged at $\$ 45.00$ million at June 30, 2014 and September 30, 2013.

Shareholders' Equity: Total shareholders' equity decreased by $\$ 8.36$ million, or $9.30 \%$, to $\$ 81.33$ million at June 30, 2014 from $\$ 89.69$ million at September 30, 2013. The decrease was primarily due to the repurchase of 12,065 shares of Series A Preferred Stock for $\$ 12.07$ million on December 20, 2013 and the payment of $\$ 833,000$ in dividends on the Company's common and preferred stock, partially offset by net income of $\$ 4.20$ million for the nine months ended June 30, 2014.

42

Comparison of Operating Results for the Three and Nine Months Ended June 30, 2014 and 2013
Net income increased $\$ 558,000$, or $63.7 \%$, to $\$ 1.43$ million for the quarter ended June 30,2014 from $\$ 876,000$ for the quarter ended June 30, 2013. Net income to common shareholders, after adjusting for the preferred stock dividend and the preferred stock discount accretion, increased $\$ 756,000$ or $111.5 \%$, to $\$ 1.43$ million for the quarter ended June 30, 2014 from $\$ 678,000$ for the quarter ended June 30, 2013. Net income per diluted common share increased $\$ 0.10$, or $100.0 \%$, to $\$ 0.20$ for the quarter ended June 30, 2014 from $\$ 0.10$ for the quarter ended June 30, 2013. The increase in net income was primarily due to a decrease in the provision for loan loss.

Net income increased $\$ 341,000$, or $8.8 \%$, to $\$ 4.20$ million for the nine months ended June 30, 2014 from $\$ 3.86$ million for the nine months ended June 30, 2013. Net income to common shareholders after adjusting for the preferred stock dividend, the preferred stock discount accretion and the discount on redemption of preferred stock, increased $\$ 675,000$, or $20.3 \%$, to $\$ 4.00$ million for the nine months ended June 30,2014 from $\$ 3.32$ million for the nine months ended June 30, 2013. Net income per diluted common share increased $\$ 0.09$, or $18.8 \%$, to $\$ 0.57$ for the nine months ended June 30, 2014 from $\$ 0.48$ for the nine months ended June 30, 2013. The increase in net income was primarily due to a decrease in the provision for loan losses.

A more detailed explanation of the income statement categories is presented below.
Net Interest Income: Net interest income decreased by $\$ 66,000$, or $1.0 \%$ to $\$ 6.43$ million for the quarter ended June 30, 2014 from $\$ 6.50$ million for the quarter ended June 30, 2013. The net interest margin decreased to $3.86 \%$ for the quarter ended June 30, 2014 from 3.88\% for the quarter ended June 30, 2013.

Total interest and dividend income decreased by $\$ 178,000$ or $2.3 \%$, to $\$ 7.40$ million for the quarter ended June 30 , 2014 from $\$ 7.58$ million for the quarter ended June 30, 2013 as the yield on interest bearing assets decreased to $4.44 \%$ from $4.52 \%$. The decrease in the weighted average yield on interest-bearing assets was primarily a result of decreased market rates for loans and adjustable rate loans repricing to lower current market interest rates. Total interest expense decreased by $\$ 112,000$ or $10.4 \%$, to $\$ 964,000$ for the quarter ended June 30,2014 from $\$ 1.08$ million for the quarter ended June 30, 2013 as the average rate paid on interest-bearing liabilities decreased to $0.70 \%$ for the quarter ended June 30, 2014 from $0.77 \%$ for the quarter ended June 30, 2013 and the average balance of interest-bearing liabilities declined $\$ 12.89$ million. The decrease in funding costs was primarily a result of CDs repricing at lower market rates and a $\$ 24.64$ million decrease in the average balance of CDs. In addition, the composition of the deposit base changed as the percentage of non-interest bearing and lower costing transaction accounts increased.

Net interest income remained unchanged at $\$ 19.33$ million for the nine months ended June 30, 2014 and 2013. The net interest margin was level at $3.83 \%$ for the nine months ended June 30, 2014 and 2013.

Total interest and dividend income decreased by $\$ 426,000$, or $1.9 \%$, to $\$ 22.29$ million for the nine months ended June 30, 2014 from $\$ 22.72$ million for the nine months ended June 30, 2013 as the yield on interest bearing assets decreased to $4.41 \%$ for the nine months ended June 30, 2014 from $4.50 \%$ for the nine months ended June 30, 2013. Total interest expense decreased by $\$ 425,000$, or $12.6 \%$, to $\$ 2.96$ million for the nine months ended June 30,2014 from $\$ 3.39$ million for the nine months ended June 30, 2013 as the average rate paid on interest bearing liabilities decreased to $0.72 \%$ for the nine months ended June 30, 2014 from $0.80 \%$ for the nine months ended June 30, 2013 and the average balance of interest bearing liabilities decreased by $\$ 10.81$ million. The decreases in total interest and dividend income and total interest expense were primarily for the same reasons for the quarterly decreases discussed above.

Average Balances, Interest and Average Yields/Cost
The following tables 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-bearing 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. (Dollars in thousands)

Interest-bearing assets: (1)

| Loans receivable (2) | $\$ 566,887$ | $\$ 7,238$ | 5.11 | $\%$ | $\$ 557,234$ | $\$ 7,422$ |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| MBS and other investments (2) | 7,573 | 66 | 3.49 | 6,448 | 69 | 5.33 |
| FHLB stock and equity | 6,332 | 6 | 0.38 | 6,540 | 5 | 4.28 |
| securities | 85,854 | 87 | 0.41 | 100,020 | 79 | 0.31 |
| Interest-bearing deposits | 666,646 | 7,397 | 4.44 | 670,242 | 7,575 | 0.32 |
| Total interest-bearing assets | 63,000 |  |  | 67,545 | 4.52 |  |
| Non-interest-bearing assets | $\$ 729,646$ |  |  | $\$ 737,787$ |  |  |
| $\quad$ Total assets |  |  |  |  |  |  |

Interest-bearing liabilities:

| Savings accounts | $\$ 92,744$ | 12 | 0.05 | $\$ 92,187$ | 11 | 0.05 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Money market accounts | 94,181 | 61 | 0.26 | 87,047 | 61 | 0.28 |
| N.O.W. accounts | 156,932 | 107 | 0.27 | 152,712 | 115 | 0.30 |
| Certificates of deposit | 159,977 | 318 | 0.80 | 184,613 | 422 | 0.92 |
| Short-term borrowings | - | - | - | 162 | - | 0.05 |
| Long-term borrowings (3) | 45,000 | 466 | 4.15 | 45,000 | 467 | 4.16 |
| Total interest-bearing liabilities | 548,834 | 964 | 0.70 | 561,721 | 1,076 | 0.77 |
| Non-interest-bearing liabilities | 100,152 |  | 87,131 |  |  |  |
| Total liabilities | 648,986 |  |  | 648,852 |  |  |
| Shareholders' equity | 80,660 |  |  | 88,935 |  |  |
| Total liabilities and | $\$ 729,646$ |  |  | $\$ 737,787$ |  |  |
| shareholders' equity |  |  |  |  |  |  |


| Net interest income | \$6,433 |  |  | \$6,499 |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Interest rate spread |  | 3.74 | \% |  | 3.75 |
| Net interest margin (4) |  | 3.86 | \% |  | 3.88 |
| Ratio of average interest-bearing assets to average interest-bearing liabilities |  | 121.47 | \% |  | 119.32 |

[^2]Interest-bearing assets: (1)

| Loans receivable (2) | $\$ 565,990$ | $\$ 21,811$ | 5.14 | $\%$ | $\$ 556,014$ | $\$ 22,231$ | 5.33 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| MBS and other investments (2) | 6,606 | 190 | 3.83 | 6,755 | 216 | 4.26 |  |
| FHLB stock and equity securities | 6,362 | 21 | 0.44 | 6,597 | 22 | 0.45 |  |
| Interest-bearing deposits | 94,205 | 268 | 0.38 | 103,789 | 247 | 0.32 |  |
| Total interest-bearing assets | 673,163 | 22,290 | 4.41 | 673,155 | 22,716 | 4.50 |  |
| Non-interest-bearing assets | 62,112 |  |  | 65,662 |  |  |  |
| $\quad$ Total assets | $\$ 735,275$ |  |  | $\$ 738,817$ |  |  |  |

Interest-bearing liabilities:

| Savings accounts | $\$ 91,794$ | 34 | 0.05 | $\$ 89,894$ | 43 | 0.06 |
| :--- | :--- | :--- | :--- | :--- | :--- | :--- |
| Money market accounts | 95,501 | 184 | 0.26 | 84,900 | 188 | 0.30 |
| N.O.W. accounts | 156,397 | 334 | 0.29 | 151,154 | 350 | 0.31 |
| Certificates of deposit | 164,200 | 1,010 | 0.82 | 192,287 | 1,406 | 0.98 |
| Short-term borrowings | - | - | - | 470 | - | 0.05 |
| Long-term borrowings (3) | 45,000 | 1,399 | 4.16 | 45,000 | 1,399 | 4.16 |
| Total interest-bearing liabilities | 552,892 | 2,961 | 0.72 | 563,705 | 3,386 | 0.80 |
| Non-interest-bearing liabilities | 99,433 |  | 84,546 |  |  |  |
| Total liabilities | 652,325 |  | 648,251 |  |  |  |
| Shareholders' equity | 82,950 |  |  | 90,566 |  |  |
| Total liabilities and |  |  | $\$ 738,817$ |  |  |  |
| shareholders' equity | $\$ 735,275$ |  |  |  |  |  |

Net interest income
\$ 19,329
\$ 19,330

| Interest rate spread | 3.69 | $\%$ | 3.70 |
| :--- | :--- | :--- | :--- |
| Net interest margin (4) | 3.83 | $\%$ | 3.83 |
| Ratio of average interest-bearing <br> assets to average interest-bearing <br> liabilities 121.75 | $\%$ | 119.42 | $\%$ |

[^3]Rate Volume Analysis
The following table sets forth the effects of changing rates and volumes on the net interest income of the Company. Information is provided with respect to the (i) effects on interest income attributable to 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. (Dollars in thousands)

Interest-bearing assets:
Loans receivable (1)
MBS and other investments
FHLB stock and equity securities
Interest-bearing deposits
Total net (decrease) increase in income on interest-bearing assets

| Three months ended June 30, 2014 <br> compared to three months ended June 30, 2013 increase (decrease) due to |  |  | Nine months ended June 30, 2014 <br> compared to nine months ended June 30, 2013 <br> increase (decrease) due to |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: |
| Rate | Volume | Net Change | Rate | Volum | Net Change |
| \$(317 | ) \$133 | \$(184 | \$ (458 | ) \$38 | \$(420 |
| (14 | ) 11 | (3 | (21 | ) (5 | ) (26 |
| 1 | - | 1 | - | (1 | ) (1 |
| 20 | (12 | ) 8 | 24 | (3 | ) 21 |
| (310 | ) 132 | (178 | ) (455 | ) 29 | (426 |

Interest-bearing liabilities:
$\left.\begin{array}{llllllll}\text { Savings accounts } & 1 & - & 1 & (8 & )(1) & )(9 & ) \\ \text { N.O.W accounts } & (11 & ) & 3 & (8 & )(17 & ) & 1 \\ \text { Money market accounts } & (5 & ) & 5 & - & (10 & ) & (16\end{array}\right)$
(1) Includes loans originated for sale.

Provision for Loan Losses: There was no provision for loan losses for the quarter ended June 30, 2014 compared to $\$ 1.39$ million for the quarter ended June 30, 2013. Net charge-offs for the quarter ended June 30, 2014 decreased to $\$ 186,000$ from $\$ 1.57$ million for the quarter ended June 30, 2013. The decrease in the provision for loan losses for the quarter ended June 30, 2014 compared to the quarter ended June 30, 2013 was primarily due to the decreased level of net charge-offs and improvements in other underlying credit quality metrics.

There was no provision for loan losses for the nine months ended June 30, 2014 compared to $\$ 2.76$ million for the nine months ended June 30, 2013. Net charge-offs for the nine months ended June 30, 2014 were $\$ 573,000$ compared to $\$ 3.46$ million for the nine months ended June 30, 2013. The decrease in the provision for loan losses for the nine months ended June 30, 2014 compared to the nine months ended June 30, 2013 was primarily due to the decreased level of net charge-offs and improvements in other underlying credit quality metrics.

The Company has established a comprehensive methodology for determining the provision for loan losses. On a quarterly basis the Company performs an analysis that considers pertinent factors underlying the quality of the loan portfolio. The factors include changes in the amount and composition of the loan portfolio, historic loss experience for various loan segments, changes in economic conditions, delinquency rates, a detailed analysis of impaired loans,

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and other factors to determine an appropriate level of allowance for loan losses. Based on its comprehensive analysis, management believes the allowance for loan losses of $\$ 10.56$ million at June 30, 2014 ( $1.86 \%$ of loans receivable and loans held for sale and $86.3 \%$ of non-performing loans) was adequate to provide for probable losses based on an evaluation of known and inherent risks in the loan portfolio at

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that date. Impaired loans are subjected to an impairment analysis to determine an appropriate reserve amount to be allocated to each loan. The aggregate principal impairment reserve amount determined at June 30, 2014 was $\$ 2.85$ million compared to $\$ 2.89$ million at June 30, 2013. The allowance for loan losses was $\$ 11.13$ million ( $2.00 \%$ of loans receivable and loans held for sale and $92.8 \%$ of non-performing loans) at June 30, 2013.

While management believes the estimates and assumptions used in its determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will not be proved incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact the Company's consolidated financial condition and results of operations. In addition, the determination of the amount of the Company's allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the establishment of additional reserves based upon their analysis of information available to them at the time of their examination. Any material increase in the allowance for loan losses would adversely affect the Company's financial condition and results of operations. For additional information, see Note 5 of the Notes to Unaudited Condensed Consolidated Financial Statements contained in "Item 1, Financial Statements."

Non-interest Income: Total non-interest income decreased $\$ 256,000$ or $10.8 \%$, to $\$ 2.12$ million for the quarter ended June 30, 2014 from $\$ 2.37$ million for the quarter ended June 30, 2013 primarily due to a $\$ 338,000$ decrease in the net gain on sales of loans, partially offset by an $\$ 85,000$ increase in ATM and debit card interchange transaction fees. The decrease in gains on sale of loans was primarily due to a decrease in the dollar volume of fixed-rate one-to-four family loans sold during the current quarter as refinance activity decreased.

Total non-interest income decreased $\$ 1.54$ million, or $19.6 \%$, to $\$ 6.32$ million for the nine months ended June 30 , 2014 from $\$ 7.87$ million for the nine months ended June 30, 2013. The decrease was primarily due to a $\$ 1.34$ million decrease in gain on sale of loans and no valuation recovery on MSRs during the nine months ended June 30, 2014 compared to $\$ 475,000$ valuation recovery on MSRs in the same period last year. These decreases to non-interest income were partially offset by a $\$ 207,000$ increase in ATM and debit card interchange transaction fees, a $\$ 138,000$ increase in service charges on deposits and a $\$ 117,000$ improvement in net OTTI on MBS and other investments. At June 30, 2014, the MSR asset had no remaining valuation reserve available for future recovery.

Non-interest Expense: Total non-interest expense increased by $\$ 193,000$, or $3.1 \%$, to $\$ 6.43$ million for the quarter ended June 30, 2014 from $\$ 6.24$ million for the quarter ended June 30, 2013. The increased expenses were primarily due to a $\$ 149,000$ increase in salaries and employee benefits expense and an $\$ 80,000$ increase in data processing and telecommunications expense. These increases were partially offset by a $\$ 73,000$ decrease in OREO and other repossessed assets expense. The increase in salaries and employee benefits was primarily due to the hiring of additional loan officers, annual salary adjustments and an increase in health insurance costs. Also contributing to the increase in salaries and employee benefits was a decrease in loan originations. Under GAAP, the portion of a loan origination fee that is attributable to the estimated employee costs to generate the loan is recorded as a reduction of salaries and employee benefits expense. With the decrease in loan originations, the loan origination fees that reduced salaries and employee benefit expense decreased by $\$ 117,000$ during the quarter ended June 30, 2014 compared to the quarter ended June 30 , 2013. The increase in data processing and telecommunications expense was primarily due to expenses associated with the Company's recent technology upgrades, which included outsourcing the core processing system. The decrease in OREO and other repossessed assets expense was primarily due to a reduction in the level of fair value write-downs during the current quarter.

Total non-interest expense increased $\$ 627,000$, or $3.3 \%$, to $\$ 19.42$ million for the nine months ended June 30, 2014 from $\$ 18.80$ million for the nine months ended June 30, 2013. The increased expenses were primarily due to a $\$ 762,000$ increase in salaries and employee benefits expense, a $\$ 155,000$ increase in ATM and debit card processing expense and a $\$ 147,000$ increase in data processing and telecommunications expense. The increases in salaries and employee benefits expense and the data processing and telecommunications expense were primarily due to the same
reasons for the quarterly increases discussed above. The increase in ATM and debit card processing expense was primarily due to conversion related expenses from the Company's technology investment to upgrade its electronic funds transfer ("EFT") platform. These increases were partially offset by a $\$ 312,000$ decrease in OREO and other repossessed assets expense and smaller decreases in several other expense categories.

Provision for Federal Income Taxes: The provision for federal income taxes increased $\$ 312,000$, or $83.6 \%$, to $\$ 685,000$ for the quarter ended June 30, 2014 from $\$ 373,000$ for the quarter ended June 30, 2013, primarily as a result of increased income before federal income taxes. The Company's effective tax rate was $32.33 \%$ for the quarter ended June 30, 2014 and $29.86 \%$ for the quarter ended June 30, 2013.

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The provision for federal income taxes increased $\$ 250,000$, or $14.1 \%$, to $\$ 2.02$ million for the nine months ended June 30, 2014 from $\$ 1.77$ million for the nine months ended June 30, 2013, primarily due to increased income before federal income taxes. The Company's effective tax rate was $32.50 \%$ for the nine months ended June 30, 2014 and $31.47 \%$ for the nine months ended June 30, 2013.

## Liquidity

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

Liquidity management is both a short and long-term responsibility of the Bank's management. The Bank adjusts its investments in liquid assets based upon management's assessment of (i) expected loan demand, (ii) projected loan sales, (iii) expected deposit flows, and (iv) yields available on interest-bearing deposits. Excess liquidity is invested generally in interest-bearing overnight deposits and other short-term investments

The Bank generally maintains sufficient cash and short-term investments to meet short-term liquidity needs. At June 30, 2014, 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 $14.55 \%$.

The Company's total cash and cash equivalents decreased by $\$ 30.53$ million, or $32.3 \%$ to $\$ 63.97$ million at June 30 , 2014 from $\$ 94.50$ million at September 30, 2013. If the Bank requires funds that exceed its ability to generate them internally, it has additional borrowing capacity with the FHLB, the Federal Reserve Bank of San Francisco ("FRB") and Pacific Coast Bankers' Bank ("PCBB"). At June 30, 2014 the Bank maintained an uncommitted credit facility with the FHLB that provided for immediately available advances up to an aggregate amount equal to $25 \%$ of total assets, limited by available collateral, under which $\$ 45.00$ million was outstanding and $\$ 133.02$ million was available for additional borrowings. The Bank maintains a short-term borrowing line with the FRB with available total credit based on eligible collateral. At June 30, 2014, the Bank had $\$ 43.45$ million available for borrowings with the FRB and there was no outstanding balance on this borrowing line. The Bank also maintains a $\$ 10.00$ million overnight borrowing line with PCBB. At June 30, 2014, the Bank did not have an outstanding balance on this borrowing line.

The Bank's primary investing activity is the origination of one- to four-family mortgage loans, commercial mortgage loans, construction loans, consumer loans, and commercial business loans. At June 30, 2014, the Bank had loan commitments totaling $\$ 44.51$ million and undisbursed construction loans in process totaling $\$ 21.46$ million. The Bank anticipates that it will have sufficient funds available to meet current loan commitments. CDs that are scheduled to mature in less than one year from June 30, 2014 totaled $\$ 97.26$ million. Historically, the Bank has been able to retain a significant amount of its non-brokered CDs as they mature. At June 30, 2014, the Bank had $\$ 3.19$ million in brokered CDs.

## Capital Resources

Timberland Bancorp, Inc. is a bank holding company registered with the Federal Reserve. Bank holding companies are subject to capital adequacy requirements of the Federal Reserve under the Bank Holding Company Act of 1956, as amended, and the regulations of the Federal Reserve. Timberland Bank, as a state-chartered, federally insured savings bank, is subject to the capital requirements established by the FDIC.

The capital adequacy requirements are quantitative measures established by regulation that require Timberland Bancorp, Inc. and the Bank to maintain minimum amounts and ratios of capital. Federally-insured state-chartered
banks are required to maintain minimum levels of regulatory capital. Under current FDIC regulations, insured state-chartered banks generally must maintain (i) a ratio of Tier 1 leverage capital to total assets of at least $3.0 \%$, ( $4.0 \%$ to $5.0 \%$ for all but the most highly rated banks), (ii) a ratio of Tier 1 capital to risk weighted assets of at least $4.0 \%$ and (iii) a ratio of total capital to risk weighted assets of at least $8.0 \%$. The Federal Reserve requires Timberland Bancorp, Inc. to maintain capital adequacy that generally parallels the FDIC requirements. At June 30, 2014, Timberland Bancorp, Inc. and the Bank each exceeded all applicable capital requirements.

The following table compares the Company's and the Bank's actual capital amounts at June 30, 2014 to its minimum regulatory capital requirements at that date (dollars in thousands):

|  | Actual Amount | Ratio | Regulatory <br> Minimum To <br> Be "Adequately <br> Capitalized" |  |  |  | To Be "Well Capitalized" Under Prompt Corrective Action Provisions |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Tier 1 leverage capital: |  |  |  |  |  |  |  |  |  |
| Consolidated | \$77,025 | 10.62 | \% | \$29,000 | 4.00 | \% | N/A | N/A |  |
| Timberland Bank | 74,262 | 10.25 |  | 28,988 | 4.00 |  | \$36,235 | 5.00 | \% |
| Tier 1 risk adjusted capital: |  |  |  |  |  |  |  |  |  |
| Consolidated | 77,025 | 13.61 |  | 22,636 | 4.00 |  | N/A | N/A |  |
| Timberland Bank | 74,262 | 13.13 |  | 22,632 | 4.00 |  | 33,948 | 6.00 |  |
| Total risk-based capital |  |  |  |  |  |  |  |  |  |
| Consolidated | 84,144 | 14.87 |  | 45,272 | 8.00 |  | N/A | N/A |  |
| Timberland Bank | 81,380 | 14.38 |  | 45,264 | 8.00 |  | 56,580 | 10.0 |  |

Key Financial Ratios and Data
(Dollars in thousands, except per share data)

PERFORMANCE RATIOS:
Return on average assets (1)
Return on average equity (1)
Net interest margin (1)
Efficiency ratio

| Three Months Ended <br> June 30, | Nine Months Ended <br> June 30, |  |  |  |  |
| :--- | :--- | :--- | :--- | :--- | :--- |
| 2014 | 2013 | 2014 | 2013 |  |  |
|  |  |  |  |  |  |
| 0.79 | $\% 0.47$ | $\%$ | 0.76 | $\% 0.70$ | $\%$ |
| 7.12 | $\% 3.94$ | $\%$ | 6.76 | $\% 5.69$ | $\%$ |
| 3.86 | $\% 3.88$ | $\%$ | 3.83 | $\% 3.83$ | $\%$ |
| 75.21 | $\% 70.31$ | $\%$ | 75.27 | $\% 69.12$ | $\%$ |

BOOK VALUES:
Book value per common share \$11.54
Tangible book value per common share (2)

| At | At | At |
| :--- | :--- | :--- |
| June 30, 2014 | September 30, <br> 2013 | June 30, 2013 <br>  <br> $\$ 11.54$ |
| $\$ 11.04$ | $\$ 10.98$ |  |
| 10.74 | 10.22 | 10.16 |

(1) Annualized

Calculation subtracts goodwill and core deposit intangible from the equity component.

Item 3. Quantitative and Qualitative Disclosures About Market Risk
There were no material changes in information concerning market risk from the information provided in the Company's Form 10-K for the fiscal year ended September 30, 2013.

## Item 4. Controls and Procedures

(a)Evaluation of Disclosure Controls and Procedures: An evaluation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act")) was carried
out under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and several other members of the Company's senior management as of the end of the period covered by this report. The Company's Chief Executive Officer and Chief Financial Officer concluded that as of June 30, 2014 the

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

Changes in Internal Controls: There have been no changes in our internal control over financial reporting (as defined in 13a-15(f) of the Exchange Act) that occurred during the quarter ended June 30, 2014, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. The Company continued, however, to implement suggestions from its internal auditor and independent auditors to strengthen existing controls. The Company does not expect that its disclosure controls and procedures and internal control over financial reporting will prevent all errors and fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can
(b) provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns in controls or procedures can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any control procedure is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; as over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

## PART II. OTHER INFORMATION

## Item 1. Legal Proceedings

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

Item 1A. Risk Factors
There have been no material changes in the Risk Factors previously disclosed in Item 1A of the Company's 2013 Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds Not applicable.

Item 3. Defaults Upon Senior Securities
Not applicable.
Item 4. Mine Safety Disclosures
Not applicable.
Item 5. Other Information
None to be reported.

## Item 6. Exhibits

## (a) Exhibits

3.1 Articles of Incorporation of the Registrant (1)
3.2
Certificate of Designation relating to the Company's Fixed Rate Cumulative Perpetual Preferred Stock Series A (2)
3.3 Amended and Restated Bylaws of the Registrant (3)
4.1 Warrant to purchase shares of Company's common stock dated December 23, 2008 (2)
4.2 Letter Agreement (including Securities Purchase Agreement Standard Terms attached as Exhibit A) dated

December 23, 2008 between the Company and the United States Department of the Treasury (2)
10.1 Employee Severance Compensation Plan, as revised (4)
10.2 Employee Stock Ownership Plan (4)
10.3 1999 Stock Option Plan (5)
10.4 Management Recognition and Development Plan (5)
10.5 2003 Stock Option Plan (6)
10.6 Form of Incentive Stock Option Agreement (7)
10.7 Form of Non-qualified Stock Option Agreement (7)
10.8 Form of Management Recognition and Development Award Agreement (7)
10.9 Employment Agreement with Michael R. Sand (8)
10.10 Employment Agreement with Dean J. Brydon (8)
31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes OxleyAct
31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes Oxley Act

Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes Oxley Act
The following materials from Timberland Bancorp Inc's Quarterly Report 10-Q for the quarter ended June 30, 2014, formatted on Extensible Business Reporting Language (XBRL) (a) Condensed Consolidated
Balance Sheets; (b) Condensed Consolidated Statements of Income; (c) Condensed Consolidated Statements of Comprehensive Income; (d) Condensed Consolidated Statements of Shareholders' Equity; (e) Condensed Consolidated Statements of Cash Flows; and (f) Notes to Unaudited Condensed Consolidated Financial Statements (9)
(1) Incorporated by reference to the Registrant's Registration Statement on Form S-1 (333-35817).
(2) Incorporated by reference to the Registrant's Current Report on Form 8-K filed on December 23, 2008.
(3) Incorporated by reference to the Registrant's Current Report on Form 8-K filed on April 29, 2010.
(4) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 1997; and to the Registrant's Current Report on Form 8-K dated April 13, 2007.
(5) Incorporated by reference to the Registrant's 1999 Annual Meeting Proxy Statement dated December 15, 1998.
(6) Incorporated by reference to the Registrant's 2004 Annual Meeting Proxy Statement dated December 24, 2003.
(7)Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended September 30, 2005.
(8) Incorporated by reference to the Registrant's Current Report on Form 8-K filed on March 29, 2013. Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration
(9) statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise not subject to liability under those sections.

## SIGNATURES

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

Timberland Bancorp, Inc.

Date: August 11, 2014
By: /s/ Michael R. Sand Michael R. Sand
Chief Executive Officer (Principal Executive Officer)

Date: August 11, 2014
By: /s/ Dean J. Brydon
Dean J. Brydon
Chief Financial Officer
(Principal Financial Officer)
52

## EXHIBIT INDEX

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

32 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act
The following materials from Timberland Bancorp Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 30, 2014, formatted on Extensible Business Reporting Language (XBRL) (a) Condensed
101 Consolidated Balance Sheets; (b) Condensed Consolidated Statements of Income; (c) Condensed Consolidated Statements of Comprehensive Income; (d) Condensed Consolidated Statements of Shareholders' Equity; (e) Condensed Consolidated Statements of Cash Flows; and (f) Notes to Unaudited Condensed Consolidated Financial Statements*

[^4]
[^0]:    (1) The loss represents charge-offs on collateral dependent loans for estimated fair value adjustments based on the estimated fair value of the collateral. Fair value is the recorded investment less the related allowance.
    (2) The loss represents OTTI credit-related charges on held to maturity MBS.

    The loss represents the results of management's periodic reviews of the recorded value to determine whether the
    (3) property continues to be recorded at the lower of its recorded book value or estimated fair value, net of estimated costs to sell.

[^1]:    (1) The loss represents charge-offs on collateral dependent loans for estimated fair value adjustments based on the
    ${ }^{(1)}$ estimated fair value of the collateral. Fair value is the recorded investment less the related allowance.
    (2) The loss represents OTTI credit-related charges on held to maturity MBS.

    The loss represents the results of management's periodic reviews of the recorded value to determine whether the
    (3) property continues to be recorded at the lower of its recorded book value or estimated fair value, net of estimated costs to sell.

[^2]:    44

[^3]:    (1) Interest yield on loans and MBS is calculated assuming a $30 / 360$ basis; interest yield on all other categories is based on 365/365 interest basis.
    (2) Average balances include loans and MBS on non-accrual status.
    (3) Includes FHLB advances with original maturities of one year or greater.
    (4)Net interest income divided by total average interest-bearing assets, annualized.

[^4]:    * Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933 or Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise not subject to liability under those sections.

