

OFFICE OF THRIFT SUPERVISION  
Washington, D.C. 20552

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: **October 31, 2006**

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

For the Transition Period from \_\_\_\_\_ to

**Docket Number 8173**

**THE WASHINGTON SAVINGS BANK, F. S. B.**  
(Exact name of Registrant as specified in its Charter)

UNITED STATES  
(State or other jurisdiction of  
incorporation or organization)

52-1271169  
(I.R.S. Employer  
Identification No.)

4201 Mitchellville Road, Suite 200, Bowie, Maryland 20716  
(Address of Principal Executive Offices)

(301) 352-3120  
(Registrant's Telephone Number)

Indicate by check mark whether the Registrant 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 and has been subject to such filing requirements for the past 90 days.

YES  NO

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

Large accelerated filer [  ] Accelerated filer [  ] Non-accelerated filer [X]

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

YES  NO

There were 7,460,219 shares of Common Stock (\$1.00 Par Value) outstanding as of December 1, 2006.

THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES  
FORM 10-Q  
INDEX

|  | <u>Page<br/>Number</u> |
|--|------------------------|
| PART I. FINANCIAL INFORMATION  |                        |
| Item 1. Financial Statements   |                        |
| Consolidated Statements of Financial Condition<br>at October 31, 2006 (Unaudited) and July 31, 2006                            | 2                      |
| Consolidated Statements of Operations -<br>Three Months ended October 31, 2006 and 2005 (Unaudited)                            | 3                      |
| Consolidated Statements of Changes in Stockholders' Equity<br>For the Three Months ended October 31, 2006 and 2005 (Unaudited) | 4                      |
| Consolidated Statements of Cash Flows -<br>Three Months ended October 31, 2006 and 2005 (Unaudited)                            | 5                      |
| Notes to Consolidated Financial Statements (Unaudited)   | 6                      |
| Item 2. Management's Discussion and Analysis of<br>Financial Condition and Results of Operations                               | 9                      |
| Item 3. Quantitative and Qualitative Disclosures about Market Risk   | 20                     |
| Item 4. Controls and Procedures  | 21                     |
| PART II.   |                        |
| Item 1. Legal Proceedings  | 21                     |
| Item 1A. Risk Factors  | 22                     |
| Item 6. Exhibits   | 22                     |
| Signatures   | 23                     |

**Item 1. Financial Statements****THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**

|  | October 31,<br>2006<br><u>(Unaudited)</u> | July 31,<br>2006<br><u></u> |
|--|---|-----------------------------|
| <b>ASSETS</b>  |   |                             |
| Cash   | \$ 6,530,158                              | \$ 3,706,470                |
| Federal funds sold and interest bearing deposits at FHLB - Atlanta   | 6,932,000                                 | 1,064,000                   |
| Time deposits with other banks   | -   | 9,000,000                   |
| Total cash and cash equivalents  | <u>13,462,158</u>                         | <u>13,770,470</u>           |
| Loans receivable - net:  |   |                             |
| Held for sale  | 6,430,472                                 | 8,638,971                   |
| Held for investment (net of allowance for loan losses<br>of \$4,660,679 and \$5,346,525 respectively)        | <u>210,438,623</u>                        | <u>242,445,933</u>          |
| Total loans receivable - net   | <u>216,869,095</u>                        | <u>251,084,904</u>          |
| Investment securities - available for sale at fair value   | 140,245,911                               | 110,835,295                 |
| Mortgage-backed securities - available for sale at fair value  | 45,328,997                                | 46,489,371                  |
| Investment in Federal Home Loan Bank stock, at cost  | 4,005,500                                 | 3,398,000                   |
| Accrued interest receivable on loans   | 1,459,637                                 | 1,730,544                   |
| Accrued interest receivable on investments   | 1,283,310                                 | 1,274,671                   |
| Real estate acquired in settlement of loans  | 2,296,524                                 | 1,583,540                   |
| Premises and equipment - net   | 6,036,760                                 | 6,090,425                   |
| Deferred income taxes  | 3,807,809                                 | 4,161,415                   |
| Income taxes receivable  | 1,282,024                                 | 1,867,803                   |
| Other assets   | <u>1,321,269</u>                          | <u>1,836,948</u>            |
| <b>TOTAL ASSETS</b>  | <u>\$ 437,398,994</u>                     | <u>\$ 444,123,386</u>       |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |   |                             |
| Deposits:  |   |                             |
| Non-interest bearing   | \$ 6,959,453                              | \$ 8,046,873                |
| Interest bearing   | <u>299,850,345</u>                        | <u>315,687,043</u>          |
| Total deposits   | 306,809,798                               | 323,733,916                 |
| Federal Home Loan Bank borrowings  | 66,500,000                                | 58,000,000                  |
| Advances from borrowers for taxes and insurance  | 527,544                                   | 793,941                     |
| Dividend payable   | 298,409                                   |                             |
| Accounts payable, accrued expenses and other liabilities   | <u>1,877,855</u>                          | <u>1,648,749</u>            |
| <b>TOTAL LIABILITIES</b>   | <u>376,013,606</u>                        | <u>384,176,606</u>          |
| STOCKHOLDERS' EQUITY:  |   |                             |
| Preferred stock, no stated par value; 10,000,000<br>shares authorized; none issued and outstanding           | -   | -                           |
| Common stock, \$1 par value; 20,000,000 shares<br>authorized; 8,064,525 and 8,036,025 issued and outstanding | 8,064,525                                 | 8,036,025                   |
| Additional paid-in capital   | 2,191,302                                 | 2,143,567                   |
| Treasury Stock - 610,681 shares at cost  | (645,124)                                 | (645,124)                   |
| Retained earnings - substantially restricted   | 52,059,127                                | 51,282,613                  |
| Accumulated other comprehensive loss   | <u>(284,442)</u>                          | <u>(870,301)</u>            |
| <b>TOTAL STOCKHOLDERS' EQUITY</b>  | <u>61,385,388</u>                         | <u>59,946,780</u>           |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>  | <u>\$ 437,398,994</u>                     | <u>\$ 444,123,386</u>       |

See notes to consolidated financial statements.

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(UNAUDITED)**

|   | Three Months ended<br>October 31, |              |
|---|-----------------------------------|--------------|
|   | <u>2006</u>                       | <u>2005</u>  |
| <b>INTEREST INCOME:</b>   |                                   |              |
| Interest and fees on loans  | \$ 4,891,983                      | \$ 8,493,479 |
| Interest on mortgage-backed securities                              | 632,996                           | -            |
| Interest and dividends on investments                               | 1,763,927                         | 923,024      |
|   | <hr/>                             | <hr/>        |
| Total interest income   | 7,288,906                         | 9,416,503    |
| <b>INTEREST EXPENSE:</b>  |                                   |              |
| Interest on deposits  | 2,721,641                         | 3,350,188    |
| Interest on other borrowings  | 811,788                           | 760,544      |
|   | <hr/>                             | <hr/>        |
| Total interest expense  | 3,533,429                         | 4,110,732    |
| <b>NET INTEREST INCOME</b>  |                                   |              |
|   | 3,755,477                         | 5,305,771    |
| Provision for loan losses   | (300,000)                         | 200,000      |
|   | <hr/>                             | <hr/>        |
| <b>NET INTEREST INCOME AFTER PROVISION<br/>FOR LOAN LOSSES</b>      | 4,055,477                         | 5,105,771    |
| <b>NON-INTEREST INCOME:</b>   |                                   |              |
| Loan related fees   | 251,803                           | 278,570      |
| Gain on sale of loans   | 290,339                           | 730,763      |
| Gain on sale of real estate acquired in settlement of loans         | 297,131                           | 88,413       |
| Gain (loss) on disposal of fixed assets                             | 5,250                             | (2,170)      |
| Service charges on deposits   | 21,164                            | 26,794       |
| Rental income   | 130,239                           | 149,268      |
| Sale of building lots and homes                                     | -                                 | 7,681        |
| Other income  | 71,612                            | 74,036       |
|   | <hr/>                             | <hr/>        |
| Total non-interest income   | 1,067,538                         | 1,353,355    |
| <b>NON-INTEREST EXPENSE:</b>  |                                   |              |
| Salaries and benefits   | 1,813,903                         | 1,993,317    |
| Occupancy expense   | 224,471                           | 219,639      |
| Depreciation  | 171,962                           | 167,121      |
| Advertising   | 25,394                            | 30,089       |
| Service bureau charges  | 130,642                           | 153,235      |
| Service charges from banks  | 23,983                            | 30,818       |
| Stationary, printing and supplies                                   | 56,843                            | 71,082       |
| Professional services   | 315,675                           | 299,027      |
| SAIF/FDIC Insurance   | 187,383                           | 248,284      |
| Other taxes   | 36,826                            | 35,042       |
| Provision for losses on real estate acquired in settlement of loans | -                                 | 63,000       |
| Other   | 475,210                           | 599,734      |
|   | <hr/>                             | <hr/>        |
| Total non-interest expense  | 3,462,292                         | 3,910,388    |
| <b>INCOME BEFORE PROVISION FOR INCOME TAXES</b>                     |                                   |              |
|   | 1,660,723                         | 2,548,738    |
| <b>PROVISION FOR INCOME TAXES</b>                                   |                                   |              |
|   | 585,800                           | 968,200      |
|   | <hr/>                             | <hr/>        |
| <b>NET INCOME</b>   | \$ 1,074,923                      | \$ 1,580,538 |
| <b>BASIC EARNINGS PER COMMON SHARE</b>                              |                                   |              |
|   | \$ 0.14                           | \$ 0.21      |
| <b>DILUTED EARNINGS PER COMMON SHARE</b>                            |                                   |              |
|   | \$ 0.13                           | \$ 0.19      |
| <b>CASH DIVIDENDS DECLARED PER COMMON SHARE</b>                     |                                   |              |
|   | \$ 0.04                           | \$ -         |
| <b>AVERAGE COMMON SHARES OUTSTANDING</b>                            |                                   |              |
|   | 7,427,680                         | 7,401,452    |
| <b>AVERAGE DILUTED COMMON SHARES OUTSTANDING</b>                    |                                   |              |
|   | 8,123,595                         | 8,124,869    |

See notes to consolidated financial statements.

THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
THREE MONTHS ENDED OCTOBER 31, 2006 AND 2005 (Unaudited)

|  | Common<br>Stock     | Additional<br>Paid-In<br>Capital | Treasury<br>Stock   | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income(Loss) | Total<br>Stockholders'<br>Equity |
|--|---------------------|----------------------------------|---------------------|----------------------|---|----------------------------------|
| BALANCE, AUGUST 1, 2005  | \$ 8,009,775        | \$ 2,010,622                     | \$ (645,124)        | \$ 46,220,169        | \$ (8,146)  | \$ 55,587,296                    |
| Exercise of Stock Options  | 2,500               | 16,877                           | -                   | -                    | -   | 19,377                           |
| Comprehensive Income:  |                     |                                  |                     |                      |   |                                  |
| Net income   | -                   | -                                | -                   | 1,580,538            | -   | 1,580,538                        |
| Net changes in unrealized gain (loss)<br>on available for sale securities<br>Net of taxes of \$(70,174)  | -                   | -                                | -                   | -                    | (128,075)   | (128,075)                        |
| Total comprehensive income   |                     |                                  |                     |                      |   | 1,452,463                        |
| BALANCE, OCTOBER 31, 2005  | <u>\$ 8,012,275</u> | <u>\$ 2,027,499</u>              | <u>\$ (645,124)</u> | <u>\$ 47,800,707</u> | <u>\$ (136,221)</u>                                   | <u>\$ 57,059,136</u>             |
| BALANCE, AUGUST 1, 2006  | \$ 8,036,025        | \$ 2,143,567                     | \$ (645,124)        | \$ 51,282,613        | \$ (870,301)  | \$ 59,946,780                    |
| Exercise of Stock Options  | 28,500              | 47,735                           | -                   | -                    | -   | 76,235                           |
| Comprehensive Income:  |                     |                                  |                     |                      |   |                                  |
| Net income   | -                   | -                                | -                   | 1,074,923            | -   | 1,074,923                        |
| Net changes in unrealized gain (loss)<br>on available for sale securities<br>Net of taxes of \$(158,724) | -                   | -                                | -                   | -                    | 585,859   | 585,859                          |
| Total comprehensive income   |                     |                                  |                     |                      |   | 1,660,782                        |
| Cash dividend payable<br>(0.04 per common share)   |                     |                                  |                     | (298,409)            |   | (298,409)                        |
| BALANCE, OCTOBER 31, 2006  | <u>\$ 8,064,525</u> | <u>\$ 2,191,302</u>              | <u>\$ (645,124)</u> | <u>\$ 52,059,127</u> | <u>\$ (284,442)</u>                                   | <u>\$ 61,385,388</u>             |

See notes to consolidated financial statements

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited)

|   | Three months ended<br>October 31, |                      |
|---|-----------------------------------|----------------------|
|   | <u>2006</u>                       | <u>2005</u>          |
| <b>OPERATING ACTIVITIES:</b>  |                                   |                      |
| Net income  | \$ 1,074,923                      | \$ 1,580,538         |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |                                   |                      |
| Provision for loan losses   | (300,000)                         | 200,000              |
| Share-based compensation  | -                                 | 11,314               |
| Depreciation  | 166,711                           | 167,120              |
| Accretion/Amortization  | (96,817)                          | 135,550              |
| Gain on sale of other real estate owned   | (297,131)                         | (88,413)             |
| Gain on sale of loans   | (290,339)                         | (730,763)            |
| Gain on sale of building lots and homes   | -                                 | (7,681)              |
| Origination of loans - held for sale  | (21,559,156)                      | (97,686,750)         |
| Proceeds from sale of loans held for sale   | 24,057,995                        | 98,105,211           |
| Decrease in other assets  | 515,679                           | 419,071              |
| Decrease in accrued interest receivable   | 262,268                           | 8,835                |
| (Decrease) in net deferred loan fees  | (143,338)                         | (327,382)            |
| Decrease in income taxes receivable   | 585,779                           | 723,447              |
| (Decrease) in accrued interest payable  | (35,363)                          | (23,424)             |
| Increase (decrease) in accounts payable, accrued expenses and other liabilities     | 229,107                           | (281,793)            |
| Net cash provided by operating activities   | <u>4,170,318</u>                  | <u>2,204,880</u>     |
| <b>INVESTING ACTIVITIES:</b>  |                                   |                      |
| Net decrease in loans   | 31,649,245                        | 59,357,600           |
| Repayment of mortgage-backed securities   | 1,664,760                         | -                    |
| Redemption of Federal Home Loan Bank Stock  | (607,500)                         | -                    |
| Purchase of investment securities - available for sale                              | (29,947,600)                      | (52,500,000)         |
| Repayment of investment securities  | 1,068,882                         | -                    |
| Purchase of premises and equipment  | (113,047)                         | (124,108)            |
| Land development costs incurred   | -                                 | (48,498)             |
| Sale of Land Held-for-Development   | -                                 | 7,681                |
| Development of real estate acquired in settlement of loans                          | (16,351)                          | (18,622)             |
| Proceeds from sale of real estate acquired in settlement of loans                   | 401,898                           | 517,878              |
| Net cash provided by investing activities   | <u>4,100,287</u>                  | <u>7,191,931</u>     |
| <b>FINANCING ACTIVITIES:</b>  |                                   |                      |
| Net decrease in demand deposits, NOW<br>accounts and savings accounts               | (9,128,946)                       | (2,710,547)          |
| Proceeds from issuance of certificates of deposit                                   | 219,151                           | 1,455,576            |
| Payments for maturing certificates of deposit                                       | (7,978,960)                       | (10,738,994)         |
| Net decrease in advance payments by borrowers for taxes and insurance               | (266,397)                         | (617,537)            |
| Increase in advance from the Federal Home Loan Bank                                 | 13,500,000                        | -                    |
| Payment of other borrowing  | (5,000,000)                       | -                    |
| Proceeds from exercise of stock options   | 76,235                            | 19,377               |
| Tax effect of stock options   | -                                 | (4,369)              |
| Net cash (used) by financing activities   | <u>(8,578,917)</u>                | <u>(12,596,494)</u>  |
| <b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>                                    | <b>(308,312)</b>                  | <b>(3,199,683)</b>   |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>                               | <b>13,770,470</b>                 | <b>56,592,933</b>    |
| <b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>                                     | <b>\$ 13,462,158</b>              | <b>\$ 53,393,250</b> |
| <b>CASH PAID DURING THE PERIOD FOR:</b>   |                                   |                      |
| Income taxes  | <u>\$ -</u>                       | <u>\$ 244,753</u>    |
| Interest  | <u>\$ 3,524,746</u>               | <u>\$ 4,131,395</u>  |
| Non-cash transactions:  |                                   |                      |
| Transfer from loans to foreclosed real estate                                       | \$ 801,400                        | \$ 360,901           |

See notes to consolidated financial statements.

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE THREE MONTHS ENDED OCTOBER 31, 2006 AND 2005**  
**(unaudited)**

1. Financial Statements

The Consolidated Financial Statements for the three months ended October 31, 2006 and 2005 have been prepared by The Washington Savings Bank, F.S.B. ("WSB") without audit. In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations, and cash flows at October 31, 2006, and for all periods presented have been made.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission and the Office of Thrift Supervision ("OTS"). Management believes that the disclosures are adequate to make the information presented not misleading. These financial statements should be read in conjunction with the financial statements and notes thereto included in WSB's Annual Report on Form 10-K for the year ended July 31, 2006 (the "2006 Annual Report"). There have been no significant changes to WSB's Accounting Policies as disclosed in the 2006 Annual Report. The results of operations for the period ended October 31, 2006, are not necessarily indicative of the operating results for the full year.

Certain prior year's amounts have been reclassified to conform with the current year's presentation.

2. Earnings Per Common Share

The following is the reconciliation of the numerators and denominators of the basic and diluted Earnings Per Common Share ("EPS") computation for all periods presented in the Consolidated Statements of Operations.

|  | <u>Three Months Ended October 31,</u>   |                                       |                                   |   |                                       |                                   |
|--|---|---------------------------------------|-----------------------------------|---|---------------------------------------|-----------------------------------|
|  | <u>2006</u>                             |                                       |                                   | <u>2005</u>                             |                                       |                                   |
|  | <u>Net Income</u><br><u>(Numerator)</u> | <u>Shares</u><br><u>(Denominator)</u> | <u>Per Share</u><br><u>Amount</u> | <u>Net Income</u><br><u>(Numerator)</u> | <u>Shares</u><br><u>(Denominator)</u> | <u>Per Share</u><br><u>Amount</u> |
| Basic EPS                                      |   |                                       |                                   |   |                                       |                                   |
| Net income available to<br>Common Stockholders | \$ <u>1,074,923</u>                     | 7,427,680                             | \$ <u>0.14</u>                    | \$ <u>1,580,538</u>                     | 7,401,452                             | \$ <u>0.21</u>                    |
| Effect of Dilutive<br>Options                  |   |                                       |                                   |   |                                       |                                   |
| Incremental Shares                             |   | <u>695,915</u>                        |                                   |   | <u>723,417</u>                        |                                   |
| Diluted EPS                                    |   |                                       |                                   |   |                                       |                                   |
| Net income available to<br>Common Stockholders | \$ <u>1,074,923</u>                     | <u>8,123,595</u>                      | \$ <u>0.13</u>                    | \$ <u>1,580,538</u>                     | <u>8,124,869</u>                      | \$ <u>0.19</u>                    |

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE THREE MONTHS ENDED OCTOBER 31, 2006 AND 2005**  
**(Continued)**

Options to purchase 5,000 shares of common stock at \$9.11 per share were outstanding at October 31, 2006, but were not included in the computation of diluted EPS because the options' exercise price was greater than the average market price of the common stock for the three months ended October 31, 2006. All other options were included in the computation of diluted EPS because the options' exercise prices were lower than the average market price of the common stock for the three months ended October 31, 2006.

All options were included in the computation of diluted EPS because the options' exercise prices were lower than the average market price of the common stock for the three months ended October 31, 2005.

3. Stock-Based Compensation

WSB has incentive compensation plans that permit the granting of incentive and non-qualified awards in the form of stock options. Generally, the terms of these plans stipulate that the exercise price of options may not be less than the fair market value of WSB's common stock on the date the options are granted. Options predominantly vest over a two year period from the date of grant, and expire not later than ten years from date of grant.

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement No. 123R, which requires stock-based compensation to be measured, based on the grant-date fair value of the awards and the cost to be recognized over the period during which an employee is required to provide service in exchange for the award. WSB adopted the provisions of SFAS No. 123R as of August 1, 2005.

Prior to August 1, 2005, WSB accounted for stock-based compensation in accordance with Accounting Principles Board Opinion (APB) No. 25 "Accounting for Stock Issued to Employees" and related Interpretations. Accordingly, no compensation expense had been recognized for stock options since all options granted had an exercise price equal to the market value of the underlying stock on the grant date. SFAS No. 123R was adopted using the modified prospective transition method. Under this method, the provisions of SFAS No. 123R apply to all awards granted or modified after the date of adoption. In addition, compensation expense must be recognized for any unvested stock option awards outstanding as of the date of adoption. Prior periods have not been restated. Total pre-tax stock-based compensation of \$11,300 and tax related benefits of \$4,400 were recognized in the Statement of Operations for the three months ending October 31, 2005. There were no awards granted and no compensation expense during the first quarter ending October 31, 2006.

*Stock Option Plans* - WSB has five stock option plans, which reserve shares of common stock for issuance to certain key employees and non-employee directors. The combination of these plans reserves 2,310,000 shares under option, of which 1,875,125 options have been granted and 434,875 options remain available for grant. Options granted generally expire ten years after grant date and are exercisable at 50% one year after the date of grant and the remaining 50% two years after the date of grant, with the exceptions of (1) the Non-Employee Directors' Plan, which options are exercisable at 25% on the first and second anniversary dates and the remaining 50% three years after the date of grant and (2) the 5,000 option grant to Phillip C. Bowman in September 2005, which were fully vested at time of grant and expire 5 years after the date of grant. The exercise price of the options granted pursuant to these plans is in each case the fair market value of the shares on the date of grant.

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**FOR THE THREE MONTHS ENDED OCTOBER 31, 2006 AND 2005**  
**(Continued)**

The following table summarizes stock option activity for the three month period ended October 31, 2006:

|                                    | <u>Shares</u>    | <u>Weighted<br/>Average<br/>Exercise<br/>Price</u> | <u>Weighted<br/>Average<br/>Remaining<br/>Life (Years)</u> | <u>Aggregate<br/>Intrinsic<br/>Value</u> |
|------------------------------------|------------------|--|--|--|
| Outstanding at<br>July 31, 2006    | 1,032,425        | \$2.91   |  |  |
| Exercised                          | (28,500)         | 2.67   |  |  |
| Granted                            | -                | -  |  |  |
| Forfeited                          | <u>(2,250)</u>   | 4.04   |  |  |
| Outstanding at<br>October 31, 2006 | <u>1,001,675</u> | <u>\$2.91</u>                                      | <u>4.2</u>   | <u>\$6,127,471</u>                       |
| Exercisable at<br>October 31, 2006 | <u>1,001,675</u> | <u>\$2.91</u>                                      | <u>4.2</u>   | <u>\$6,127,471</u>                       |

New Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board (the "FASB") issued FASB Interpretation No. 48 (FIN 48), Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement 109, which provides guidance on the measurement, recognition, and disclosure of tax positions taken or expected to be taken in a tax return. The interpretation also provides guidance on de-recognition, classification, interest and penalties, and disclosure. FIN 48 prescribes that a tax position should only be recognized if it is more-likely-than-not that the position will be sustained upon examination by the appropriate taxing authority. A tax position that meets this threshold is measured as the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. The cumulative effect of applying FIN 48 is to be reported as an adjustment to the beginning balance of retained earnings in the period of adoption. FIN 48 is effective for fiscal years beginning after December 15, 2006. WSB is currently assessing the impact, if any, that the adoption may have on its financial statements.

In September 2006, the FASB issued Statement No. 157, "Fair Value Measurements." This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. The adoption of this interpretation is not anticipated to have a material impact on our financial condition, results of operations or liquidity.

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND**  
**RESULTS OF OPERATIONS**

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

General

The Washington Savings Bank, F.S.B. and subsidiaries' ("WSB") results of operations are primarily determined by the difference between the interest income and fees earned on loans, investments and other interest-earning assets and the interest expense paid on deposits and other interest-bearing liabilities. The difference between the average yield earned on interest-earning assets, and the average cost of interest-bearing liabilities is known as net interest-rate spread. The principal expense to WSB is the interest it pays on deposits and other borrowings. The difference between interest income on interest-earning assets and interest expense on interest-bearing liabilities is referred to as net interest income. Net interest income is significantly affected by general economic conditions and by policies of state and federal regulatory authorities and the monetary policies of the Federal Reserve Board. WSB's net income is also affected by the level of its non-interest income, including loan related fees, deposit-based fees, rental income, operations of its service corporation subsidiary, gain on sale of real estate acquired in settlement of loans ("REO"), and gain on sale of loans, as well as its operating and tax expenses.

Both basic and diluted EPS amounts are shown on the Consolidated Statements of Operations. However, "basic" earnings per share is utilized in this report's narrative when per share amounts are listed, unless otherwise stated.

This report contains forward-looking statements within the meaning of and pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. A forward-looking statement encompasses any estimate, prediction, opinion or statement of belief contained in this report and the underlying management assumptions, including those identified by terminology such as "may," "will," "believe," "expect," "estimate," "anticipate," "continue," or similar expressions. Forward-looking statements are based on current expectations and assessments of potential developments affecting market conditions, interest rates and other economic conditions and assumptions and results may ultimately vary from the statements made in this report. WSB's future results and prospects may be dependent upon a number of factors that could cause WSB's performance to compare unfavorably to prior periods. Among these factors are: (a) ongoing review of WSB's business and operations; (b) implementation of changes in lending practices and lending operations; (c) WSB's implementation of measures designed to address the issues in the 2004 Supervisory Agreement with the OTS and any regulatory actions taken in response thereto; (d) the Board of Directors ongoing review of WSB's capital management plan; (e) changes in accounting principles; (f) government legislation and regulation; (g) changes in interest rates; (h) changes in the economy; (i) credit or other risks of lending activity; (j) the impact of any legal or regulatory proceedings; and (k) other expectations, assessments and risks that are specifically mentioned in this report, in our Annual Report on Form 10-K for the year ended July 31, 2006 ("2006 Form 10-K") and in such other reports filed with the OTS. WSB wishes to caution readers not to place undue reliance on any forward-looking statements, which speak only as of the date made, and to advise readers that various factors, including those described above, could affect WSB's financial performance and could cause WSB's actual results or circumstances for future periods to differ materially from those anticipated or projected. Unless required by law, WSB does not undertake, and specifically disclaims any obligations to publicly release the result of any revisions that may be made to any forward-looking statements to reflect statements to the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND**  
**RESULTS OF OPERATIONS**  
**(Continued)**

Critical Accounting Policies

The preparation of consolidated financial statements requires management to make judgments in the application of certain of its accounting policies that involve significant estimates and assumptions about the effect of matters that are inherently uncertain. These estimates and assumptions are based on information available as of the date of the financial statements, and may materially impact the reported amounts of certain assets, liabilities, revenues and expenses as the information changes over time. Accordingly, different amounts could be reported as a result of the use of revised estimates and assumptions in the application of these accounting policies.

Accounting policies considered relatively more critical due to either the subjectivity involved in the estimate and/or the potential impact that changes in the estimates can have on the reported financial results include the accounting for the allowance for loan losses. Information concerning this policy is included in the "Critical Accounting Policies" section of Management's Discussion and Analysis in WSB's 2006 Form 10-K. There were no significant changes in this accounting policy during the first three months of fiscal 2007.

Recent Regulatory and Related Developments

In March 2004, WSB entered into the 2004 Supervisory Agreement with the OTS which addressed a number of supervisory issues. In June 2005, the Board of Directors of WSB adopted the Resolution at the request of OTS relating to WSB's compliance with the 2004 Supervisory Agreement and federal laws and regulations. Subsequently, the OTS has terminated the 2004 Supervisory Agreement and permitted the Board of Directors of WSB to terminate the Resolution. The resolution of the Supervisory Agreement and non-objection to the termination of the Board Resolution, which is due in large part to the dedication and hard work by the Board, management and staff, was a significant step in our strategic plan for the Bank. We continue to work on transforming the Bank both in reducing concentrations and risk within the loan portfolio and in expanding loan and deposit products and services to be competitive within the industry which, we believe are in the best interest of our customers and shareholders. See "Regulatory section in WSB's 2006 Form 10-K.

WSB has evaluated its capital management plan including its dividend policy and believes that the current capital levels are appropriate to resume paying quarterly dividends effective with the first quarter of fiscal 2007. This development is a result of the progress made in our strategic plan for delivering long term shareholder value. The first fiscal quarter cash dividend of four cents per share will be paid on December 15, 2006, to stockholders of record as of December 1, 2006. The Board will continue to review WSB's dividend practice on a quarterly basis. WSB continues to remain "Well Capitalized" by regulatory standards.

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND**  
**RESULTS OF OPERATIONS**  
**(Continued)**

Consolidated Results of Operations

Net income for the three months ended October 31, 2006 was \$1,075,000, or \$0.14 per basic share and \$0.13 per diluted share, compared to net earnings of \$1,581,000, or \$0.21 per basic share and \$0.19 per diluted share for the corresponding 2005 period. Net income for the 2006 period includes a \$300,000 "negative" provision, a recovery from the allowance for loan losses, compared to a \$200,000 provision for the same period in 2005. Net earnings for the three months ended October 31, 2006, represent a decrease of \$506,000, or 32% over the same period last year.

The decrease in net income from the comparable quarter last year is due primarily to the continued reduction in the Bank's concentration in higher-yielding construction loans and the general slowdown of the residential real estate market. Management continues to seek more diversity in its loan portfolio and is establishing commercial business and commercial real estate lending departments. Management has begun hiring experienced commercial business and commercial real estate lenders in an effort to significantly expand its nonresidential loan portfolio. Management believes that the announced acquisition of local banks by out of state institutions may create additional opportunities for expansion of WSB's commercial business and commercial real estate lending initiatives as existing customers of these merging institutions may choose to maintain relationships with locally-based institutions. Given the slowdown of the residential real estate market and the costs of implementing a more diverse lending strategy, management believes that the next several quarters may produce earnings significantly below that of similar periods a year ago. However, management strongly believes that this will eventually provide the bank and its shareholders greater profitability and shareholder value.

Due to the decreased demand for housing and current interest rate environment, mortgage loan originations both nationally and for the Bank, have declined. WSB's experienced reduction in loan production has resulted in a 29% decrease in net interest income and a 21% decrease in non-interest income, compared to prior year fiscal quarter. The decrease in non-interest income is primarily the result of a decrease in loan related fees: primarily gain on loan sales for loans sold in the secondary market. WSB has benefited the past several years from the historically low interest rate environment and strong demand for housing which had resulted in higher levels of mortgage originations and related earnings from loan fees and gains on loan sales.

Interest Income/Expense

Total interest income decreased \$2.1 million, or 22.6%, for the first quarter of fiscal 2007 compared to the corresponding period last year, due primarily to a decrease in both the average volume and yield of interest-earning assets.

The average three-month balance of interest-earning assets decreased to \$417.2 million from \$509.4 million, due primarily to a decrease in the loans held-for-investment portfolio. The decrease in average yield on interest-earning assets to 6.99% from 7.39% is the result of the reinvestment of the loan portfolio runoff in short term investment securities. Investment in short term securities is being used to maintain liquidity for future loan growth as we restructure the existing loan portfolio under the business plan with a transition into a more diversified loan portfolio with lower credit risk.

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND**  
**RESULTS OF OPERATIONS**  
**(Continued)**

Total interest expense decreased \$577,000, or 14.0% for the three month period ended October 31, 2006, compared to the same period in the prior year. The decrease was attributable to the decrease in both the average interest rate on WSB's interest-bearing liabilities and average outstanding balances. For the three month period ended October 31, 2006, WSB's average interest-bearing liabilities were \$377.56 million with an average rate of 3.71%, compared to \$461.2 million with an average rate of 4.30%, for the corresponding period last fiscal year.

Net interest income decreased \$1.6 million, or 29.2% for the three month period ended October 31, 2006, compared to the same period in the prior fiscal year. Due to the lower average cost of WSB's interest-bearing liabilities, WSB's net interest rate spread increased to 3.28% for the three month period ended October 31, 2006 from 3.09% for the same period in the prior fiscal year. The ratio of WSB's interest-bearing assets to interest-bearing liabilities increased slightly to 110.54% from 110.46%.

Management continues to reinvest excess liquidity as a result of the loan portfolio runoff primarily in short term investment securities so as to provide liquidity for future loan growth. The reinvesting of high yielding loan funds into the investment portfolio will result in lower interest income until loan production again outpaces loan runoff and funds invested in our securities portfolio are redirected to loan production.

Provisions for Loan and REO Losses

WSB's loan portfolio is subject to varying degrees of credit risk. Credit risk is mitigated through portfolio diversification, and limiting exposure to any single customer or industry. WSB maintains an allowance for loan losses (the "allowance") to absorb losses inherent in the loan portfolio. The allowance is based on careful, continuous review and evaluation of the loan portfolio, along with ongoing, quarterly assessments of the probable losses inherent in that portfolio. The methodology for assessing the appropriateness of the allowance includes: (1) a formula allowance reflecting historical losses by credit category, (2) the specific allowance for risk rated credits on an individual or portfolio basis, and (3) a nonspecific allowance which considers risk factors not taken into factor by the other two components of the methodology. The amount of the allowance is reviewed monthly by WSB's Loan Committee, and reviewed and approved monthly by the Board of Directors.

The allowance is increased by provisions for loan losses, which are charged to expense. Charge-offs of loan amounts determined by management to be uncollectible or impaired decrease the allowance, while recoveries of loans previously charged-off are added back to the allowance. WSB makes provisions for loan losses in amounts necessary to maintain the allowance at an appropriate level, as established by use of the allowance methodology. Under the methodology, WSB considers trends in credit risk against broad categories of homogenous loans, as well as a loan by loan review of loans criticized or classified by management. Classified loans exceeding \$300,000 are evaluated individually as part of the calculation of the adequacy of the allowance.

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND**  
**RESULTS OF OPERATIONS**  
**(Continued)**

Management continues to see favorable developments in many of its previously internally criticized loans in which many such loans have been refinanced out of the bank or have seen credit enhancements secured from borrowers to better position the bank as to the collateral value securing outstanding loans. As a result of these developments within the portfolio, management believes that an excess in reserve position for loan losses developed during the quarter. A recovery of prior provisioning of \$300,000 was made from the allowance for loan losses during the first quarter of fiscal year 2007. The reserve for loan losses is very subjective in nature, relying significantly on historical loss experience, collateral valuations available to management on specific loans, and economic factors deemed to exist at quarter end affecting the inherent loss within the portfolio. Management believes the current reserve level is appropriate, and that the recapture of prior provisioning brings the subsequent reserve position to justified levels. While significant progress has been made addressing management's assessment as to the inherent risk within the portfolio, the slowing real estate market, especially as it pertains to custom high-end residential properties merits the existing allowance level, and management cautions the reader not to rely on the possibility of further recaptures of prior loan loss provisioning.

During the three months ended October 31, 2006, the allowance decreased in net by \$686,000 or 13%, to \$4.7 million from \$5.3 million at July 31, 2006, as a result of net charge-offs of \$386,000 and the recovery of prior provisioning of \$300,000. At October 31, 2006, the allowance was 2.17% of total loans held-for-investment, versus 2.16% of total loans held-for-investment, at July 31, 2006.

WSB has experienced a reduction in its loan portfolio as well as payoffs and/or credit enhancements of previously internally criticized loans, which has resulted in a lower level of inherent probable loss. Assets subject to WSB's Loan Committee criticism includes loans which meet the sub-standard criteria due to collateral deficiencies that may reflect possible losses. Based on the review of the individual loans involved, management estimates probable losses. Management has continued to assess the probable losses as new and relevant data is obtained.

Management believes that the allowance reflects its best estimate of the losses existing in the \$215.1 million loans-held for investment portfolio as of October 31, 2006. The \$6.4 million loan held-for-sale portfolio has already been committed to be purchased by investors at October 31, 2006 and will be settled subsequent to that date. Analysis of WSB's history of sold loans indicates that generally credit losses are not realized after the sale of loans.

WSB's determination of the adequacy of the allowance requires significant judgment, and estimates of probable losses inherent in the loans held-for-investment portfolio can vary significantly from the amounts actually observed. See Critical Accounting Policies in the 2006 Form 10-K. While management uses available information to recognize probable losses, future additions to the allowance may be necessary based on changes in the credits comprising the portfolios, changes in the financial condition of borrowers, such as may result from changes in economic conditions, or other considerations determined by management to be appropriate. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the loan portfolio and the allowance. Such review may result in additional provisions based upon their judgments of information available at the time of each examination.

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND**  
**RESULTS OF OPERATIONS**  
**(Continued)**

Management has developed a comprehensive review process to monitor the adequacy of the allowance for loan losses. The review process and guidelines were developed utilizing guidance from federal banking regulatory agencies and relies on relevant observable data. The observable data considered in the determination of the allowance is modified as more relevant data becomes available. The results of this review process support management's view that the allowance reflects probable losses within the loan portfolio as of October 31, 2006. Please refer to WSB's 2006 Form 10-K under the caption "Significant Accounting Policies" for an overview of the underlying methodology management employs on a monthly basis to evaluate the allowance.

Changes in the estimation valuations may take place based on the status of the economy and the estimate of the value of the property securing loans and as a result, the allowance may increase or decrease. Future adjustments could substantially affect the amount of the allowance.

The following occurred during the first quarter of fiscal 2007:

- WSB's continued reduction in the loans held for investment portfolio.
- WSB has experienced defaults primarily in construction residential loans and land lot loans. Such defaults on custom built properties and land lots carry additional risk of loss and are more susceptible to price increases during the construction process.
- As a result of an analysis of its current portfolio, WSB has recognized a decrease of the loss allocation percentages to internally classified loans. This decrease is due to a significant runoff that has been experienced in internally classified loans. A result of this runoff has been a corresponding reduction in the specific allocations for loss exposure.

Management believes its evaluation as to the adequacy of the allowance as of October 31, 2006 is appropriate, and cautions the reader that the negative provision for this quarter is likely unique, and not necessarily indicative of future quarters provisioning. Subjective judgment is significant in the determination of the provision and allowance for loan losses, manifested in the valuation of collateral, a borrower's prospects of repayment, and in establishing allowance factors and components for the formula allowance for homogeneous loans. The establishment of allowance factors is a continuing exercise, based on management's assessment of the factors and their impact on the portfolio, and that allowance factors may change from period to period, resulting in an increase or decrease in the amount of the provision or allowance, based upon the same volume and classification of loans. A time lag between the recognition of loss exposure in the evaluation of the adequacy of the allowance and a loan's ultimate resolution and or charge-off is normal and to be expected. A discussion of some of the factors that have had a significant impact during the quarter in the evaluation of the adequacy of WSB's allowance for loan losses is discussed above.

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND**  
**RESULTS OF OPERATIONS**  
**(Continued)**

WSB has experienced noticeable change in its loan portfolio during the quarter, which was observed in management's analysis of the adequacy of the allowance for loan loss during the quarter, and at quarter end. Management reviews monthly the adequacy of the allowance for loan losses, provisioning accordingly to meet the deemed losses within the portfolio. For a better understanding of the allowance and the evaluation process refer to WSB's 2006 Form 10-K for a more complete description.

WSB, as shown below in tabular format, has seen a decrease of charge-offs compared to the first quarter of fiscal 2006. While there has been a decrease in loan charge-offs, we believe there is additional, yet unidentified, probable losses within the portfolio, which may be reflected as charge-offs against the allowance in future quarters, as these losses manifest themselves and loan collection efforts continue.

| Fiscal year                                   | 2007         |              | 2006         |              |              |  |
|---|--------------|--------------|--------------|--------------|--------------|--|
|   | 1st Qtr      | 4th Qtr      | 3rd Qtr      | 2nd Qtr      | 1st Qtr      |  |
| Provision for loan losses                     | \$ (300,000) | \$ 0         | \$ 0         | \$ 0         | \$ 200,000   |  |
| Loan charge-offs                              | \$ 400,659   | \$ 575,177   | \$ 280,564   | \$ 51,024    | \$ 1,548,218 |  |
| Loan recoveries                               | 14,813       | 186,238      | 79,359       | 9,830        | 400          |  |
| Net Charge-offs                               | \$ 385,846   | \$ 388,939   | \$ 201,205   | \$ 41,194    | \$ 1,547,818 |  |
| Allowance for loan losses at period end       | \$ 4,660,680 | \$ 5,346,526 | \$ 5,735,465 | \$ 5,936,670 | \$ 5,977,864 |  |
| Total loans held for investment at period end | 215,099,302  | 247,792,458  | 266,349,126  | 305,525,989  | 367,610,162  |  |

At October 31, 2006, total non-performing loans were \$8.8 million of which included non-accrual loans of \$8.3 million and \$518,000 in accruing loans which were contractually past due more than four months but with current payments, compared to \$10.8 million, which included non-accrual loans of \$9.7 million and \$1.1 million in accruing loans which were contractually past due more than four months but with current payments, or 4.35% of total loans held-for-investment, at July 31, 2006. The allowance is approximately 53% of non-accrual loans, versus 49.6% at July 31, 2006. Significant variation in this ratio may occur from period to period because the amount of non-performing loans depends largely on the condition of a small number of individual credits and borrowers relative to the total loan and lease portfolio. Most of the \$518,000 in loans that are contractually past due have current payments, request for extensions need to be formally filed on their current contract to extend the maturity date to bring the loan to current status.

While there has been a decrease in non-accruals since July 31, 2006, there is not a direct relationship between the discontinuation of interest accrual and the level of inherent risk of loss associated with those loans or the portfolio.

Based upon management's analysis of WSB's Real Estate Owned ("REO"), WSB's had no provision for loss/write-down for the three month period ending October 31, 2006. REO held at October 31, 2006 and July 31, 2006, was \$2.3 million and \$1.6 million, respectively, which was net of \$0 reserves for REO losses at October 31, 2006 and July 31, 2006

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND**  
**RESULTS OF OPERATIONS**  
**(Continued)**

Non-Interest Income

Total non-interest income decreased \$286,000, or 21.1% for the three month period ended October 31, 2006, respectively, compared to the same period in the prior year. The decrease was attributable to a decrease in the gain on sale of loans, loan related fees, and rental income which was offset in part, by an increase on the gain on sale real estate acquired in settlement of loans.

Loan-related fees decreased \$27,000, or 10% for the three month period ending October 31, 2006 due to a reduction in WSB's loan settlements. Real estate loans closed for the three month period ended October 31, 2006, were approximately \$42.6 million, compared to approximately \$99.4 million for the same period last year. The decrease in real estate loans closed is primarily the result of a higher interest rate environment, and a reduction in loan refinancing volume. Gain on the sale of loans decreased \$440,000 for the three month period ending October 31, 2006. WSB's ability to realize gains in future periods depends largely on interest rates and the demand for mortgage loans. WSB's loans in process, which are loans that have not yet settled as of October 31, 2006 decreased to approximately \$37.3 million, compared to \$99.9 million at October 31, 2005.

The decrease in rental income of \$19,000 the three month period ending October 31, 2006 is primarily due to the reduction in rented space at the Corporate Building. The square footage previously designated for other businesses has decreased due to the additional space needed for WSB's support staff.

The increase on the gain on sale of real estate acquired in settlement of loans is the result of the sale of two "REO" properties in which WSB recorded a net gain.

Non-Interest Expenses

Non-interest expenses decreased \$448,000, or 11.5% for the first quarter ended October 31, 2006 as compared to the corresponding prior fiscal year periods.

The decrease in non-interest expenses for the three month period ended October 31, 2006 compared to the same period last year was primarily due to decreases of \$179,000 in salaries and benefits, \$125,000 in other expenses, which consisted primarily of repairs and installation and other operating expenses and \$61,000 in deposit insurance premiums, which offset the increase of \$17,000 in professional services and \$4,800 in depreciation expense.

The decrease in salaries and benefits is the result of the reduced loan production on loans sold in the secondary market and the commissions associated with these loans. Other expenses decreased due to a decrease in the loans held for investment portfolio and the related fees associated with this portfolio.

The increase in professional services is legal fees associated with the pending litigation by a former employee, consultant costs associated with the implementation of the mortgage origination software, the restructuring of the mortgage banking operations, and the search to hire experienced commercial business and commercial real estate lenders in an effort to significantly expand the nonresidential loan portfolio.

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND**  
**RESULTS OF OPERATIONS**  
**(Continued)**

Income Taxes

The effective income tax rate for the three months ended October 31, 2006 was 35.2% compared to 38.0% for the same period last year. The decrease compared to last year is the result of higher percentage of income attributable to WSB's Investments portfolio of which a significant portion is not subject to Maryland state taxes.

Liquidity and Capital Resources

Total assets were \$437.4 million and \$444.1 million at October 31, 2006 and July 31, 2006, respectively. The decrease in assets at October 31, 2006, compared to July 31, 2006, was primarily attributable to a decrease in the loan portfolio, partially offset by increases in the investment securities portfolio.

Deposits were \$306.8 million at October 31, 2006, compared to \$323.7 million at July 31, 2006. The decrease in deposits at October 31, 2006, compared to July 31, 2006, was primarily due to decreases in certificates of deposit. Management anticipates to continue to utilize excess funding liquidity to offset a runoff of higher costing certificate of deposits which were previously originated to fund loan production.

Total borrowings at October 31, 2006 were \$66.5 million, which consisted of Federal Home Loan Bank ("FHLB") advances, compared to \$58.0 million at July 31, 2006, which consisted of \$53.0 million in FHLB advances and \$5.0 million in First Tennessee Federal Funds Purchased. WSB maintains funding activities with correspondent banks and the Federal Home Loan Bank of Atlanta, which are cancelable by the lender and subject to lender discretion. To the extent WSB does not or can not use FHLB borrowings, it would rely on alternative funding sources including its depositor base and correspondent bank lines of credit.

WSB continually seeks to increase its core deposits and advertises its lower-cost NOW accounts, no fee checking incentives, an overdraft protection program, variable money fund savings account priced to current interest rates, and the advantages of customer access to ATM networks.

As a member of the FHLB system, and in order to maintain insurance with the Federal Deposit Insurance Corporation ("FDIC"), WSB must maintain average daily balances of long-term liquid assets of not less than 4% of the average daily balance of its liquidity base (net withdraw able savings accounts and borrowings during the preceding calendar month which are payable within one year). Liquid assets are defined as cash, Federal Reserve deposits, time and savings deposits in certain institutions, obligations of states and political subdivisions thereof, highly rated corporate debt, mortgage loans and mortgage-backed securities ("MBS"), and accrued interest receivable and principal on certain qualified unpledged assets, payable within five years. Internal sources of liquidity used by WSB are various short-term investments, mortgage-backed securities, and short-term borrowings. During October 2006, WSB's long-term average daily balances of liquid assets were \$189.6 million, which exceeded the \$12.4 million required.

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND**  
**RESULTS OF OPERATIONS**  
**(Continued)**

Current regulations require subsidiaries of an institution to be separately capitalized and require investments in and extensions of credit to any subsidiary engaged in activities not permissible for a bank to be deducted in the computation of an institution's regulatory capital. These regulations have affected WSB through its service corporation subsidiary, which is engaged in real estate development and construction activities. At October 31, 2006, WSB's investment in its service corporation subsidiary was \$511,000, and the subsidiary's assets totaled \$701,000. Therefore, for regulatory capital calculations, WSB was required to deduct \$511,000 from its capital and \$701,000 from its assets. WSB's regulatory capital and regulatory assets below also reflect increases of \$284,000 and \$443,000, respectively, which represents unrealized losses (after-tax for capital deductions and pre-tax for asset deductions, respectively) on investment securities classified as available for sale. In addition, WSB's risk-based capital reflects an increase of \$3.2 million in the general loan loss reserve. The loan loss reserve factor represents 1.25% of WSB's risk weighted assets. Regulatory thrift capital ratios required, WSB's actual ratios, and the amount over which WSB's ratios exceed regulatory required, as of October 31, 2006, are shown as follows.

| <u>Capital Category</u> | <u>Regulatory Ratios Required</u> | <u>WSB's Ratio</u>      | <u>WSB's Excess of Requirements</u> | <u>Calculations</u>             | <u>Based Upon</u>                          |
|-------------------------|-----------------------------------|-------------------------|-------------------------------------|---------------------------------|--|
| Leverage                | \$ 17,513,686<br>4.00%            | \$ 61,158,784<br>13.97% | \$ 43,645,098<br>9.97%              | \$ 61,158,784<br>\$ 437,842,160 | Regulatory Capital<br>Regulatory Assets    |
| Tangible                | \$ 6,567,632<br>1.50%             | \$ 61,158,784<br>13.97% | \$ 54,591,152<br>12.47%             | \$ 61,158,784<br>\$ 437,842,160 | Regulatory Capital<br>Regulatory Assets    |
| Risk-Based              | \$ 20,251,090<br>8.00%            | \$ 64,323,017<br>25.41% | \$ 44,071,927<br>17.41%             | \$ 64,323,017<br>\$ 253,138,629 | Regulatory Capital<br>Risk-Weighted Assets |

WSB's management believes that, under current regulations, WSB will continue to meet its minimum capital requirements in the foreseeable future. However, events beyond the control of WSB, such as a shift in interest rates or a downturn in the economy in areas where WSB extends credit, could adversely affect future earnings and, consequently, the ability of WSB to meet its future minimum capital requirements.

Cash dividends are subject to determination and declaration by the Board of Directors, which takes into account WSB's financial condition, results of operations, tax considerations, industry standards, economic conditions, and other factors, including regulatory restrictions. However, the ability of WSB to pay quarterly cash dividends will be dependent on earnings, financial condition and business of WSB, as well as other factors, such as regulatory requirements. Cash dividends that are declared are paid in a subsequent quarter.

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND**  
**RESULTS OF OPERATIONS**  
**(Continued)**

For a discussion of the regulatory restrictions on the declaration and payment of dividends, see "Business—Supervision and Regulation—Restrictions on Capital Distributions." WSB has evaluated its capital management plan including its dividend policy and believes that the current capital levels are appropriate to resume paying quarterly dividends effective with the first quarter of fiscal 2007. This development is a result of the progress made in our strategic plan for delivering long term shareholder value. The first fiscal quarter cash dividend of four cents per share will be paid on December 15, 2006, to stockholders of record as of December 1, 2006. The Board will continue to review WSB's dividend practice on a quarterly basis. WSB continues to remain "Well Capitalized" by regulatory standards.

The Qualified Thrift Lender ("QTL") Test currently requires that "qualified thrift investments" be at least 65% of portfolio assets as defined by the OTS. At October 31, 2006, WSB's ratio was approximately 72% of defined portfolio assets.

Off Balance Sheet Transactions

WSB is a party to financial instruments with off-balance sheet risk including commitments to extend credit under existing lines of credit and commitments to sell loans. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated Statement of Financial Condition.

Off-balance sheet financial instruments whose contract amounts represent credit and interest rate risk are summarized as follows:

|  |            |
|--|------------|
| Commitments to originate new loans   | \$ 263,900 |
| Unfunded commitments to extend credit under existing<br>construction, equity line and commercial lines of credit | 26,254,361 |
| Standby letters of credit  | 1,359,361  |
| Commitments to sell loans held-for-sale  | 6,430,472  |

WSB does not have any unconsolidated special purpose entities or other similar forms of off-balance sheet financing arrangements.

Commitments to originate new loans or to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Loan commitments generally expire within 90 days. Most equity line commitments for the unfunded portion of equity lines are for a term of 12 months, and commercial lines of credit are generally renewable on an annual basis. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. WSB evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by WSB upon extension of credit, is based on management's credit evaluation of the borrower.

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND**  
**RESULTS OF OPERATIONS**  
**(Continued)**

Commitments to sell loans held-for-sale are agreements to sell loans to third parties at an agreed upon price.

Contractual Obligations

The following chart list WSB's contractual obligations as of October 31, 2006:

|                  | Payments due by period<br>(dollars in thousands) |                         |                          |                         |                      |
|------------------|--|-------------------------|--------------------------|-------------------------|----------------------|
|                  | Total  | Less than 1<br>year     | 1-3 years                | 3-5 years               | More than 5<br>years |
| Long-term debt   | \$ 66,500  | \$ 5,000                | \$ 23,500                | \$ 38,000               | -                    |
| Operating leases | 818  | 259                     | 265                      | 294                     | -                    |
| Time Deposits    | <u>253,798</u>                                   | <u>83,344</u>           | <u>123,933</u>           | <u>46,521</u>           | <u>-</u>             |
| <b>Total</b>     | <b><u>\$ 321,116</u></b>                         | <b><u>\$ 88,603</u></b> | <b><u>\$ 147,698</u></b> | <b><u>\$ 84,815</u></b> | <b><u>\$ -</u></b>   |

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Management of WSB considers interest rate risk ("IRR") and credit risk as the two most significant factors impacting WSB's financial performance. WSB currently utilizes no derivatives to mitigate its credit risk, relying instead on loan review and an adequate loan loss allowance. WSB's exposure to IRR is reviewed on at least a quarterly basis by the Board of Directors and management, and is measured in accordance with OTS Thrift Bulletin No. 13a using interest rate risk sensitivity analysis, including Net Portfolio Value ("NPV") and net interest income under various rate scenarios.

The OTS provides all institutions that file the Consolidated Maturity Rate Schedule ("CMR") as part of their quarterly thrift financial report with an interest rate sensitivity report of NPV on a calendar quarter basis. The NPV is defined as the netting of the present value of expected cash flows related to existing assets and liabilities and off-balance sheet contracts. In addition to the discounted cash flow analysis, the OTS simulator model also employs an option-based pricing approach to measuring the interest rate sensitivity of the NPV. Per the OTS interest rate risk exposure report, WSB's sensitivity measure, or decline in the NPV ratio, at September 30, 2006 was a minimal 134 basis points, compared to 262 basis points at September 30, 2005. WSB relies on the OTS model and does not prepare its own model.

The following table compares the calculated estimates of change in NPV and net interest income as of September 30, 2006 (the most recent data available) to current limits established by management and approved by the Board of Directors.

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND**  
**RESULTS OF OPERATIONS**  
**(Continued)**

Percentage Change In

| Basis Point Change<br>In Market Rates | Net Interest Income |                  | Net Portfolio Value<br>as a % of PV of Assets |                    |
|---------------------------------------|---------------------|------------------|---|--------------------|
|                                       | Board Limits        | Projected Change | Minimum<br>Board Limits                       | OTS<br>Projections |
| +200                                  | -30%                | +18%             | 6%  | 16%                |
| - 100                                 | -30%                | - 9%             | 10%   | 16%                |

Item 4. Controls and Procedures

WSB's management, under the supervision and with the participation of WSB's Principal Executive Officer and Principal Financial Officer, evaluated the effectiveness of the design and operation of WSB's disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d – 15(e) of the Securities Exchange Act of 1934, as of the end of the period covered by this report. Based on that evaluation, WSB's Principal Executive Officer and Principal Financial Officer concluded that WSB's disclosure controls and procedures are effective in timely alerting them to material information which is required to be included in the periodic reporting that WSB must file with the OTS.

During the quarterly period covered by the report, there were no changes (including corrective actions with regard to significant or material weaknesses) in the WSB's internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect WSB's internal controls over financial reporting.

PART II.

Item 1. Legal Proceedings

On July 29, 2005, WSB was notified of suit in John Sullivan v. The Washington Savings Bank, F.S.B., Stephen J. Troese, Randall Robey and the Office of Thrift Supervision (U.S. District Court for the District of Maryland, Case No. L05-CV2083). The complaint arises out of the termination of Mr. Sullivan's employment by WSB, alleges a range of federal and state statutory and common law claims, and purports to claim compensatory damages in the amount of \$1 million and, in connection with certain tort claims, \$5 million in punitive damages, plus all costs, interests, and attorney's fees. On May 12, 2006, the court released OTS from the suit. WSB has undertaken to indemnify, and advance expenses for, its co-defendants, Stephen Troese, a director of the Company, and Randall Robey, an officer of the Company. On September 19, 2005, WSB filed a motion with the court to dismiss the complaint on the ground that all claims are subject to arbitration, and in the alternative has sought to dismiss most claims against it and co-defendants Troese and Robey for failure to state a claim. On June 28, 2006, the Court granted that motion and dismissed the case, concluding that all claims were subject to arbitration. The plaintiff has since moved for reconsideration of that decision and has informed the Company that he intends to proceed with arbitration; as of the date of this response, the plaintiff has initiated an arbitration proceeding. The Company believes that its actions to terminate Mr. Sullivan were legally justified. The Company further believes that it has substantial defenses to each of the claims asserted by Mr. Sullivan, and thus is vigorously defending the case. However, at this time it is not possible to predict the outcome of this matter or to estimate the amount or range of amounts for which the Company may be liable in the event of an unfavorable outcome.

**THE WASHINGTON SAVINGS BANK, F.S.B. AND SUBSIDIARIES**  
**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND**  
**RESULTS OF OPERATIONS**  
**(Continued)**

On April 6, 2006, the Internal Revenue Service issued a notice attributable to the disallowance of a conservation easement charitable donation. On May 8, 2006, WSB filed a timely Protest appealing an Internal Revenue Service proposed adjustment on the valuation of the conservation easement donated to the Maryland Environmental Trust. The bank maintains that it complied with the statutory requirements of 26 U.S.C. §170(h).

Based the relevant statutory provisions, regulations and case law on point, WSB believes the Bank will successful in establishing that it complied with and satisfied the applicable rules and regulations and therefore, is entitled to a charitable conservation easement donation. The courts have traditionally resolved valuation disputes by reaching a middle ground between the competing values a proposed by the Internal Revenue Service and the taxpayer. Therefore, at this time, we are unable to determine whether or to what extent WSB's valuation of the conservation easement will be sustained.

In addition, from time to time, WSB is a party to litigation or administrative proceedings relating to claims arising from its operations in the normal course of business. Management believes that the ultimate resolution of any such litigation or administrative proceedings currently pending against WSB is unlikely, either individually or in the aggregate, to have a material adverse effect on WSB's results of operations or financial condition.

**Item 1A. Risk Factors**

For discussion of risk factors affecting WSB, see "Cautionary Notice Regarding Forward-Looking Statements" on page 11 of this quarterly report on Form 10-Q.

**Item 6. Exhibits**

- 3.1 Amended and Restated Federal Stock Charter of WSB. (Incorporated by reference from WSB's Quarterly Report on Form 10-Q for the quarter ended January 31, 1997.)
- 3.2 Amended and Restated By-Laws of WSB. (Incorporated by reference from WSB's Form 8-K, as filed on February 22, 2005.)
- 3.3 Certificate of Amendment to Federal Stock Charter of WSB. (Incorporated by reference from WSB's Definitive Proxy Statement filing for the year ended July 31, 2001, as filed on October 22, 2001.)
- 31.1 Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (Filed herewith).
- 31.2 Certification of Principal Financial Officer pursuant Section 302 of the Sarbanes-Oxley Act of 2002. (Filed herewith).
- 32.1 Certification of Principal Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (Furnished herewith).
- 32.2 Certification of Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (Furnished herewith).

## SIGNATURES

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

THE WASHINGTON SAVINGS BANK, F.S.B.

By: /s/ Phillip C. Bowman  
Phillip C. Bowman  
Chief Executive Officer

By: /s/ Randall M. Robey  
Randall M. Robey  
Senior Vice President and Chief Financial Officer

Date: December 13, 2006

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER PURSUANT TO SECTION 302 OF THE  
SARBANES-OXLEY ACT OF 2002**

I, Phillip C. Bowman, Chief Executive Officer of The Washington Savings Bank, F.S.B. ("WSB"), certify that:

1. I have reviewed this quarterly report on Form 10-Q of WSB;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of WSB as of, and for, the periods presented in this quarterly report;
4. WSB's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision to ensure that material information relating to WSB, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of WSB's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. WSB's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting to WSB's auditors and the audit committee of WSB's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect WSB's ability to record, process, summarize and report financial data; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in WSB's internal control over financial reporting.

Date: December 13, 2006

By: /s/ Phillip C. Bowman  
Phillip C. Bowman  
Chief Executive Officer

**CERTIFICATION OF CHIEF FINANCIAL OFFICER PURSUANT TO SECTION 302 OF THE  
SARBANES-OXLEY ACT OF 2002**

I, Randall M. Robey, Sr. Vice-President and Chief Financial Officer of The Washington Savings Bank, F.S.B. ("WSB"), certify that:

1. I have reviewed this quarterly report on Form 10-Q of WSB;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of WSB as of, and for, the periods presented in this quarterly report;
4. WSB's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and we have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision to ensure that material information relating to WSB, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of WSB's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
4. WSB's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting to WSB's auditors and the audit committee of WSB's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect WSB's ability to record, process, summarize and report financial data; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in WSB's internal control over financial reporting.

Date: December 13, 2006

By: /s/ Randall M. Robey  
Randall M. Robey  
Sr. Vice President  
and Chief Financial Officer

**EXHIBIT 32.1**

Certification of Principal Executive Officer pursuant to 18 U.S.C. Section 1350

I hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, to my knowledge and on the date hereof, that the accompanying Quarterly Report on Form 10-Q of The Washington Savings Bank, F.S.B. (“WSB”) for the quarterly period ended October 31, 2006, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and that the information contained in this Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of WSB.

By: /s/ Phillip C. Bowman  
Phillip C. Bowman  
Chief Executive Officer

December 13, 2006

**EXHIBIT 32.2**

Certification of Principal Financial Officer pursuant to 18 U.S.C. Section 1350

I hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, to my knowledge on the date hereof, that the accompanying Quarterly Report on Form 10-Q of The Washington Savings Bank, F.S.B. ("WSB") for the quarterly period ended October 31, 2006, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and that the information contained in this Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of WSB.

By: /s/ Randall M. Robey  
Randall M. Robey  
Sr. Vice President  
and Chief Financial Officer

December 13, 2006