

# **Home Financial Bancorp**

Accountants' Report and Consolidated Financial Statements

June 30, 2006 and 2005



## Independent Accountants' Report

Audit Committee, Board of Directors and Stockholders  
Home Financial Bancorp  
Spencer, Indiana

We have audited the accompanying consolidated balance sheets of Home Financial Bancorp as of June 30, 2006 and 2005, and the related consolidated statements of income, stockholders' equity and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Home Financial Bancorp as of June 30, 2006 and 2005, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*BKD, LLP*

Indianapolis, Indiana  
September 21, 2006

**Home Financial Bancorp**  
**Consolidated Balance Sheets**  
**June 30, 2006 and 2005**

**Assets**

	<u>2006</u>	<u>2005</u>
Cash	\$ 691,153	\$ 868,546
Short-term interest-bearing deposits	<u>3,640,889</u>	<u>3,824,129</u>
Total cash and cash equivalents	4,332,042	4,692,675
Interest-bearing deposits	1,500,000	300,000
Investment securities - available for sale	2,049,510	2,594,703
Loans, net of allowance for loan losses of \$499,995 and \$389,522	62,618,621	55,731,811
Real estate acquired for development	525,474	427,274
Premises and equipment	2,077,345	2,092,400
Federal Home Loan Bank of Indianapolis stock	1,225,000	1,220,500
Interest receivable	423,635	369,124
Other assets	<u>1,648,251</u>	<u>2,224,295</u>
Total assets	<u>\$ 76,399,878</u>	<u>\$ 69,652,782</u>

**Liabilities**

Deposits		
Noninterest-bearing	\$ 3,587,013	\$ 3,112,801
Interest-bearing deposits	<u>40,955,921</u>	<u>41,542,298</u>
Total deposits	44,542,934	44,655,099
Borrowings	24,000,000	17,000,000
Other liabilities	<u>428,375</u>	<u>668,864</u>
Total liabilities	<u>68,971,309</u>	<u>62,323,963</u>

**Commitments and Contingencies**

**Stockholders' Equity**

Preferred stock, without par value		
Authorized and unissued - 2,000,000 shares		
Common stock, without par value		
Authorized - 5,000,000 shares		
Issued and outstanding - 2006 - 1,354,450 shares and 2005 - 1,355,950 shares	3,056,034	3,058,909
Additional paid-in capital	324,925	285,821
Retained earnings	4,337,781	4,227,075
Unearned compensation	(270,846)	(285,366)
Unearned ESOP shares	—	(26,457)
Accumulated other comprehensive income (loss)	<u>(19,325)</u>	<u>68,837</u>
Total stockholders' equity	<u>7,428,569</u>	<u>7,328,819</u>
Total liabilities and stockholders' equity	<u>\$ 76,399,878</u>	<u>\$ 69,652,782</u>

# Home Financial Bancorp

## Consolidated Statements of Income

### Years Ended June 30, 2006 and 2005

	2006	2005
<b>Interest Income</b>		
Loans	\$ 4,747,609	\$ 4,540,435
Deposits with financial institutions	154,436	103,513
Investment securities	163,781	112,666
Federal Home Loan Bank stock	<u>56,539</u>	<u>51,620</u>
Total interest and dividend income	<u>5,122,365</u>	<u>4,808,234</u>
<b>Interest Expense</b>		
Deposits	1,266,283	974,208
Federal Home Loan Bank advances	<u>861,505</u>	<u>618,999</u>
Total interest expense	<u>2,127,788</u>	<u>1,593,207</u>
<b>Net Interest Income</b>	2,994,577	3,215,027
Provision for loan losses	<u>421,400</u>	<u>250,000</u>
<b>Net Interest Income After Provision for Loan Losses</b>	<u>2,573,177</u>	<u>2,965,027</u>
<b>Other Income</b>		
Service charges on deposit accounts	365,879	210,479
Gain on sale of real estate acquired for development	31,690	104,003
Net gain (loss) on available-for-sale securities	28,718	(25,540)
Equity in losses of partnership	(83,500)	(48,655)
Other income	<u>190,534</u>	<u>134,274</u>
Total other income	<u>533,321</u>	<u>374,561</u>
<b>Other Expenses</b>		
Salaries and employee benefits	1,438,896	1,376,336
Net occupancy expenses	131,063	125,907
Equipment expenses	40,381	64,835
Computer processing fees	283,221	259,547
Printing and office supplies	66,883	69,393
Legal and professional fees	158,932	189,142
Director and committee fees	63,650	63,950
Advertising expense	75,392	61,148
Repossessed property expense	133,930	218,843
Other expenses	<u>432,620</u>	<u>343,887</u>
Total other expenses	<u>2,824,968</u>	<u>2,772,988</u>
<b>Income Before Income Tax</b>	281,530	566,600
Income tax expense	<u>22,280</u>	<u>114,620</u>
<b>Net Income</b>	<u>\$ 259,250</u>	<u>\$ 451,980</u>
<b>Net Income Per Share</b>		
Basic	\$ .20	\$ .35
Diluted	.20	.34

# Home Financial Bancorp

## Consolidated Statements of Stockholders' Equity

### Years Ended June 30, 2006 and 2005

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Unearned Compensation	Unearned ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Total
<b>Balances, July 1, 2005</b>	1,356,050	\$ 3,059,159	\$ 235,918	\$ 3,918,668	\$ (32,886)	(59,947)	\$ 4,782	\$ 7,125,694
Comprehensive income								
Net income				451,980				451,980
Other comprehensive income, net of tax								
Unrealized gain on securities, net of reclassification adjustment							64,055	<u>64,055</u>
Comprehensive income								<u>516,035</u>
Cash dividends (\$.12 per share)				(143,298)				(143,298)
ESOP shares earned			49,903			33,490		83,393
Contribution for unearned RRP shares					(267,000)			(267,000)
RRP shares earned					14,520			14,520
Purchase of stock	(100)	(250)		(275)				(525)
<b>Balances, June 30, 2005</b>	1,355,950	3,058,909	285,821	4,227,075	(285,366)	(26,457)	68,837	7,328,819
Comprehensive income								
Net income				259,250				259,250
Other comprehensive loss, net of tax								
Unrealized losses on securities, net of reclassification adjustment							(88,162)	<u>(88,162)</u>
Comprehensive income								<u>171,088</u>
Cash dividends (\$.12 per share)				(143,344)				(143,344)
ESOP shares earned			39,104			26,457		65,561
RRP shares earned					14,520			14,520
Issuance of stock	500	2,125						2,125
Purchase of stock	(2,000)	(5,000)		(5,200)				(10,200)
<b>Balances, June 30, 2006</b>	<u>1,354,450</u>	<u>\$ 3,056,034</u>	<u>\$ 324,925</u>	<u>\$ 4,337,781</u>	<u>\$ (270,846)</u>	<u>\$ —</u>	<u>\$ (19,325)</u>	<u>\$ 7,428,569</u>

# Home Financial Bancorp

## Consolidated Statements of Cash Flows

### Years Ended June 30, 2006 and 2005

	2006	2005
<b>Operating Activities</b>		
Net income	\$ 259,250	\$ 451,980
Items not requiring (providing) cash		
Provision for loan losses	421,400	250,000
Investment securities amortization, net	6,633	12,732
ESOP shares earned	65,561	83,393
RRP shares earned	14,520	14,520
Depreciation	88,481	111,971
Deferred income taxes	22,980	53,886
Gain on sale of real estate acquired for development	(31,690)	(104,003)
Foreclosed asset gains	(39,307)	(39,594)
Investment securities (gains) losses	(28,718)	25,540
Losses from partnership	83,560	48,655
Net change in interest receivable	(54,511)	(21,724)
Other adjustments	<u>(28,122)</u>	<u>572,726</u>
Net cash provided by operating activities	<u>779,977</u>	<u>1,460,082</u>
<b>Investing Activities</b>		
Purchases of interest-bearing deposits	(1,200,000)	(300,000)
Purchases of securities available for sale	—	(631,250)
Proceeds from sales of securities available for sale	76,638	—
Proceeds from maturities and paydowns of securities available for sale	344,852	542,592
Net changes in loans	(8,420,448)	(6,468,888)
Proceeds from sale of foreclosed assets	1,515,843	1,173,545
Purchase of premises and equipment	(73,426)	(84,013)
Purchase of real estate acquired for development and development cost	(197,044)	(358,567)
Proceeds from sale of real estate acquired for development	81,043	427,145
Purchase of FHLB of Indianapolis stock	<u>(4,500)</u>	<u>(50,900)</u>
Net cash used in investing activities	<u>(7,877,042)</u>	<u>(5,750,336)</u>
<b>Financing Activities</b>		
Net change in		
Noninterest bearing deposits	474,212	699,248
Interest bearing deposits	(586,377)	5,059,406
Proceeds from other borrowings	17,500,000	6,500,000
Repayment of other borrowings	(10,500,000)	(6,500,000)
Issuance of stock	2,125	—
Purchase of stock	(10,200)	(525)
Dividends paid	(143,328)	(143,298)
Contribution of RRP shares	<u>—</u>	<u>(267,000)</u>
Net cash provided by financing activities	<u>6,736,432</u>	<u>5,347,831</u>
<b>Net Change in Cash and Cash Equivalents</b>	(360,633)	1,057,577
<b>Cash and Cash Equivalents, Beginning of Year</b>	<u>4,692,675</u>	<u>3,635,098</u>
<b>Cash and Cash Equivalents, End of Year</b>	<u>\$ 4,332,042</u>	<u>\$ 4,692,675</u>
<b>Additional Cash Flows and Supplementary Information</b>		
Interest paid	\$ 2,123,350	\$ 1,572,269
Income tax paid, net of refunds	27,947	17,084
Transfers from loans to foreclosed assets	1,112,238	1,255,228

**Home Financial Bancorp**  
**Notes to Consolidated Financial Statements**  
**June 30, 2006 and 2005**  
(Table Dollar Amounts in Thousands, Except Share Data)

**Note 1: Nature of Operations and Summary of Significant Accounting Policies**

The accounting and reporting policies of Home Financial Bancorp (Company) and its wholly owned subsidiary, Owen Community Bank, s.b. (Bank) and the Bank's wholly owned subsidiary, BSF, Inc. (BSF), conform to accounting principles generally accepted in the United States of America and reporting practices followed by the thrift industry. The more significant of the policies are described below.

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

The Company is a savings and loan holding company whose principal activity is the ownership and management of the Bank. The Bank operates under a federal thrift charter, known as a federal stock savings bank, and provides full banking services. As a federally chartered thrift, the Bank is subject to regulation by the Office of Thrift Supervision and the Federal Deposit Insurance Corporation.

The Bank generates mortgage and consumer loans and receives deposits from customers located primarily in Owen, Putnam and surrounding counties. The Bank's loans are generally secured by specific items of collateral including real property and consumer assets.

BSF engages in purchasing and developing large tracts of real estate. After land is purchased, BSF subdivides the real estate into lots, makes improvements such as streets, and sells individual lots, usually on contract for deed.

**Consolidation** - The consolidated financial statements include the accounts of the Company, Bank and BSF after elimination of all material intercompany transactions.

**Cash Equivalents** - The Company considers all liquid investments with original maturities of three months or less to be cash equivalents.

**Investment Securities** - Debt securities are classified as held to maturity when the Company has the positive intent and ability to hold the securities to maturity. Securities held to maturity are carried at amortized cost. Debt securities not classified as held to maturity are classified as available for sale. Securities available for sale are carried at fair value with unrealized gains and losses reported separately in accumulated other comprehensive income, net of tax.

Amortization of premiums and accretion of discounts are recorded using the interest method as interest income from securities. Realized gains and losses are recorded as net security gains (losses). Gains and losses on sales of securities are determined on the specific-identification method.

**Home Financial Bancorp**  
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**Loans** are carried at the principal amount outstanding. A loan is impaired when, based on current information or events, it is probable that the Company will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement. Loans whose payments have insignificant delays not exceeding 90 days outstanding are not considered impaired. The Company considers its investment in one-to-four family residential loans and consumer loans to be homogeneous and therefore excluded from separate identification for evaluation of impairment. Interest income is accrued on the principal balances of loans. The accrual of interest on impaired and nonaccrual loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed when considered uncollectible. Interest income is subsequently recognized only to the extent cash payments are received. Certain loan fees and direct costs are being deferred and amortized as an adjustment of yield on the loans over the contractual lives of the loans. When a loan is paid off or sold, any unamortized loan origination fee balance is credited to income.

**Allowance for loan losses** is maintained to absorb loan losses based on management's continuing review and evaluation of the loan portfolio and its judgment as to the impact of economic conditions on the portfolio. The evaluation by management includes consideration of past loss experience, changes in the composition of the portfolio, the current condition and amount of loans outstanding, and the probability of collecting all amounts due. Impaired loans are measured by the present value of expected future cash flows, or the fair value of the collateral of the loan, if collateral dependent. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The determination of the adequacy of the allowance for loan losses is based on estimates that are particularly susceptible to significant changes in the economic environment and market conditions. Management believes that as of June 30, 2006, the allowance for loan losses is adequate based on information currently available. A worsening or protracted economic decline in the area within which the Company operates would increase the likelihood of additional losses due to credit and market risks and could create the need for additional loss reserves.

**Real estate acquired for development** is carried at the lower of cost or fair value. Costs relating to development and improvements of property are allocated to individual lots and capitalized, whereas costs relating to holding the property are expensed. Gains and losses on sales of lots are determined on the specific-identification method.

**Premises and equipment** are carried at cost net of accumulated depreciation. Depreciation is computed using the accelerated and straight-line methods based principally on the estimated useful lives of the assets. Maintenance and repairs are expensed as incurred while major additions and improvements are capitalized. Gains and losses on dispositions are included in current operations.

**Federal Home Loan Bank (FHLB) stock** is a required investment for institutions that are members of the FHLB system. The required investment in the common stock is based on a predetermined formula.

**Home Financial Bancorp**  
**Notes to Consolidated Financial Statements**  
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(Table Dollar Amounts in Thousands, Except Share Data)

**Pension plan costs** are based on actuarial computations and charged to current operations. The funding policy is to pay at least the minimum amounts required by ERISA.

**Stock options** - The Company has a stock-based employee compensation plan, which is described more fully in Note 16. The Company accounts for this plan under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the grant date. No options were granted during the two years in the period ended June 30, 2006 and all previously granted shares were fully vested prior to July 1, 2006.

In December 2004, the Financial Accounting Standards Board (FASB) issued a revision to SFAS 123 (SFAS 123R), which eliminated the ability to account for share-based compensation transactions using Account Principles Board Opinion No. 25 and generally requires that such transactions be accounted for using a fair value based method. SFAS 123R will be effective for the Company beginning July 1, 2006. SFAS 123R applies to all awards granted after the required effective date and to awards modified, repurchased, or cancelled after that date. The cumulative effect of initially applying this Statement, if any, is recognized as of the required effective date.

Beginning July 1, 2006, the Company will apply SFAS 123R using the modified version of prospective application. Under the prospective transition method, compensation cost is recognized on or after the required effective date for the portion of outstanding awards for which the requisite service has not yet been rendered, based on the grant-date fair value of those awards calculated under SFAS 123R for either recognition or proforma disclosures. The effect on the Company's results of operations will depend on the level of future option grants and the calculation of the fair value of the options granted at such future date, as well as the vesting periods provided, and so cannot be predicted for future awards.

**Income tax** in the consolidated statements of income includes deferred income tax provisions or benefits for all significant temporary differences in recognizing income and expenses for financial reporting and income tax purposes. The Company and Bank file consolidated tax returns.

**Earnings per share** have been computed based upon the weighted-average common shares and potential common shares outstanding during the period. Unearned Employee Stock Ownership Plan (ESOP) shares and unvested RRP shares have been excluded from the computation of average common shares and potential common shares outstanding.

**Home Financial Bancorp**  
**Notes to Consolidated Financial Statements**  
**June 30, 2006 and 2005**  
(Table Dollar Amounts in Thousands, Except Share Data)

**Note 2: Investment Securities**

	2006			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Available for sale				
U. S. Treasury securities	\$ 484	\$ —	\$ (23)	\$ 461
Federal agencies	756	—	(36)	720
Mortgage-backed securities	621	1	(7)	615
Municipal bonds	132	—	—	132
Marketable equity securities	<u>89</u>	<u>33</u>	<u>—</u>	<u>122</u>
Total investment securities	<u>\$ 2,082</u>	<u>\$ 34</u>	<u>\$ (66)</u>	<u>\$ 2,050</u>

	2005			Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Available for sale				
U. S. Treasury securities	\$ 482	\$ 20	\$ —	\$ 502
Federal agencies	756	26	—	782
Mortgage-backed securities	962	24	—	986
Municipal bonds	144	—	—	144
Marketable equity securities	<u>137</u>	<u>44</u>	<u>—</u>	<u>181</u>
Total investment securities	<u>\$ 2,481</u>	<u>\$ 114</u>	<u>\$ —</u>	<u>\$ 2,595</u>

Maturities of available-for-sale investments at June 30, 2006:

	Amortized Cost	Approximate Fair Value
After five through ten years	\$ 1,372	\$ 1,313
Mortgage-backed and marketable equity securities not due on a single maturity date	<u>710</u>	<u>737</u>
	<u>\$ 2,082</u>	<u>\$ 2,050</u>

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Securities with a carrying value of \$1,796,000 and \$2,270,000 were pledged at June 30, 2006 and 2005 to secure FHLB advances.

Proceeds from sales of securities available for sale during 2006 and 2005 were \$77,000 and \$0, respectively. Gains realized from sales of securities during 2006 and 2005 totaled \$29,000 and \$0, respectively. There were no losses from sales of securities realized during 2006 and 2005; however, losses of \$26,000 were recorded during 2005 due to the other-than-temporary decline in the value of securities. Net gains on security transactions for 2006 resulted in a tax expense of \$11,000. Net losses on security transactions for 2005 resulted in a tax benefit of \$10,000.

Certain investments in debt and marketable equity securities are reported in the 2006 financial statements at an amount less than their historical cost. Total fair value of these investments at June 30, 2006 was \$1,425,000, which is approximately 69.5 percent of the Company's investment portfolio. These declines primarily resulted from increases in market interest rates and failure of certain investments to maintain consistent credit quality ratings or meet projected earnings targets.

Should the impairment of any of these securities become other than temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period the other-than-temporary impairment is identified.

The following table shows our investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2006. There were no securities at an unrealized loss position at June 30, 2005.

Description of Securities	2006				Total	
	Less than 12 Months Fair Value	12 Months or More Unrealized Losses	12 Months or More Fair Value	12 Months or More Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury securities	\$ 461	\$ (23)	\$ —	\$ —	\$ 461	\$ (23)
Mortgage-backed securities	244	(7)	—	—	244	(7)
Federal agencies	<u>720</u>	<u>(36)</u>	<u>—</u>	<u>—</u>	<u>720</u>	<u>(36)</u>
Total temporarily impaired securities	<u>\$ 1,425</u>	<u>\$ (66)</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 1,425</u>	<u>\$ (66)</u>

**Home Financial Bancorp**  
**Notes to Consolidated Financial Statements**  
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**Note 3: Loans and Allowance**

	<b>2006</b>	<b>2005</b>
Real estate mortgage loans		
Residential	\$ 40,029	\$ 32,322
Mobile home and land	9,368	9,501
Nonresidential	8,118	7,962
Mobile home loans	5,273	6,239
Commercial and industrial	236	250
Consumer loans	525	446
	63,549	56,720
Undisbursed portion of loans	(390)	(585)
Deferred loan fees	(40)	(13)
Allowance for loan losses	(500)	(390)
	(930)	(988)
Total loans	\$ 62,619	\$ 55,732
	<b>2006</b>	<b>2005</b>
Allowance for loan losses		
Balances, July 1	\$ 390	\$ 396
Provision for loan losses	421	250
Recoveries	6	4
Loans charged off	(317)	(260)
Balances, June 30	\$ 500	\$ 390

At June 30, 2006 and 2005, accruing loans delinquent 90 days or more totaled \$668,000 and \$0, respectively. Non-accruing loans at June 30, 2006 and 2005 were \$1,055,000 and \$1,027,000, respectively.

**Note 4: Premises and Equipment**

	<b>2006</b>	<b>2005</b>
Land	\$ 348	\$ 348
Buildings	2,530	2,525
Construction in progress	72	37
Equipment	997	964
Total cost	3,947	3,874
Accumulated depreciation	(1,870)	(1,782)
Net	\$ 2,077	\$ 2,092

**Home Financial Bancorp**  
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**Note 5: Investment in Limited Partnership**

An investment in a limited partnership of \$405,000 and \$447,000 at June 30, 2006 and 2005 included in other assets represents a 99 percent equity in Cunot Apartments (Cunot), a limited partnership organized to build, own and operate a 24-unit apartment complex for senior living. In addition to recording its equity in the losses of Cunot, the Company has recorded the benefit of low income housing tax credits of \$107,000 for the years ended June 30, 2006 and 2005. Condensed unaudited financial statements for Cunot at June 30, 2006 and 2005 and for the two years in the period ended June 30, 2006 are as follows:

	<b>2006</b>	<b>2005</b>
Condensed balance sheets		
Assets		
Cash	\$ 124	\$ 148
Land and property	1,216	1,253
Other assets	5	6
Total assets	\$ 1,345	\$ 1,407
Liabilities		
Notes payable	\$ 610	\$ 610
Other liabilities	310	331
Total liabilities	920	941
Partners' equity	425	466
Total liabilities and partners' equity	\$ 1,345	\$ 1,407
Condensed statements of operations		
Total revenue	\$ 71	\$ 77
Total expenses	(111)	(118)
Net loss	\$ (40)	\$ (41)

**Home Financial Bancorp**  
**Notes to Consolidated Financial Statements**  
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(Table Dollar Amounts in Thousands, Except Share Data)

**Note 6: Deposits**

	2006	2005
Noninterest-bearing demand	\$ 3,555	\$ 3,100
Interest-bearing demand	2,361	3,011
Money market deposits	2,144	2,225
Savings	5,870	5,251
Certificates of \$100,000 or more	9,998	11,716
Other certificates	20,615	19,352
Total deposits	\$ 44,543	\$ 44,655

Certificates maturing in years ending June 30:

2007	\$ 18,693
2008	6,287
2009	1,776
2010	2,738
2011	1,119
	\$ 30,613

Brokered deposits totaled approximately \$4.4 million and \$6.9 million at June 30, 2006 and 2005.

**Note 7: Borrowings**

FHLB advance maturities in years ending June 30:

2007	\$ 9,000
2008	5,000
2009	3,500
2010	500
2011	1,000
Thereafter	5,000
	\$ 24,000

The Federal Home Loan Bank advances are secured by mortgage loans and investment securities totaling \$42,896,000. Advances, at interest rates from 2.82 to 5.32 percent, are subject to restrictions or penalties in the event of prepayment. Advances totaling \$1,000,000 may, at certain dates, be converted to adjustable rate advances by the FHLB. If converted, the advances may be prepaid without penalty.

**Home Financial Bancorp**  
**Notes to Consolidated Financial Statements**  
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(Table Dollar Amounts in Thousands, Except Share Data)

**Note 8: Income Tax**

	<b>2006</b>	<b>2005</b>
Income tax expense		
Currently payable		
Federal	\$ (27)	\$ 17
State	26	44
Deferred		
Federal	22	53
State	<u>1</u>	<u>1</u>
Total income tax expense	<u>\$ 22</u>	<u>\$ 115</u>
	<b>2006</b>	<b>2005</b>
Reconciliation of federal statutory to actual tax expense		
Federal statutory income tax at 34%	\$ 96	\$ 193
Effect of state income taxes	18	30
Business tax credits	(107)	(107)
Other	<u>15</u>	<u>(1)</u>
Actual tax expense	<u>\$ 22</u>	<u>\$ 115</u>
Effective tax rate	8.6%	25.5%

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A cumulative net deferred tax asset is included in other assets. The components of the asset are as follows:

	<b>2006</b>	<b>2005</b>
<b>Assets</b>		
Allowance for loan losses	\$ 211	\$ 164
Pension and employee benefit	9	19
Securities available for sale	12	—
Loan fees	17	5
Partnership investment	8	12
Unrealized capital loss carryforward	114	127
Other	—	3
Total assets	371	330
<b>Liabilities</b>		
Depreciation	(74)	(39)
State income tax	(16)	(16)
FHLB stock	(51)	(51)
Securities available for sale	—	(45)
Prepaid expenses	(40)	(43)
Other	(20)	—
Total liabilities	(201)	(194)
Net deferred tax asset	\$ 170	\$ 136

Retained earnings at June 30, 2006, include approximately \$700,000 for which no deferred federal income tax liability has been recognized. This amount represents an allocation of income to bad debt deductions as of June 30, 1988 for tax purposes only. Reduction of amounts so allocated for purposes other than tax bad debt losses including redemption of bank stock or excess dividends, or loss of “bank status” would create income for tax purposes only, which income would be subject to the then-current corporate income tax rate. The unrecorded deferred federal income tax liability on the above amounts was approximately \$240,000 at June 30, 2006.

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**Note 9: Other Comprehensive Income (Loss)**

	<b>Before-Tax Amount</b>	<b>2006 Tax (Expense) Benefit</b>	<b>Net-of-Tax Amount</b>
Unrealized losses on securities			
Unrealized holding losses arising during the year	\$ (117)	\$ 47	\$ (70)
Less: reclassification adjustment for gains realized in net income	<u>29</u>	<u>(11)</u>	<u>18</u>
Other comprehensive loss	<u>\$ (146)</u>	<u>\$ 58</u>	<u>\$ (88)</u>
	<b>Before-Tax Amount</b>	<b>2005 Tax (Expense) Benefit</b>	<b>Net-of-Tax Amount</b>
Unrealized gains on securities			
Unrealized holding gains arising during the year	\$ 80	\$ (32)	\$ 48
Less: reclassification adjustment for losses realized in net income	<u>(26)</u>	<u>10</u>	<u>(16)</u>
Other comprehensive income	<u>\$ 106</u>	<u>\$ (42)</u>	<u>\$ 64</u>

**Note 10: Commitments and Contingent Liabilities**

In the normal course of business there are outstanding commitments and contingent liabilities, such as commitments to extend credit, which are not included in the accompanying financial statements. The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit is represented by the contractual or notional amount of those instruments. The Company uses the same credit policies in making such commitments as it does for instruments that are included in the consolidated balance sheets.

Financial instruments whose contract amount represents credit risk as of June 30 were as follows:

	<b>2006</b>	<b>2005</b>
Commitments to extend credit	\$ 2,058	\$ 6,387
Unused lines of credit	300	138

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Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. 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. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation. Collateral held varies, but may include residential real estate, or other assets of the borrower.

The Company has entered into agreements with two officers, which provide for salary continuation for a three-year period under certain circumstances, primarily related to change of control of the Company or Bank, as defined. Under the terms of the agreements, these payments could occur if, following a change of control, such officers are terminated other than for cause or unreasonable changes are made in their employment relationships. These agreements extend automatically for one year on each anniversary date unless certain conditions are met.

The Company and Bank are also subject to claims and lawsuits, which arise primarily in the ordinary course of business. It is the opinion of management that the disposition or ultimate determination of such possible claims or lawsuits will not have a material adverse effect on the consolidated financial position of the Company or Bank.

**Note 11: Stockholders' Equity**

The Company's Board of Directors has approved the repurchase of up to 15 percent of the Company's outstanding shares of common stock. Such purchases will be made subject to market conditions in open market or block transactions.

**Note 12: Dividends and Capital Restrictions**

The Company is not subject to any regulatory restriction on the payment of dividends to its stockholders.

Without prior approval, current regulations allow the Bank to pay dividends to the Company not exceeding retained net profits for the current calendar year to date plus those for the previous two calendar years. At June 30, 2006, total stockholder's equity of the Bank was \$6,958,000 of which \$6,113,000 was restricted from dividend distribution to the Company. Although well capitalized, under current regulations in effect, the Bank is required to apply to the Office of Thrift Supervision to pay dividends to the Company.

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**Note 13: Regulatory Capital**

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies and is assigned to a capital category. The assigned capital category is largely determined by three ratios that are calculated according to the regulations: total risk adjusted capital, Tier 1 capital, and Tier 1 leverage ratios. The ratios are intended to measure capital relative to assets and credit risk associated with those assets and off-balance sheet exposures of the entity. The capital category assigned to an entity can also be affected by qualitative judgments made by regulatory agencies about the risk inherent in the entity's activities that are not part of the calculated ratios.

There are five capital categories defined in the regulations, ranging from well capitalized to critically undercapitalized. Classification of a bank in any of the undercapitalized categories can result in actions by regulators that could have a material effect on a bank's operations. At June 30, 2006 and 2005, the Bank was categorized as well capitalized and met all subject capital adequacy requirements. There are no conditions or events since June 30, 2006 that management believes has changed the Bank's classification.

The Bank's actual and required capital amounts and ratios are as follows:

	Actual		2006 Required for Adequate Capital		Required To Be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total risk-based capital (to risk-weighted assets)	\$ 6,922	14.5%	\$ 3,810	8.0%	\$ 4,762	10.0%
Tier I capital (to risk-weighted assets)	6,422	13.5	1,905	4.0	2,857	6.0
Core capital (to adjusted total assets)	6,422	8.5	3,017	4.0	3,772	5.0
Core capital (to adjusted tangible assets)	6,422	8.5	1,509	2.0	N/A	N/A
Tangible capital (to adjusted total assets)	6,422	8.5	1,132	1.5	N/A	N/A

	Actual		2005 Required for Adequate Capital		Required To Be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total risk-based capital (to risk-weighted assets)	\$ 6,499	14.9%	\$ 3,496	8.0%	\$ 4,370	10.0%
Tier I capital (to risk-weighted assets)	6,109	14.0	1,748	4.0	2,622	6.0
Core capital (to adjusted total assets)	6,109	8.9	2,738	4.0	3,422	5.0
Core capital (to adjusted tangible assets)	6,109	8.9	1,369	2.0	N/A	N/A
Tangible capital (to adjusted total assets)	6,109	8.9	1,027	1.5	N/A	N/A

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**Note 14: Employee Benefit Plans**

The Bank is a participant in a pension fund known as the Pentegra Group. This plan is a multi-employer plan; separate actuarial valuations are not made with respect to each participating employer. On July 1, 2006, the Company elected to freeze the defined benefit plan to stop accruing benefits to plan participants beyond what was already earned to that date and to prevent new participants from entering the plan. The plan required contributions in the amount of \$127,000 and \$97,000 for the years ended June 30, 2006 and 2005. The plan provides pension benefits for substantially all of the Bank's employees.

The Company has a Retirement Savings Section 401(k) plan in which substantially all employees may participate. The Company matches employees' contributions at the rate of 50 percent of the first 6 percent of base salary contributed by participants. The Company's expense for the plan was \$22,000 and \$19,000 for the years ended June 30, 2006 and 2005.

The Company has an ESOP covering substantially all employees of the Bank. The ESOP acquired 161,896 shares of the Company's common stock at \$2.50 per share with funds provided by a loan from the Company. Accordingly, the unearned common stock acquired by the ESOP is shown as a reduction of stockholders' equity. Shares are released to participants proportionately as the loan is repaid. Dividends on allocated shares are recorded as dividends and charged to retained earnings. Dividends on unallocated shares, which may be distributed to participants or used to repay the loan, are treated as compensation expense. Compensation expense is recorded equal to the fair market value of the stock when contributions, which are determined annually by the Board of Directors of the Bank, are made to the ESOP. The expense under the ESOP was \$66,000 and \$83,000 for the years ended June 30, 2006 and 2005. At June 30, 2006, all 161,896 ESOP shares have been allocated. At June 30, 2005, the ESOP had 143,681 allocated shares, 11,987 suspense shares and 6,228 committed-to-be released shares. As of June 30, 2006, no unearned shares remained. The fair value of the unearned ESOP shares at June 30, 2005 was \$76,670. The Company is obligated at the option of each beneficiary to repurchase shares of the ESOP upon the beneficiary's termination or after retirement.

The Company has a Recognition and Retention Plan and Trust (RRP). The RRP may acquire up to 130,948 shares of the Company's common stock for awards to management. Shares awarded to management under the RRP vest at a rate of 20 percent at the end of each full 12 months of service with the Bank after the date of grant. As of June 30, 2006, 80,948 shares of common stock have been awarded to management. Nonvested shares have been recorded as unearned compensation and shown as a reduction to stockholders' equity. Expense under the RRP was \$15,000 for the years ended June 30, 2006 and 2005.

The Company has entered into employee agreements with certain officers that provide for the continuation of salary and certain benefits for a specified period of time.

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**Note 15: Related Party Transactions**

The Bank has entered into transactions with certain directors and officers. Such transactions were made in the ordinary course of business on substantially the same terms and conditions, including interest rates and collateral, as those prevailing at the same time for comparable transactions with other customers, and did not, in the opinion of management, involve more than normal credit risk or present other unfavorable features. The aggregate amount of loans, as defined, to such related parties were as follows:

Balances, July 1, 2005	\$	90
New loans, including renewals		385
Payments, etc. including renewals		<u>(64)</u>
 Balances, June 30, 2006	 \$	 <u>411</u>

Deposits from related parties held by the Bank at June 30, 2006 and 2005 totaled \$856,000 and \$677,000.

**Note 16: Stock Option Plan**

The Company has reserved 202,370 shares of Company stock for the granting of options to certain directors, officers and other key employees of the Company and the Bank.

Incentive stock options for 52,300 shares of common stock have been granted with ten year terms that expire October 13, 2007 and non-qualified options for 24,000 and 3,000 shares have been granted with ten year terms that expire October 14, 2007 and August 25, 2008.

The following is a summary of the status of the Company's stock option plan and changes in that plan as of and for the years ended June 30:

Options	2006		2005	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Outstanding, beginning of year	79,800	\$ 4.24	79,800	\$ 4.24
Exercised	<u>(500)</u>	4.25	<u>—</u>	
Outstanding and exercisable, end of year	<u>79,300</u>	4.24	<u>79,800</u>	4.24

There were no option grants during the two years in the period ended June 30, 2006. As of June 30, 2006, 76,300 options outstanding have an exercise price of \$4.25 and a remaining contractual life of one year, and 3,000 options outstanding have an exercise price of \$4.13 and a remaining contractual life of two years. There were 122,570 shares available for grant at June 30, 2006.

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**Note 17: Earnings Per Share**

Earnings per share were computed as follows:

	<b>Net Income</b>	<b>2006 Weighted- Average Shares</b>	<b>Per- Share Amount</b>
<b>Basic Earnings Per Share</b>			
Income available to common stockholders	\$ 259	1,292,396	\$ .20
<b>Effect of Dilutive Stock Options</b>	—	15,947	
<b>Diluted Earnings Per Share</b>			
Income available to common stockholders and assumed conversions	\$ 259	1,308,343	\$ .20
	<b>Net Income</b>	<b>2005 Weighted- Average Shares</b>	<b>Per- Share Amount</b>
<b>Basic Earnings Per Share</b>			
Income available to common stockholders	\$ 452	1,297,804	\$ .35
<b>Effect of Dilutive Stock Options</b>	—	21,062	
<b>Diluted Earnings Per Share</b>			
Income available to common stockholders and assumed conversions	\$ 452	1,318,866	\$ .34

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**Note 18: Fair Values of Financial Instruments**

The following methods and assumptions were used to estimate the fair value of each class of financial instrument:

**Cash and Cash Equivalents** - The fair value of cash and cash equivalents approximates carrying value.

**Securities Available for Sale** - Fair values are based on quoted market prices.

**Loans** - For both short-term loans and variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair value for other loans is estimated using discounted cash flow analyses using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality.

**FHLB Stock** - Fair value of FHLB stock is based on the price at which it may be resold to the FHLB.

**Interest Receivable** - The fair values of interest receivable approximate carrying values.

**Deposits** - The fair values of interest-bearing demand, NOW, money market deposit and savings accounts are equal to the amount payable on demand at the balance sheet date. The carrying amounts for variable rate, fixed-term certificates of deposit approximate their fair values at the balance sheet date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on such time deposits.

**Borrowings** - The fair value of borrowings is estimated using a discounted cash flow calculation, based on current rates for similar debt. Fair value approximates carrying value.

**Off-Balance Sheet Commitments** - Commitments include commitments to originate mortgage loans, and extend lines of credit and are generally of a short-term nature. The fair value of such commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.

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The estimated fair values of the Company's financial instruments are as follows:

	2006		2005	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Assets</b>				
Cash and cash equivalents	\$ 4,332	\$ 4,332	\$ 4,693	\$ 4,693
Interest-bearing deposits	1,500	1,500	300	300
Securities available for sale	2,050	2,050	2,595	2,595
Loans, net	62,619	63,339	55,732	58,414
FHLB stock	1,225	1,225	1,221	1,221
Interest receivable	424	424	369	369
<b>Liabilities</b>				
Deposits	44,543	43,959	44,655	44,485
Borrowings	24,000	23,403	17,000	16,857
<b>Off-Balance Sheet Assets</b>				
Commitments to extend credit				

**Note 19: Condensed Financial Information (Parent Company Only)**

Presented below is condensed financial information as to financial position, results of operations and cash flows of the Company:

**Condensed Balance Sheets**

	2006	2005
<b>Assets</b>		
Cash and cash equivalents	\$ 106	\$ 109
Securities available for sale	122	181
Premises and equipment	508	525
Investment in subsidiaries	6,958	6,698
Other assets	<u>284</u>	<u>394</u>
Total assets	<u>\$ 7,978</u>	<u>\$ 7,907</u>
<b>Liabilities</b>		
	\$ 549	\$ 578
<b>Stockholders' Equity</b>		
	<u>7,429</u>	<u>7,329</u>
Total liabilities and stockholders' equity	<u>\$ 7,978</u>	<u>\$ 7,907</u>

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**Condensed Statements of Income**

	<b>2006</b>	<b>2005</b>
<b>Income</b>		
Dividends from Bank	\$ 74	\$ 215
Net loss on available-for-sale securities	29	(26)
Interest and other income	—	(1)
Total income	103	188
<b>Expenses</b>		
Salaries and employee benefits	64	82
Legal and professional fees	29	54
Other expenses	97	94
Total expenses	190	230
<b>Loss before income tax benefit and equity in undistributed income of Bank</b>	(87)	(42)
<b>Income tax benefit</b>	19	101
<b>Income (loss) before equity in undistributed income of Bank</b>	(68)	59
<b>Equity in undistributed income of Bank</b>	327	393
<b>Net Income</b>	\$ 259	\$ 452

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**Condensed Statements of Cash Flows**

	<b>2006</b>	<b>2005</b>
<b>Operating Activities</b>		
Net income	\$ 259	\$ 452
Items not providing cash	<u>(188)</u>	<u>(285)</u>
Net cash provided by operating activities	<u>71</u>	<u>167</u>
<b>Investing Activity</b> - proceeds from sales of securities available for sale	<u>77</u>	<u>—</u>
<b>Financing Activities</b>		
Dividends paid	(143)	(143)
Issuance of stock	2	—
Purchase of stock	<u>(10)</u>	<u>(1)</u>
Net cash used in financing activities	<u>(151)</u>	<u>(144)</u>
<b>Net Change in Cash and Cash Equivalents</b>	(3)	23
<b>Cash and Cash Equivalents at Beginning of Year</b>	<u>109</u>	<u>86</u>
<b>Cash and Cash Equivalents at End of Year</b>	<u>\$ 106</u>	<u>\$ 109</u>