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**2008 Annual Report**

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*Offering the stability and  
shelter of our financial  
umbrella since 1869.*

LSB  
Financial  
Corp. 



*ANNUAL MEETING*

*The Annual Meeting of Shareholders of LSB Financial Corp.  
will be held April 15, 2009 at 9:00 a.m. local time at the LSB  
Building, located at 22 N. Second Street, Lafayette, Indiana.*

# LSB FINANCIAL CORP.

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## FINANCIAL HIGHLIGHTS

December 31, 2008  
(Dollars in Thousands)

Total assets .....	\$373,012
Total loans, net of allowance.....	326,639
Securities and short-term investments .....	21,032
Deposits.....	258,587
Borrowings .....	78,500
Shareholders' equity.....	34,075
Shareholders' equity as percent of assets.....	9.14%
Net Income .....	\$1,740

## ANNUAL MEETING

**The Annual Meeting of Shareholders of LSB  
Financial Corp. will be held April 15, 2009 at  
9:00 a.m. local time at the LSB Building, located  
at 22 N. Second Street, Lafayette, Indiana.**

# LSB FINANCIAL CORP.

Dear Fellow Shareholder:

In what may have been the most difficult year in banking since the Great Depression, the performance of our outstanding LSB team enables us to report a number of accomplishments:

1. In a year where nearly one-third of all FDIC-insured savings institutions lost money, we increased earnings by 10.6%. Our net income for the year was \$1,740,000, or \$1.12 per share, compared to \$1,574,000 or \$0.99 per share, the previous year. This equates to a return on average equity of 5.08% and a return on average assets of 0.48%, comparing favorably to an industry average loss of -5.94% and -0.55%, respectively.

2. Remarkably, we were able to hold the net interest margin erosion to 45 basis points, ending the year at 2.97%. Total loans increased by \$29.7 million, or 10.0%, deposits grew to \$258.6 million, up 11.5%, and assets ended the year at \$373.0 million, an increase of 9.1%. Net interest income declined by \$1.1 million because the Fed's seven interest rate cuts in 2008 caused the prime rate to fall by 400 basis points. Although these rate decreases immediately affected loan rates, deposit rates resisted the cuts as the largest banks continued to offer higher interest rates to attract more deposits and improve their liquidity.

3. We were able to decrease our nonperforming loans from \$10.0 million to \$8.0 million during the year. We approached 2008 with some trepidation about the recession's effect on the local economy but with continued determination to work closely with struggling borrowers in an effort to improve the bank's credit quality. Our focus on credit quality began in earnest in December 2006 with the establishment of an independent credit department which, at the time, was working through an overbuilt housing market and steep increases in property taxes. As you may recall, in 2007 we allocated \$1.6 million to loan loss reserves, anticipating that many of our foreclosed properties that had been working through the foreclosure process would be sold at sheriff's sales in 2008. We acquired and moved \$3.0 million of foreclosed properties in 2008 and wrote off additional losses on approved short sales, where properties were sold by borrowers for less than the amount of their loan. Our charge-offs to loan loss reserves totaled \$1.2 million in 2008. Although we cannot predict how hard the national recession will affect us, this is our lowest level for nonperforming loans since December 2006. The adjustments we made to other real estate owned (OREO) property values in 2007 put us in a good position for 2008. We sold over \$4.6 million of OREO properties and recognized additional losses of only \$156,000. Compared to \$3.9 million at December 31, 2007, our OREO properties at December 31, 2008, totaled \$1.4 million, our lowest balance since mid-2005. An all important ratio, nonperforming loans compared to total loans dropped from 3.32% at December 31, 2007, to 2.41% at December 31, 2008.

4. Although we feel privileged to have been approved to receive Troubled Assets Relief Program (TARP) money, our strong capitalization level, improving loan quality, and generally stable local economy, as well as the continuing lack of clarity about the final government-mandated stipulations for those who accept this money, have led our board of directors to respectfully decline to participate. In October of last year, the Treasury announced TARP under emergency legislation to address the tremendous challenges facing the financial industry. Federal regulators were encouraging banks to apply for capital infusions through the plan's

Capital Purchase Program (CPP); at the same time, the U.S. Treasury was encouraging banks to apply for the money to help unfreeze lending. Applications were due in less than a month, which made careful evaluation of the program difficult. Nevertheless, because of concern about the economy, many banks, including LSB, applied for the funds as a way to secure time to consider their position.

With a Tier 1 capital to assets ratio of 9.14% at year-end, Lafayette Savings Bank is considered well capitalized compared to the regulatory well-capitalized Tier 1 to assets ratio of 5.0%. Despite the cushion, we applied various stress tests to determine whether our capital was sufficient to keep us well capitalized should the national economic downturn severely affect the local economy. We evaluated that likelihood in light of the diverse local economy, the presence of Purdue University and its thriving Research Park, and the reported \$600 million of capital invested in Greater Lafayette in 2008. We took into account that our business plan has resulted in a balance sheet not troubled by subprime loans, with no derivative investment products purchased to obtain high returns, and no preferred stock from Freddie Mac or Fannie Mae. On January 6, 2009, we received preliminary approval from the Treasury to receive \$8.6 million of CPP money. We declined the funds because our community-oriented approach to banking has served us well for the past 140 years and we believe it will continue to provide us with sufficient capital to weather the effects of the national slowdown.

5. As growth slowed back in the third quarter of 2007, we increased the dividend to \$0.25 per share. That rate held for the next six quarters, until we lowered it to \$0.125 in the first quarter of 2009. We completely agree with the original goals of the TARP, that building up capital during hard times is prudent and that continuing to lend to keep a stable economy is crucial. We believe that the money we save by reducing our dividend directly accomplishes both those things. Despite the troubled national economy, locally we continue to see substantial numbers of well-qualified borrowers applying for loans, and we acted on our belief that using our equity to fund loans and thus grow the balance sheet is a prudent way to manage our capital. Also, the reduced dividend will give us the flexibility to make strategic repurchases of our own stock, which like most bank stock is selling below book value. Further, any capital we are able to retain because of this lower dividend rate will bolster capital levels internally rather than taking CPP money.

Despite our improved performance, we are nonetheless a financial stock. As did most financial stocks, our price decreased over the year, ending the year at \$9.95. At year-end we were trading at 45% of book value and 8.9 times earnings. It is our hope that continued strong earnings, along with recognition as having been "TARP qualified" and our own decision not to participate in the program, will identify us as a solid investment.

During the year, Harry A. Dunwoody, senior vice president, retired from the bank. Harry worked for the bank for over 19 years and served 14 years as a director of the company. Those of you who know Harry (at one time or another, he probably made most of you a loan) realize what a caring person he was. When he retired he asked us to use his accumulated vacation and sick days to establish a pool of paid time off to lessen the burden for employees who had exhausted theirs. Thus the Compassionate Time-Off Program became an official benefit to our employees.

As the banking industry picks its way through the minefield of 2009, we have no clear idea just how much the national recession will affect our local economy. We will continue our

efforts to manage our capital, control expenses, and grow the interest margin. Thank you for your continued support. Our team is committed to exceeding expectations every day, whether for customers, shareholders, or each other.

Respectfully,

A handwritten signature in black ink, appearing to read "Randolph F. Williams". The signature is fluid and cursive, with a long horizontal stroke at the end.

Randolph F. Williams  
President & Chief Executive Officer

## SELECTED FINANCIAL INFORMATION

The selected financial data presented below should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as the audited Consolidated Financial Statements contained elsewhere in this Annual Report.

	<u>December 31,</u>				
	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
	(Dollars in Thousands)				
<b><u>Selected Financial Condition Data:</u></b>					
Total assets .....	\$373,012	\$342,010	\$368,400	\$372,664	\$355,045
Loans receivable, including loans held for sale, net ....	326,639	296,908	317,691	330,971	318,927
Securities available-for-sale .....	11,853	13,221	16,316	11,611	7,947
Short-term investments.....	9,179	4,846	8,336	7,687	6,818
Deposits .....	258,587	232,030	255,304	265,993	256,631
Total borrowings .....	78,500	74,256	76,618	72,033	66,808
Shareholders' equity .....	34,075	33,932	34,840	32,821	30,393

	<u>December 31,</u>				
	<u>2008</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>
	(Dollars in Thousands, except share data)				
<b><u>Selected Operations Data:</u></b>					
Total interest income.....	\$ 21,319	\$ 22,882	\$ 23,263	\$ 21,498	\$ 19,286
Total interest expense.....	<u>11,286</u>	<u>11,655</u>	<u>11,142</u>	<u>9,664</u>	<u>8,416</u>
Net interest income .....	10,033	11,227	12,121	11,834	10,870
Provision for loan losses .....	<u>1,102</u>	<u>1,570</u>	<u>1,018</u>	<u>1,200</u>	<u>500</u>
Net interest income after provision for loan losses .....	8,931	9,657	11,103	10,634	10,370
Deposit account service charges .....	1,736	1,838	1,766	1,423	889
Gain on sales of mortgage loans .....	117	201	214	322	593
Gain on call of securities.....	---	6	---	---	---
Loss on real estate owned .....	(156)	(1,097)	---	---	---
Other non-interest income.....	<u>1,194</u>	<u>1,098</u>	<u>858</u>	<u>764</u>	<u>747</u>
Total non-interest income .....	2,891	2,046	2,838	2,509	2,240
Total non-interest expense .....	<u>9,286</u>	<u>9,322</u>	<u>8,593</u>	<u>8,111</u>	<u>7,554</u>
Income before taxes .....	2,536	2,381	5,348	5,032	5,056
Income taxes .....	<u>796</u>	<u>807</u>	<u>1,998</u>	<u>1,764</u>	<u>1,792</u>
Net income .....	<u>\$ 1,740</u>	<u>\$ 1,574</u>	<u>\$ 3,350</u>	<u>\$ 3,268</u>	<u>\$ 3,264</u>
Earnings per share .....	\$ 1.12	\$ 1.00	\$ 2.08	\$ 2.03	\$ 2.10
Earnings per share, assuming dilution.....	1.12	0.99	2.07	2.02	2.03
Dividends paid per share.....	1.00	0.90	0.68	0.61	0.51

	<u>2008</u>	<u>2007</u>	<u>December 31,</u> <u>2006</u>	<u>2005</u>	<u>2004</u>
<b><u>Selected Financial Ratios and Other Data:</u></b>					
<b>Performance Ratios:</b>					
Return on assets (ratio of net income to average total assets) .....	0.48%	0.45%	0.91%	0.89%	0.95%
Return on equity (ratio of net income to average equity) .....	5.08	4.52	9.88	10.21	11.19
Average interest rate spread during period.....	2.82	3.25	3.33	3.23	3.20
Net interest margin <sup>(1)</sup> .....	2.97	3.42	3.48	3.37	3.32
Operating expense to average total assets .....	2.58	2.66	2.33	2.20	2.20
Average interest-earning assets to average interest-bearing liabilities .....	1.05x	1.05x	1.05x	1.05x	1.05x
<b>Quality Ratios:</b>					
Non-performing assets to total assets at end of period .....	2.52%	4.08%	3.17%	2.83%	1.67%
Allowance for loan losses to non-performing loans .....	46.35	37.04	23.72	27.00	35.38
Allowance for loan losses to loans receivable .....	1.12	1.23	0.86	0.85	0.66
<b>Capital Ratios:</b>					
Shareholders' equity to total assets at end of period .....	9.14	9.92	9.46	8.81	8.56
Average shareholders' equity to average total assets.....	9.53	9.92	9.19	8.69	8.50
Dividend payout ratio.....	89.43	90.00	32.69	30.05	24.54
<b>Other Data:</b>					
Number of full-service offices .....	5	5	5	5	5

<sup>(1)</sup> Net interest income divided by average interest-earning assets.

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

### **EXECUTIVE OVERVIEW**

#### **General**

LSB Financial Corp., an Indiana corporation (“LSB Financial” or the “Company”), is the holding company of Lafayette Savings Bank, FSB (“Lafayette Savings” or the “Bank”). LSB Financial has no separate operations and its business consists only of the business of Lafayette Savings. References in this Annual Report to “we,” “us” and “our” refer to LSB Financial and/or Lafayette Savings as the context requires.

Lafayette Savings is, and intends to continue to be, an independent, community-oriented financial institution. The Bank has been in business for 139 years and differs from many of our competitors in having a local board and local decision-making in all areas of business. In general, our business consists of attracting or acquiring deposits and lending that money out primarily as real estate loans to construct and purchase single-family residential properties and, to a lesser extent, multi-family and commercial properties and to fund land development projects. We also make a limited number of commercial business and consumer loans.

We have an experienced and committed staff and enjoy a good reputation for serving the people of the community and understanding their financial needs and for finding a way to meet those needs. We contribute time and money to improve the quality of life in our market area and many of our employees volunteer for local non-profit agencies. We believe this sets us apart from the other 19 banks and credit unions that compete with us. We also believe that operating independently under the same name for over 139 years is a benefit to us—especially as acquisitions and consolidations periodically disrupt financial institutions and services. Focusing time and resources on acquiring customers who may be feeling disenfranchised by their no-longer-local bank has proved to be a successful strategy.

In this year of worsening recession and extraordinary economic times, we find ourselves in a community that to some extent has been sheltered from the worst effects of the slowdown. The greater Lafayette area enjoys diverse employment including several major manufacturers; a strong education sector with Purdue University and a large local campus of Ivy Tech Community College; government offices of Lafayette, West Lafayette and Tippecanoe County and a growing high-tech presence with the Purdue Research Park. This diversity served to insulate us from some of the severity of the effects of economic downturns felt in other parts of the country. A year-end report by the Lafayette Chamber of Commerce noted nearly \$600 million in new capital investments in 2008 with new projects underway as the two new hospitals in the area spur growth of a medical corridor and Purdue University and the Purdue Research Park plan additional growth. That report indicated that only one local employer surveyed anticipated reductions in staff although that one, Wabash National, the area’s second largest industrial employer, experienced a plant shutdown at year-end. Wabash National expects that new product lines and new contracts will increase levels of production by the second quarter of 2009. The Tippecanoe County unemployment rate a December 2008 was 6.0%, a higher than usual level likely caused by temporary layoffs at Wabash National discussed below. The local economy has stayed relatively strong thanks to the presence of Purdue University which employs almost

15,000 people and has enrollment at the West Lafayette campus of over 40,000. The University's new construction in 2008 provided capital investments of over \$242 million, thanks in part to their successful fundraising campaign which raised over \$7 billion. The success of the Purdue Research Park in attracting high-tech companies to the Lafayette area is seen in the 52 buildings with 1.3 million square feet owned or leased by 160 companies employing 3,100 people. Its 195,000 square feet of incubator space makes it the largest institutionally operated incubator program in the nation. The county also has a relatively strong manufacturing sector. Some examples of new growth in 2008 include Federal Express announcing it will build a distribution center in Lafayette in 2009, EDS Indiana Technical Resource Center leasing 13,000 square feet in Purdue Research Park and hiring 92 people with additional growth planned for 45,000 square feet occupied in 2009 and 200 employees hired by 2010. TRW plans to expand its operations with a new \$29 million facility in south Lafayette that will employ 200 people. Caterpillar currently has a \$1.6 million office building underway and increased employment by 350 in 2008 with 50 more projected to be hired in 2009. Subaru of Indiana projected production of 195,000 vehicles in 2008 and increased its national sales by 3% in 2008, the only major auto manufacturer to do so. Wabash National, after struggling in the last few years and shutting down their plant from December 2008 through February 2009, invested \$8 million in new equipment, \$1 million on real estate improvements and plans a \$3 million facility improvement as part of a new strategic plan. They project that sales will increase from \$15 million in 2008 to \$35 million in 2009, to \$80 million in 2012 due to, among other things, multi-year contracts signed with several national corporations including orders for their new utility trucks, cargo trailers and storage units, and orders for a projected 34,270 new trailers. They anticipate calling back all laid-off employees by the second quarter of 2009. The other area of growth involves the construction of two new hospitals (one already in operation) and the resulting medical corridor currently being developed to accommodate the office space needed for related services.

The community is making progress working through the effects of the overbuilding of one- to four-family housing when housing starts increased from a somewhat typical 858 starts in 2001 to 1,219 in 2004. New construction has dropped every year since, to 448 in 2008. Many of the houses which had been sold to marginally qualified borrowers reappeared on the market as foreclosed properties, further slowing the need for new housing. While this increase in foreclosed properties and distressed housing sales has been a drag on the economy, this was due more to aggressive marketing of houses to people who couldn't afford them rather than because of increased levels of unemployment. In addition, unlike in other parts of the country, housing values in the Metropolitan Statistical Area of which Tippecanoe County is a part have increased by 2.88% over the last 12 months according to a report from the Office of Federal Housing Enterprise Oversight.

We continue to work with borrowers who have fallen behind on their loans. The majority of our delinquent loans are secured by real estate and we believe we have sufficient reserves to cover incurred losses. The challenge is to get delinquent borrowers back on a workable payment schedule or to get control of their properties through an overburdened court system. We acquired 29 properties in 2008 through foreclosure or deeds-in-lieu of foreclosure.

The funds we use to make loans come primarily from deposits from customers in our market area, from brokered deposits and from Federal Home Loan Bank ("FHLB") advances. In addition we maintain an investment portfolio of available-for-sale securities to provide liquidity as needed. Our intention is to seek out the least expensive source of funds, but if the need is immediate we will acquire pre-payable FHLB advances which are immediately available for

member banks within their borrowing tolerance and can then be replaced with local or brokered deposits as they become available. Our reliance on brokered funds as a percentage of total deposits increased in 2008 from 20.6% to 23.6% with the actual dollar amount increasing from \$47.8 million to \$61.0 million. We generally prefer brokered deposits over FHLB advances when the rates are competitive with the cost of raising money locally. The deposits are available with a range of terms, there is no collateral requirement and the money is predictable as it cannot be withdrawn early except in the case of the death of a depositor and there is no option to have the money rollover at maturity. While we always welcome local deposits, the cost and convenience of brokered funds make them a useful alternative. We will also continue to rely on FHLB advances to provide immediate liquidity and help manage interest rate risk.

Our primary source of income is net interest income, which is the difference between the interest income earned on our loan and investment portfolio and the interest expense incurred on deposits and borrowings. Our net interest income depends on the balance of our loan and investment portfolios and the size of our net interest margin – the difference between the income generated from loans and the cost of funding. Our net interest income also depends on the shape of the yield curve. Since January 2007, the Federal Reserve has lowered short-term rates from around 5.0% to almost zero while long-term rates which had also been near 5.0% fell to under 3.0%. Because deposits are generally tied to shorter-term market rates and loans are generally tied to longer-term rates this would typically be viewed as a positive step. In reality, loans—especially those immediately repricable to prime—fell immediately while deposits generally stayed high due to a demand for liquidity, especially by big banks whose presence in the deposit markets was ubiquitous. Our expectation for 2009 is that deposits will gradually respond to the lower market rates as banks are less concerned about the loss of liquidity. Overall loan rates are expected to stay low.

Rate changes can typically be expected to have an impact on interest income. Falling rates generally increase borrower preference for fixed rate products, which we typically sell on the secondary market, and existing adjustable rate loans can be expected to reprice to lower rates, which could be expected to have a negative impact on our interest income. Also any new loans put on the books will be at comparatively low rates. Because the government is working to push long-term rates to fall further to help ease the housing crisis, we expect to see a return to a high volume of refinancing.

Our primary expense is interest on deposits and FHLB advances which are used to fund loan growth. We offer customers in our market area time deposits for terms ranging from three months to five years, checking accounts and savings accounts. We also purchase brokered deposits and FHLB advances as needed to provide funding or improve our interest rate risk position. Generally when interest rates are low, depositors will choose shorter-term products and conversely when rates are high, depositors will choose longer-term products.

We consider expected changes in interest rates when structuring our interest-earning assets and our interest-bearing liabilities. When rates are expected to increase we try to book shorter-term assets that will reprice relatively quickly to higher rates over time, and book longer-term liabilities that will remain for a longer time at lower rates. Conversely, when rates are expected to fall, we would like our balance sheet to be structured such that loans will reprice more slowly to lower rates and deposits will reprice more quickly. We currently offer a three-year and a five-year certificate of deposit that allows depositors one opportunity to have their rate adjusted to the market rate at a future date to encourage them to choose longer-term deposit

products. However, since we are not able to predict market interest rate fluctuations, our asset/liability management strategy may not prevent interest rate changes from having an adverse effect on our results of operations and financial condition.

Our results of operations may also be affected by general and local competitive conditions, particularly those with respect to changes in market rates, government policies and actions of regulatory authorities.

## **2008 Summary**

Our strategy in 2008 was similar to that in 2007 - enhancing the credit analysis department, working to manage non-performing loans and dispose of other real estate owned, controlling the cost of funds and other expenses and focusing on growth in other income. Later in the year we focused on selectively extending credit to borrowers who had been denied credit at larger, national banks who were hesitant to loan in the current environment, and in enhancing our secondary loan market availability to enable us to provide VA and FHA loans to qualified borrowers.

Because the local economy fared better in 2008 than the rest of the country, the opportunity for loan growth was better than expected. Unit residential real estate sales in 2008 were one unit below 2007 and were trending higher at year end. Commercial real estate activity was centered in the new medical corridor connecting the two new hospitals, industrial growth on the south side of town, and ongoing building at Purdue University and in the Purdue Research Park. The loan increase was across all real estate related categories. Non-real estate and home equity loans declined over 2008. Our credit department is now fully staffed with a department manager, two experienced credit analysts and two collectors, including one experienced in workouts and debt restructuring. In 2008, we sold \$4.6 million of other real estate owned (OREO) properties, consisting of 42 properties. Our residential loan originators originated and sold \$10.2 million of residential loans on the secondary market for a gain of \$117,000.

In 2007 we allocated \$1.6 million to loan loss reserves anticipating that many of our delinquent loans would be foreclosed in 2008. The allocation increased the ratio of loan loss reserves to total loans at December 31, 2007 to 1.23%, the highest rate we have ever shown. We charged off \$1.2 million to loan loss reserves in 2008 which resulted in the addition of \$2.3 million of foreclosed properties to OREO. We also wrote off additional losses on properties sold through approved short sales where properties were sold by borrowers for less than the amount of their loan. We were able to decrease our non-performing loans from \$10.0 million at December 31, 2007 to \$8.0 million at December 31, 2008. This is our lowest level for non-performing loans since December 2006. At December 31, 2008, our allowance for loan losses compared to non-performing loans was 46.35% compared to 37.04% at December 31, 2007. Non-performing loans compared to total loans dropped from 3.32% at December 31, 2007 to 2.52% at December 31, 2008. Our OREO properties at December 31, 2008 were \$1.4 million, our lowest balance since mid-2005, and compared to \$3.9 million at December 31, 2007. In addition, even after working through this number of properties, the ratio of loan loss reserves to total loans ended the year at 1.12% which we believe to be adequate to absorb estimated incurred losses inherent in our loan portfolio. While we continue to seek to lower our delinquencies, based on our analysis we believe we have sufficient reserves to cover incurred losses. In 2008 we also wrote off losses of \$156,000 on the sale of OREO properties including \$16,000 of net

loss on the actual sale of properties and \$140,000 of writedowns taken to adjust the value of OREO properties to the estimated, realizable value.

The Federal Reserve rate adjustments which took short-term rates to virtually zero and longer-term rates to the 2% to 3% range, while returning the yield curve to a more normal shape, did not have the expected effect of maintaining interest rate margins. All loans tied to prime reacted immediately to the rate cuts. New loan rates fell as well, as have, gradually, other variable rate loans. Deposit rates however remained high due to the liquidity demands of bigger banks that kept deposit rates well over Treasury indications. Because banks were unsure about whether their normal borrowing sources would be available, many of them turned to the brokered CD markets and/or paid premium rates for customer deposits. For banks like us with routine funding needs the cost of funds stayed frustratingly high.

Other non-interest income, excluding the gain on sale of loans and the loss on the sale of OREO, decreased by \$12,000 primarily from a \$102,000 decrease in deposit service fees offset by a \$60,000 increase in loan fees due to higher fees for loan closings and an increase in loan modification fees and a \$28,000 increase in fees from our new in-house wealth management department.

The results of our loan and deposit activity in 2008 are illustrated in the chart on page 14 and include:

- Residential mortgage loans (including loans held for sale) increased by 4.7% from \$137.6 million to \$144.1 million.
- All other real estate loans, net, including multi-family, land, land development, construction and commercial real estate loans increased 21.9% from \$127.6 million to \$159.7 million.
- Commercial business lending decreased 26.1% from \$19.3 million to \$14.3 million.
- At December 31, 2008, 70.4% of our gross loan portfolio had adjustable interest rates.
- Total deposit accounts increased 11.5% from \$232.0 million at December 31, 2007 to \$258.6 million at December 31, 2008, with core deposits increasing 7.9% from \$75.9 million to \$81.9 million over the same period.

## **2009 Overview**

We expect to see continued slow-to-moderate growth in our residential loan portfolio through 2009 with interest rates remaining low and rates on residential mortgage loans at historically low levels. While we expect to see significant residential mortgage loan refinance activity as borrowers take advantage of lower rates to bring down their mortgage costs, we intend to primarily originate these loans for sale on the secondary market, only keeping some of our shorter-term fixed rate loans in our portfolio. We expect to have the opportunity to consider new commercial loan relationships as some of the larger banks have moved to tighten credit. We anticipate some increase in commercial real estate and commercial business loan activity from

the medical corridor being built around the two new hospitals and from building related to the Purdue Research Park and other areas of expansion. We are fortunate that the local economy is showing such resilience in the face of the recession. However, portfolio loan growth overall is expected to be modest.

Our operating results will continue to be affected by several factors involving the disposition of properties in foreclosure or held in other real estate owned, including the level of the provision for loan losses, gains and losses on the sale of properties once we acquire title to them, the loss of interest income on non-performing assets and non-interest expenses incurred in obtaining, marketing and disposing of the properties. These factors are expected to have less of an impact than in 2008 since the level of OREO properties at year-end was at its lowest point in three years and our non-performing loans were down \$2.0 million from last year. Our allowance for loan losses to non-performing loans is at 46.4%, the highest level in four years. The allowance for loan losses ended the year at 1.12%. Because of staff increases in the credit area, we expect the quality of our loan portfolio to improve as improved credit analysis translates into higher credit quality of our new loans while we proactively work with troubled borrowers while their situation is still salvageable. We monitor these and all other loans in our portfolio carefully and perform specific impairment analyses on any loans over 90 days delinquent. Based on our analysis, we believe that our current loan loss reserve is sufficient to cover probable losses.

We intend to continue to follow a strategy for growth in 2009 that includes (1) maintaining a strong capital position, (2) managing our vulnerability to changes in interest rates by emphasizing adjustable rate and/or shorter-term loans, (3) optimizing our net interest margin by supplementing our traditional mortgage lending with prudent multi-family and commercial real estate, consumer and construction loans, (4) working to originate and sell residential mortgage loans in the secondary market for a fee, (5) originating FHA and VA loans to access a market not previously available to us, and (6) funding our growth by using a mix of local and brokered deposits and FHLB advances, whichever is most cost-effective.

### **Possible Implications of Current Events**

Significant external factors impact our results of operations including the general economic environment, changes in the level of market interest rates, government policies, actions by regulatory authorities and competition. Our cost of funds is influenced by interest rates on competing investments and general market rates of interest. Lending activities are influenced by the demand for real estate loans and other types of loans, which are in turn affected by the interest rates at which such loans are made, general economic conditions affecting loan demand and the availability of funds for lending activities.

Management continues to assess the impact on the Company of the uncertain economic and regulatory environment affecting the country at large and the financial services industry in particular. The level of turmoil in the financial services industry does present unusual risks and challenges for the Company, as described below:

In response to the financial crises affecting the banking system and financial markets and going concern threats to investment banks and other financial institutions, on October 3, 2008, the Emergency Economic Stabilization Act of 2008 (the "EESA") was signed into law. Pursuant

to the EESA, the U.S. Department of Treasury (the "Treasury") has the authority to, among other things, purchase up to \$700 billion of mortgages, mortgage-backed securities and certain other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U.S. financial markets.

On October 14, 2008, the Treasury also announced it would offer to qualifying U.S. banking organizations the opportunity to sell preferred stock, along with warrants to purchase common stock, to the Treasury under the Troubled Asset Relief Program ("TARP") Capital Purchase Program (the "CPP"). On January 6, 2009, the Company received preliminary approval of its application under the TARP CPP to sell \$8.6 million in preferred stock to the Treasury. However, based on the Company's strong capitalization level, improving loan quality, generally stable local economy and the lack of clarity regarding final government-mandated stipulations for those who accept the TARP money, the Company's board of directors has decided the Company will not participate in the TARP CPP.

***The Current Economic Environment Poses Challenges For Us and Could Adversely Affect Our Financial Condition and Results of Operations.*** We are operating in a challenging and uncertain economic environment, including generally uncertain national conditions which could have implications for our local markets. The capital and credit markets have been experiencing volatility and disruption for more than 12 months. In recent months, the volatility and disruption has reached unprecedented levels. The risks associated with our business become more acute in periods of a slowing economy or slow growth. Financial institutions continue to be affected by sharp declines in the real estate market and constrained financial markets. While we are taking steps to decrease and limit our exposure to problem loans, and while our local economy has remained somewhat insulated from the most severe effects of the current economic environment, all financial institutions nonetheless retain direct exposure to the residential and commercial real estate markets and are affected by these events.

Our loan portfolio includes commercial real estate loans, residential mortgage loans, and construction and land development loans. Continued declines in real estate values, home sales volumes and financial stress on borrowers as a result of the uncertain economic environment, including job losses, could have an adverse effect on our borrowers or their customers, which could adversely affect our financial condition and results of operations. In addition, a national economic recession or further deterioration in local economic conditions in our markets could drive losses beyond that which is provided for in our allowance for loan losses and result in the following other consequences: loan delinquencies, problem assets and foreclosures may increase; demand for our products and services may decline; deposits may decrease, which would adversely impact our liquidity position; and collateral for our loans, especially real estate, may decline in value, in turn reducing customers' borrowing power, and reducing the value of assets and collateral associated with our existing loans.

***Impact of Recent and Future Legislation.*** As noted above, Congress and the U.S. Treasury Department have recently adopted legislation and taken actions to address the disruptions in the financial system and declines in the housing market. It is not clear at this time what impact the EESA, TARP, other liquidity and funding initiatives of the Treasury and other bank regulatory agencies that have been previously announced, and any additional programs that may be initiated in the future, will have on the financial markets and the financial services industry. The actual impact that EESA and such related measures undertaken to alleviate the credit crisis will have generally on the financial markets, including the extreme levels of

volatility and limited credit availability currently being experienced, is unknown. The failure of such measures to help stabilize the financial markets and a continuation or worsening of current financial market conditions could materially and adversely affect all financial institutions, including the Company.

In addition to the legislation mentioned above, federal and state governments could pass additional legislation responsive to current credit conditions. As an example, the Bank could experience higher credit losses because of federal or state legislation or regulatory action that reduces the amount the Bank's borrowers are otherwise contractually required to pay under existing loan contracts. Also, the Bank could experience higher credit losses because of federal or state legislation or regulatory action that limits its ability to foreclose on property or other collateral or makes foreclosure less economically feasible.

***Adverse Effect On Our Industry from Difficult Market Conditions.*** Although the Metropolitan Statistical Area of which Tippecanoe County is a part has experienced a slight increase in housing values over the past 12 months, widespread downturns in the U.S. housing market may have an effect here. The market turmoil and tightening of credit generally have led to an increased level of commercial and consumer delinquencies, lack of consumer confidence, increased market volatility and widespread reduction of business activity. We do not expect that the difficult conditions in the financial markets are likely to dissipate in the near future. A worsening of these conditions would likely have adverse effects on us and others in the financial institutions industry. In particular, we may face the following risks in connection with these events:

- We expect to face increased regulation of our industry. Compliance with such regulation may increase our costs and limit our ability to pursue business opportunities.
- Our ability to assess the creditworthiness of our customers may be impaired if the models and approaches we use to select, manage and underwrite our customers become less predictive of future behaviors.
- The process we use to estimate losses inherent in our credit exposure requires difficult, subjective and complex judgments, including forecasts of economic conditions and how these economic predictions might impair the ability of our borrowers to repay their loans, which may no longer be capable of accurate estimation which may, in turn, impact the reliability of the process.
- Competition in our industry could intensify as a result of the increasing consolidation of financial services companies in connection with current market conditions.
- We may be required to pay significantly higher deposit insurance premiums because market developments have significantly depleted the insurance fund of the Federal Deposit Insurance Corporation and reduced the ratio of reserves to insured deposits.

***Current Levels of Market Volatility Are Unprecedented.*** The capital and credit markets have been experiencing unprecedented levels of volatility and disruption for more than a year. In some cases the markets have produced downward pressure on stock prices and credit availability for certain issuers without regard to those issuers' underlying financial strength. If current levels of market disruption and volatility continue or worsen, our ability to access capital may be

adversely affected which, in turn, could adversely affect our business, financial condition and results of operations.

***Additional Increases in Insurance Premiums.*** The Federal Deposit Insurance Corporation (“FDIC”) insures the Bank’s deposits up to certain limits. The FDIC charges us premiums to maintain the Deposit Insurance Fund. The Bank elected to obtain unlimited deposit insurance protection for non-interest bearing transaction deposit accounts under the FDIC’s Temporary Liquidity Guarantee Program, which will increase its insurance premiums by 10 basis points per annum.

Current economic conditions have increased expectations for bank failures. The FDIC takes control of failed banks and ensures payment of deposits up to insured limits using the resources of the Deposit Insurance Fund. The FDIC has designated the Deposit Insurance Fund long-term target reserve ratio at 1.25 percent of insured deposits. Due to recent bank failures, the FDIC insurance fund reserve ratio has fallen below 1.15 percent, the statutory minimum. The FDIC has developed a restoration plan that will uniformly increase insurance assessments by 7 basis points (annualized) effective January 1, 2009. In 2008, assessments ranged from 5 to 43 basis points of assessable deposits depending upon the institution’s risk profile. Effective April 1, 2009, the range of assessments increases to between 7 and 77 1/2 basis points, with possible future adjustments not to exceed 3 basis points from the base scale per quarter without notice and comment. Further increases in premium assessments would increase the Company’s expenses.

On February 27, 2009, the FDIC proposed an interim rule to impose a 20 basis point emergency special assessment on June 30, 2009. The assessment would be collected on September 30, 2009. On March 5, 2009, FDIC Chairman Sheila Bair announced that if Congress adopts legislation expanding the FDIC’s line of credit with Treasury from \$30 billion to \$100 billion, the FDIC might have the flexibility to reduce the special emergency assessment, from 20 to possibly 10 basis points. Assuming that deposit levels remain constant, we anticipate that the special assessment for the Bank would total approximately \$517,000 at the 20 basis points level, but if the FDIC is able to reduce the special assessment to 10 basis points, the Bank’s assessment would total approximately \$258,000. The interim rule would also allow an additional emergency assessment of up to 10 basis points after June 30, 2009 as deemed necessary by the Board of the FDIC. Either assessment would have a material impact on the 2009 results of operations.

***Future Reduction in Liquidity in the Banking System.*** The Federal Reserve Bank has been providing vast amounts of liquidity in to the banking system to compensate for weaknesses in short-term borrowing markets and other capital markets. A reduction in the Federal Reserve’s activities or capacity could reduce liquidity in the markets, thereby increasing funding costs to the Bank or reducing the availability of funds to the Bank to finance its existing operations.

***Concentrations of Real Estate Loans Could Subject the Company to Increased Risks in the Event of a Real Estate Recession or Natural Disaster.*** A significant portion of the Company’s loan portfolio is secured by real estate. The real estate collateral in each case provides an alternate source of repayment in the event of default by the borrower and may deteriorate in value during the time the credit is extended. While property values in this area have been relatively unaffected by the economic downturn and actually increased in 2008, a weakening of the real estate market in our primary market area could result in an increase in the number of borrowers unable to refinance or who may default on their loans and a reduction in the value of the collateral securing their loans, which in turn could have an adverse effect on our profitability

and asset quality. If we are required to liquidate the collateral securing a loan to satisfy the debt during a period of reduced real estate values, our earnings and capital could be adversely affected.

Significant natural disasters can also negatively affect the value to real estate that secures our loans or interrupt our business operations, also negatively impacting our operating results or financial condition.

***Credit Risk Could Adversely Affect Our Operating Results or Financial Condition.*** One of the greatest risks facing lenders is credit risk – that is, the risk of losing principal and interest due to a borrower’s failure to perform according to the terms of a loan agreement. During 2007, the banking industry experienced increasing trends in problem assets and credit losses which resulted from weakening national economic trends and a decline in housing values. While management attempts to provide an allowance for loan losses at a level adequate to cover probable incurred losses based on loan portfolio growth, past loss experience, general economic conditions, information about specific borrower situations, and other factors, future adjustments to reserves may become necessary, and net income could be significantly affected, if circumstances differ substantially from assumptions used with respect to such factors.

***Interest Rate Risk Could Adversely Affect Our Operations.*** The Company's earnings depend to a great extent upon the level of net interest income, which is the difference between interest income earned on loans and investments and the interest expense paid on deposits and other borrowings. Interest rate risk is the risk that the earnings and capital will be adversely affected by changes in interest rates. While the Company attempts to adjust its asset/liability mix in order to limit the magnitude of interest rate risk, interest rate risk management is not an exact science. Rather, it involves estimates as to how changes in the general level of interest rates will impact the yields earned on assets and the rates paid on liabilities. Moreover, rate changes can vary depending upon the level of rates and competitive factors. From time to time, maturities of assets and liabilities are not balanced, and a rapid increase or decrease in interest rates could have an adverse effect on net interest margins and results of operations of the Company. Volatility in interest rates can also result in disintermediation, which is the flow of funds away from financial institutions into direct investments, such as U.S. Government and corporate securities and other investment vehicles, including mutual funds, which, because of the absence of federal insurance premiums and reserve requirements, generally pay higher rates of return than financial institutions.

### **Critical Accounting Policies**

Generally accepted accounting principles are complex and require management to apply significant judgments to various accounting, reporting and disclosure matters. Management of LSB Financial Corp. must use assumptions and estimates to apply these principles where actual measurement is not possible or practical. For a complete discussion of LSB Financial Corp.’s significant accounting policies, see Note 1 to the Consolidated Financial Statements as of December 31, 2008. Certain policies are considered critical because they are highly dependent upon subjective or complex judgments, assumptions and estimates. Changes in such estimates may have a significant impact on the financial statements. Management has reviewed the application of these policies with the Audit Committee of LSB Financial Corp.’s Board of Directors. These policies include the following:

### *Allowance for Loan Losses*

The allowance for loan losses represents management's estimate of probable losses inherent in Lafayette Savings' loan portfolios. In determining the appropriate amount of the allowance for loan losses, management makes numerous assumptions, estimates and assessments.

The strategy also emphasizes diversification on an industry and customer level, regular credit quality reviews and quarterly management reviews of large credit exposures and loans experiencing deterioration of credit quality.

Lafayette Savings' allowance consists of three components: probable losses estimated from individual reviews of specific loans, probable losses estimated from historical loss rates, and probable losses resulting from economic or other deterioration above and beyond what is reflected in the first two components of the allowance.

Larger commercial loans that exhibit probable or observed credit weaknesses and all loans that are rated substandard or lower are subject to individual review. Where appropriate, reserves are allocated to individual loans based on management's estimate of the borrower's ability to repay the loan given the availability of collateral, other sources of cash flow and legal options available to the Bank. Included in the review of individual loans are those that are impaired as provided in SFAS 114, *Accounting by Creditors for Impairment of a Loan*. Any allowances for impaired loans are determined by the present value of expected future cash flows discounted at the loan's effective interest rate or fair value of the underlying collateral. Historical loss rates are applied to other commercial loans not subject to specific reserve allocations.

Homogenous smaller balance loans, such as consumer installment and residential mortgage loans are not individually risk graded. Reserves are established for each pool of loans based on the expected net charge-offs for one year. Loss rates are based on the average net charge-off history by loan category.

Historical loss rates for commercial and consumer loans may be adjusted for significant factors that, in management's judgment, reflect the impact of any current conditions on loss recognition. Factors which management considers in the analysis include the effects of the national and local economies, trends in the nature and volume of loans (delinquencies, charge-offs and non-accrual loans), changes in mix, asset quality trends, risk management and loan administration, changes in the internal lending policies and credit standards, collection practices and examination results from bank regulatory agencies and the Bank's internal loan review.

Allowances on individual loans are reviewed quarterly and historical loss rates are reviewed annually and adjusted as necessary based on changing borrower and/or collateral conditions and actual collection and charge-off experience.

Lafayette Savings' primary market area for lending is Tippecanoe County, Indiana. When evaluating the adequacy of allowance, consideration is given to this regional geographic concentration and the closely associated effect of changing economic conditions on Lafayette Savings' customers.

## *Mortgage Servicing Rights*

Mortgage servicing rights (MSRs) associated with loans originated and sold, where servicing is retained, are capitalized and included in other intangible assets in the consolidated balance sheet. The value of the capitalized servicing rights represents the present value of the future servicing fees arising from the right to service loans in the portfolio. Critical accounting policies for MSRs relate to the initial valuation and subsequent impairment tests. The methodology used to determine the valuation of MSRs requires the development and use of a number of estimates, including anticipated principal amortization and prepayments of that principal balance. Events that may significantly affect the estimates used are changes in interest rates, mortgage loan prepayment speeds and the payment performance of the underlying loans. The carrying value of the MSRs is periodically reviewed for impairment based on a determination of fair value. For purposes of measuring impairment, the servicing rights are compared to a valuation prepared based on a discounted cash flow methodology, utilizing current prepayment speeds and discount rates. Impairment, if any, is recognized through a valuation allowance and is recorded as amortization of intangible assets.

### **Financial Condition at December 31, 2008 compared to Financial Condition at December 31, 2007.**

#### **SELECTED FINANCIAL CONDITION DATA (Dollars in thousands)**

	December 31, <u>2008</u>	December 31, <u>2007</u>	\$ <u>Difference</u>	% <u>Difference</u>
Total assets	\$373,012	\$342,010	\$31,002	9.06%
Loans receivable, including loans held for sale, net	326,639	296,908	29,731	10.01
Residential mortgage loans	144,100	137,611	6,489	4.72
Home equity lines of credit	13,610	14,018	(408)	(2.91)
Other real estate loans	155,510	127,593	27,917	21.88
Commercial business loans	14,277	19,307	(5,030)	(26.05)
Consumer loans	1,843	2,439	(596)	(24.44)
Loans sold	10,247	19,735	(9,488)	(48.08)
Nonperforming loans	7,976	9,935	(1,959)	(19.72)
Loans past due 90 days, still accruing	---	59	(59)	(100.00)
Other real estate owned	1,412	3,944	(2,532)	(64.20)
Nonperforming assets	9,388	13,938	(4,550)	(23.64)
Available-for-sale securities	11,853	13,221	(1,368)	(10.35)
Short-term investments	9,179	4,846	4,333	89.41
Deposits	258,587	232,030	26,557	11.45
Core deposits	81,907	75,939	5,968	7.86
Brokered deposits	61,001	47,766	13,235	27.71
FHLB advances	78,500	74,256	4,244	5.72
Shareholders' equity (net)	34,075	33,932	143	0.42

As shown in the chart above, the net balance in our loan portfolio increased by \$29.7 million from December 31, 2007 to December 31, 2008. Loans increased primarily due to the decision by larger banks to withdraw existing or fail to extend new credit, resulting in many

good borrowers looking for new lending relationships. The increase also can be attributed to the resilience of the local economy driven by the medical sector and Purdue University and the Purdue Research Park.

In mid-2008 we began the process necessary to allow the bank to offer FHA and VA loans which had been missing from our portfolio offerings. In the last quarter of 2008 when mortgage rates fell, we were able to offer not just FHA and VA loans but a wide array of mortgage products and compete more effectively in the local market. We sold \$19.7 million of residential loans in 2007 compared to \$10.2 in 2008, with over 40% of those in the fourth quarter. These loans were sold based on asset/liability considerations and to increase income from the gain on sale of loans. See "Asset/Liability Management."

The \$1.4 million decrease in our securities was primarily due to runoff while the \$4.3 million increase in short-term investments reflected the flow of cash needed to fund loans held for sale until remittance was received.

Deposit balances increased by \$26.6 million to fund higher loan demand. \$5.6 million was in core deposit growth and \$21.0 million was in time deposits, \$13.2 million of which were brokered funds.

We utilize advances available through the FHLB to provide additional funding for loan growth as well as for asset/liability management purposes. At December 31, 2008, we had \$78.5 million in FHLB advances outstanding. Based on the collateral we currently have listed under a blanket collateral arrangement with the FHLB, we could borrow up to \$15.0 million in additional advances. We have other collateral available if needed. These advances are generally available on the same day as requested and allow us the flexibility of keeping our daily cash levels tighter than might otherwise be prudent.

Non-performing assets, which include non-accruing loans, accruing loans 90 days past due and foreclosed assets, decreased from \$13.9 million at December 31, 2007 to \$9.4 million at December 31, 2008. Non-performing assets at December 31, 2008 consisted of \$5.4 million of loans on residential real estate, \$2.2 million on land or commercial real estate loans, \$23,000 on consumer loans and \$366,000 on commercial business loans. Foreclosed assets consisted of \$1.2 million of residential property and \$220,000 of commercial real estate. At December 31, 2008, our allowance for losses equaled 1.12% of total loans (including loans held for sale) compared to 1.23% at December 31, 2007. The allowance for loan losses at December 31, 2008 totaled 39.38% of nonperforming assets compared to 26.56% at December 31, 2007, and 46.35% of non-performing loans at December 31, 2008 compared to 37.04% at December 31, 2007. Our non-performing assets equaled 2.52% of total assets at December 31, 2008 compared to 4.08% at December 31, 2007.

When a non-performing loan is added to our classified loan list, an impairment analysis is completed to determine expected losses upon final disposition of the property. An adjustment to loan loss reserves is made at that time for any anticipated losses. This analysis is updated quarterly thereafter. Because of the large numbers of foreclosures—according to *Forbes*, Indiana reported foreclosure rates among the top ten in the nation in 2006 and in 2007 moved from second to ninth—the court systems frequently have backlogs in scheduling loan hearings. It may take up to two years to move a foreclosed property through the system to the point where we can obtain title to and dispose of it. We attempt to acquire properties through deeds-in-lieu of

foreclosure if there are no other liens on the properties. In 2007, we acquired 7 properties through deeds-in-lieu of foreclosure and an additional 24 properties through foreclosure. In 2008, we acquired 25 properties through deeds-in-lieu of foreclosure and an additional 9 properties through foreclosure. As a result, \$1.2 million was charged against loan loss reserves for these properties in 2008 to reduce the carrying value of the property to the estimated realizable value. Although we believe we use the best information available to determine the adequacy of our allowance for loan losses, future adjustments to the allowance may be necessary, and net income could be significantly affected if circumstances and/or economic conditions cause substantial changes in the estimates we use in making the determinations about the levels of the allowance for losses. Additionally, various regulatory agencies, as an integral part of their examination process, periodically review our allowance for loan losses. These agencies may require the recognition of additions to the allowance based upon their judgments of information available at the time of their examination.

Shareholders' equity increased \$143,000, or 0.42%, during 2008 primarily as a result of net income of \$1.7 million, offset by our payment of dividends on common stock and the repurchase of 8,900 shares of our stock as part of a stock repurchase program. Shareholders' equity to total assets was 9.14% at December 31, 2008 compared to 9.92% at December 31, 2007.

## **Results of Operations**

Our results of operations depend primarily on the levels of net interest income, which is the difference between the interest income earned on loans and securities and other interest-earning assets, and the interest expense on deposits and borrowed funds. Our results of operations are also dependent upon the level of our non-interest income, including fee income and service charges, gains or losses on the sale of loans and the level of our non-interest expenses, including general and administrative expenses. Net interest income is dependent upon the volume of interest-earning assets and interest-bearing liabilities and upon the interest rate which is earned or paid on these items. Our results of operations are also affected by the level of the provision for loan losses. We, like other financial institutions, are subject to interest rate risk to the degree that our interest-bearing liabilities mature or reprice at different times, or on a different basis, than our interest-earning assets.

## Average Balances, Interest Rates and Yields

The following table presents for the periods indicated the total dollar amount of interest income earned on average interest-earning assets and the resultant yields on such assets, as well as the interest expense paid on average interest-bearing liabilities, and the rates paid on such liabilities. No tax equivalent adjustments were made. All average balances are monthly average balances. Non-accruing loans have been included in the table as loans carrying a zero yield.

	Average Outstanding Balance	2008 Interest Earned/ Paid	Yield/ Rate	Average Outstanding Balance	2007 Interest Earned/ Paid	Yield/ Rate
<b>Interest-Earning Assets:</b>						
Loans receivable <sup>(1)</sup> .....	\$312,923	20,492	6.55%	\$302,947	21,894	7.23%
Mortgage-backed securities.....	4,171	213	5.11	5,274	272	5.16
Other investments.....	16,594	412	2.48	16,208	534	3.29
FHLB stock .....	<u>3,997</u>	<u>202</u>	5.05	<u>3,997</u>	<u>182</u>	4.55
Total interest-earning assets .....	337,686	21,319	6.31	328,426	22,882	6.97
Non-interest earning assets.....	<u>21,611</u>			<u>22,655</u>		
Total assets .....	<u>\$359,296</u>			<u>\$351,081</u>		
<b>Liabilities and Shareholders' Equity:</b>						
<b>Interest-Bearing Liabilities:</b>						
Savings deposits .....	\$22,135	237	1.07	\$19,304	199	1.03
Demand and NOW deposits .....	61,710	514	0.83	58,460	601	1.03
Time deposits .....	162,789	6,930	4.26	165,353	7,285	4.41
Borrowings .....	<u>76,025</u>	<u>3,605</u>	4.74	<u>70,778</u>	<u>3,570</u>	5.04
Total interest-bearing liabilities .....	322,659	11,286	3.50	313,895	11,655	3.71
Other liabilities .....	<u>3,402</u>			<u>3,292</u>		
Total liabilities .....	325,061			317,187		
Shareholders' equity .....	<u>34,235</u>			<u>33,894</u>		
Total liabilities and shareholders' equity .....	<u>\$359,296</u>			<u>\$351,081</u>		
Net interest income .....		<u>\$10,033</u>			<u>\$11,227</u>	
Net interest rate spread .....			2.82%			3.25%
Net earning assets.....	<u>\$15,027</u>			<u>\$14,531</u>		
Net yield on average interest-earning assets .....			2.97%			3.42%
Average interest-earning assets to average interest-bearing liabilities .....	<u>1.05x</u>			<u>1.05x</u>		

<sup>(1)</sup> Calculated net of deferred loan fees, loan discounts, loans in process and loss reserves.

## Rate/Volume Analysis of Net Interest Income

The following table presents the dollar amount of changes in interest income and interest expense for the major categories of interest-earning assets and interest-bearing liabilities. The change in total interest income and total interest expense is allocated between those related to changes in the outstanding balances and those due to changes in interest rates. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (i) changes in volume (*i.e.*, changes in volume multiplied by old rate) and (ii) changes in rate (*i.e.*, changes in rate multiplied by old volume). For purposes of this table, changes attributable to both rate and volume, which cannot be segregated, have been allocated proportionately to the change due to volume and change due to rate.

	Year Ended December 31,					
	2007 vs. 2008			2006 vs. 2007		
	Increase (Decrease)		Total Increase Decrease	Increase (Decrease)		Total Increase Decrease
	Due to			Due to		
Volume	Rate	(In thousands)	Volume	Rate		
Interest-earning assets:						
Loans receivable.....	\$703	\$(2,105)	\$(1,402)	\$(1,429)	\$880	\$(549)
Mortgage-backed securities.....	(56)	(3)	(59)	135	39	174
Other investments.....	12	(134)	(122)	(71)	84	13
FHLB stock.....	--	20	20	(5)	(14)	(19)
Total interest-earning assets .....	<u>\$659</u>	<u>\$(2,222)</u>	<u>\$(1,563)</u>	<u>\$(1,370)</u>	<u>\$989</u>	<u>\$(381)</u>
Interest-bearing liabilities:						
Savings deposits.....	\$30	\$8	\$38	\$5	\$30	\$35
Demand deposits and NOW accounts.....	32	(119)	(87)	23	201	224
Time deposits .....	(112)	(243)	(355)	(899)	904	5
Borrowings.....	256	(221)	35	13	236	249
Total interest-bearing liabilities .....	<u>\$206</u>	<u>\$(575)</u>	<u>\$(369)</u>	<u>\$(858)</u>	<u>\$1,371</u>	<u>\$513</u>
Net interest income.....			\$(1,194)			\$(894)

## Comparison of Operating Results for the Years Ended December 31, 2008 and December 31, 2007.

**General.** Net income for the year ended December 31, 2008 was \$1.7 million, an increase of \$166,000, or 10.55%, over net income for the year ended December 31, 2007. This increase was primarily due to an \$845,000 increase in non-interest income a \$468,000 decrease in the provision for loan losses, a \$36,000 decrease in non-interest expense and an \$11,000 decrease in income taxes, partially offset by a \$1.2 million decrease in net interest income.

Our return on average assets was 0.48% for the year ended 2008, compared to 0.45% for the year ended 2007. Return on equity was 5.08% for the year ended 2008 compared to 4.52% for 2007. During 2008 we paid regular quarterly cash dividends on common stock totaling \$1.6 million, or \$1.00 per share, for the year, representing a dividend payout ratio (dividends declared per share divided by diluted net income per share) of approximately 89.43%.

**Net Interest Income.** Net interest income for the year ended December 31, 2008 decreased \$1.2 million over the same period in 2007. Our net interest margin (net interest income divided by average interest-earnings assets) decreased from 3.42% at December 31, 2007 to 2.97% at December 31, 2008. The largest factor in the decrease was the decrease in the average rate on loans from 7.23% in 2007 to 6.55% in 2008 caused primarily by the aggressive rate cuts by the Federal Reserve. This decrease was partially offset by an increase in loan volume from an average balance of \$303 million in 2007 to an average balance of \$313 million in 2008. Similarly, interest expenses on deposits and advances decreased but to a much smaller extent. The average rate on deposits decreased from 3.33% in 2007 to 3.11% in 2008 while advances decreased from 5.04% in 2007 to 4.74% in 2008. Overall, the average rate on loans and investments decreased by 66 basis points while the average rate on investments and advances decreased by 21 basis points.

Interest income on loans decreased \$1.4 million for the year ended December 31, 2008 compared to the year ended December 31, 2007 primarily because of reduced rates. The volume of loans in our portfolio increased by \$10.0 million while the average yield decreased from 7.23% for the year ended December 31, 2007 to 6.55% for the year ended December 31, 2008.

Interest income on investments decreased \$161,000 including an increase of \$20,000 in interest income on FHLB stock for the year ended December 31, 2008 compared to the year ended December 31, 2007. The decrease in interest on investments was primarily due to lower rates particularly on short-term investments, as well as the \$1.1 million paydown of mortgage-backed securities. Average investments decreased \$717,000 from 2007 to 2008 with a decrease in the average rate earned from 3.75% in 2007 to 3.01% in 2008. The increase in interest income on FHLB stock was due to an increase in the average rate paid from 4.55% in 2007 to 5.05% in 2008.

Interest expense for the year ended December 31, 2008 decreased \$369,000 over the same period in 2007. This decrease was primarily due to a decrease in the average rate paid on interest-bearing liabilities from 3.71% in 2007 to 3.50% in 2008 reflecting the generally lower rates over the period. The decrease in interest expense was comprised of a \$404,000 decrease in the average rate on deposit accounts from 3.33% to 3.11% offset by a \$3.5 million increase in the average balance of deposit accounts. A decrease in the average rate of FHLB advances from 5.04% in 2007 to 4.74% in 2008 was almost completely offset by the increase in the average balance from \$70.8 million to \$76.0 million over the same period.

**Provision for Loan Losses.** The evaluation of the level of loan loss reserves is an ongoing process that includes closely monitoring loan delinquencies. The following chart shows delinquent loans as well as a breakdown of non-performing assets. Over \$3.0 million of the total delinquencies are related to scheduled property sales in the first quarter of 2009 and are expected to be paid off or brought current at that time.

	12/31/08	12/31/07	12/31/06
Loans delinquent 30-59 days	\$ 1,483	\$ 364	\$ 1,086
Loans delinquent 60-89 days	<u>3,187</u>	<u>1,763</u>	<u>3,961</u>
Total delinquencies	4,670	2,127	5,070
Accruing loans past due 90 days	0	59	147
Non-accruing loans	<u>7,976</u>	<u>9,935</u>	<u>7,364</u>
Total non-performing loans	7,976	9,994	7,511
OREO	<u>1,412</u>	<u>3,944</u>	<u>4,169</u>
<b>Total non-performing assets</b>	<b><u>\$9,388</u></b>	<b><u>\$13,938</u></b>	<b><u>\$11,680</u></b>

The accrual of interest income is discontinued when a loan becomes 90 days and three payments past due. Loans 90 days past due but not yet three payments past due will continue to accrue interest as long as it has been determined that the loan is well secured and the borrower has the capacity to repay. Troubled debt restructurings are considered non-accruing loans until sufficient time has passed for them to establish a pattern of compliance with the terms of the restructure. Delinquent loans, non-performing loans and other real estate owned (“OREO”) properties all showed improvement compared to the prior quarter and the prior year, reflecting the efforts of the staff and the condition of the local economy.

The decrease in non-performing loans at December 31, 2008 compared to December 31, 2007 was generally due to properties being taken into OREO, payoffs or improvements in the borrower’s situation which brought them back to performing status. We took \$2.3 million of foreclosed properties into OREO in 2008 and sold a total of \$4.6 million of OREO properties, writing off \$156,000 or 6.8% in the process.

We establish our provision for loan losses based on a systematic analysis of risk factors in the loan portfolio. The analysis includes consideration of concentrations of

credit, past loss experience, current economic conditions, the amount and composition of the loan portfolio, estimated fair value of the underlying collateral, delinquencies and other relevant factors. From time to time, we also use the services of a consultant to assist in the evaluation of our growing commercial real estate loan portfolio. On at least a quarterly basis, a formal analysis of the adequacy of the allowance is prepared and reviewed by management and the Board of Directors. This analysis serves as a point-in-time assessment of the level of the allowance and serves as a basis for provisions for loan losses.

More specifically, our analysis of the loan portfolio will begin at the time the loan is originated, at which time each loan is assigned a risk rating. If the loan is a commercial credit, the borrower will also be assigned a similar rating. Loans that continue to perform as agreed will be included in one of ten non-classified loan categories. Portions of the allowance are allocated to loan portfolios in the various risk grades, based upon a variety of factors, including historical loss experience, trends in the type and volume of the loan portfolios, trends in delinquent and non-performing loans, and economic trends affecting our market. Loans no longer performing as agreed are assigned a higher risk rating, eventually resulting in their being regarded as classified loans. A collateral re-evaluation is completed on all classified loans. This process results in the allocation of specific amounts of the allowance to individual problem loans, generally based on an analysis of the collateral securing those loans. These components are added together and compared to the balance of our allowance at the evaluation date.

We recorded a \$1.1 million provision for loan losses during 2008 as a result of our analyses of our current loan portfolios, compared to \$1.6 million during 2007. The provisions were necessary to maintain the allowance for loan losses at a level considered adequate to absorb losses inherent and incurred in the loan portfolio. During the year 2008, we charged \$1.2 million against loan loss reserves on 47 loans either written off or taken into other real estate owned in 2008. We expect to obtain possession of more properties in 2009 that are currently in the process of foreclosure. The final disposition of these properties may be expected to result in a loss in some cases. The \$1.1 million provision for loan losses in 2008 was considered adequate to cover further charge-offs based on our evaluation and our loan mix.

At December 31, 2008, non-performing assets, consisting of non-performing loans, accruing loans 90 days or more delinquent and other real estate owned, totaled \$9.4 million compared to \$13.9 million at December 31, 2007. In addition to our non-performing assets, we identified \$5.2 million in other loans of concern where information about possible credit problems of borrowers causes management to have doubts as to the ability of the borrowers to comply with present repayment terms and that may result in disclosure of such loans as non-performing assets in the future. The vast majority of these loans, as well as our non-performing assets, are well collateralized.

At December 31, 2008, we believe that our allowance for loan losses was adequate to absorb estimated incurred losses inherent in our loan portfolio. Our allowance for losses equaled 1.12% of net loans receivable and 46.35% of non-

performing loans at December 31, 2008, compared to 1.23% and 37.04% at December 31, 2007, respectively. Our nonperforming assets equaled 2.52% of total assets at December 31, 2008 compared to 4.08% at December 31, 2007.

***Non-Interest Income.*** Non-interest income for the year ended December 31, 2008 increased by \$845,000, or 41.30%, compared to the same period in 2007. The increase was primarily due to a \$941,000 decrease in the loss recognized on the sale of OREO properties or adjustments to the values of properties still held to reflect updated appraisal values. There was also a \$96,000 increase in other non-interest income primarily due to a \$60,000 increase in loan fees due to higher fees for loan closings and an increase in loan modification fees and a \$28,000 increase in fees from our new in-house wealth management department. These increases were partially offset by a \$102,000 decrease in service charges and fees on deposit accounts and by an \$84,000 decrease in the gain on sale of loans due to the decrease in the volume of loans sold from \$19.7 million in 2007 to \$10.2 million in 2008.

***Non-Interest Expense.*** Non-interest expense for the year ended December 31, 2008 decreased \$36,000 over the same period in 2007. The decrease was primarily due to a \$236,000 decrease in other expenses largely due to a \$132,000 improvement in the costs of disposing of impaired loans and a \$70,000 decrease in loan expenses due to the end of a loan promotion in 2007 that waived closing costs, offset by a \$97,000 increase in salaries due to costs of staffing the new loan credit department and increased health insurance costs, a \$56,000 increase in computer expenses due partly to program enhancements and a \$52,000 increase in occupancy costs due primarily to periodic maintenance costs.

***Income Tax Expense.*** Our income tax provision decreased by \$11,000 for the year ended December 31, 2008 compared to the year ended December 31, 2007 primarily due to decreases in effective state income tax expense as well as increases in income not subject to tax.

## **Asset/Liability Management**

We, like other financial institutions, are subject to interest rate risk to the extent that our interest-bearing liabilities reprice on a different basis than our interest-earning assets. The Office of Thrift Supervision (“OTS”), our primary regulator, supports the use of a net portfolio value (“NPV”) approach to the quantification of interest rate risk. In essence, this approach calculates the difference between the present value of expected cash flows from assets and the present value of expected cash flows from liabilities, as well as cash flows from off-balance-sheet contracts. An NPV ratio in any interest rate scenario, is defined as the NPV in that rate scenario divided by the market value of assets in the same scenario—essentially a market value adjusted capital ratio.

It has been and continues to be a priority of the Board of Directors and management to manage interest rate risk to maintain an acceptable level of potential changes to interest income as a result of interest rate changes. Our asset/liability policy,

established by the Board of Directors, sets forth acceptable limits on the amount of change in net portfolio value given certain changes in interest rates. We have an asset/liability management committee which meets quarterly to review our interest rate position, and an investment committee which reviews the interest rate risk position and other related matters with the Board of Directors, and makes recommendations for adjusting this position to the full Board of Directors. In addition, the investment committee of the Board of Directors meets semi-annually with our outside investment advisors to review our investment portfolio and strategies relating to interest rate risk. Specific strategies have included the sale of long-term, fixed rate loans to reduce the average maturity of our interest-earning assets and the use of FHLB advances to lengthen the effective maturity of our interest-bearing liabilities. In the future, our community banking emphasis, including the origination of commercial business loans, is intended to further increase our portfolio of short-term and/or adjustable rate loans.

Presented below, as of December 31, 2008 and 2007, is an analysis of our interest rate risk as measured by the effect on NPV caused by instantaneous and sustained parallel shifts in the yield curve, in 100 basis point increments, up 300 basis points and down 200 basis points, and compared to our Board policy limits. (One hundred basis points equals one percent.) The Board Limit column indicates the lowest allowable limits for NPV after each interest rate shock. Assumptions used in calculating the amounts in this table are OTS assumptions. No information is provided for a negative 200 basis point shift in interest rates, due to a low prevailing interest rate environment making such scenarios unlikely.

Change in Interest Rate (Basis Points)	Board Limit Post-shock NPV Ratio	At December 31, 2008		At December 31, 2007	
		Post-shock NPV Ratio	Change (Basis Points)	Post-shock NPV Ratio	Change (Basis Points)
300 bp	6.00%	9.27%	(113)	10.59%	(128)
200	7.00	9.81	(59)	11.21	(65)
100	8.00	10.18	(22)	11.62	(24)
0	8.00	10.40	---	11.86	---
-100	8.00	10.40	---	11.97	11
-200	7.00			12.04	18

In evaluating our exposure to interest rate risk, certain shortcomings inherent in the method of analysis presented in the foregoing table must be noted. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Further, in the event of a change in interest rates, prepayments and early withdrawal levels may deviate significantly from those assumed in calculating the table. Finally, the ability of many borrowers to service their debt may decrease in the event of an interest rate increase. As a result, the actual effect of changing interest rates may differ from that presented in the foregoing table.

## **Liquidity and Capital Resources**

Our primary sources of funds are deposits, repayment and prepayment of loans, interest earned on or maturation of investment securities and short-term investments, borrowings and funds provided from operations. While maturities and the scheduled amortization of loans, investments and mortgage-backed securities are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by general market interest rates, economic conditions and competition.

We monitor our cash flow carefully and strive to minimize the level of cash held in low-rate overnight accounts or in cash on hand. We also carefully track the scheduled delivery of loans committed for sale to be added to our cash flow calculations.

Our primary investing activities are the origination of loans and the purchase of securities. During the year ended December 31, 2008, the Bank originated loans totaling \$114.0 million and purchased no securities. These activities were funded primarily by principal repayments and prepayments on loans and maturities of investment securities totaling \$74.3 million. The proceeds from the sale of loans totaled \$10.2 million for the year ended December 31, 2008. There were no security sales in 2007 or 2008.

Because there was an increase in the balance of loans in our portfolio in 2008, increases in our deposits, primarily time deposits were also used to fund loans. We also currently use, and intend to continue to use, FHLB advances as a source of funding for loans when advantages on interest rate risk matches can be found.

Liquidity management is both a daily and long-term function for our senior management. We adjust our investment strategy, within the limits established by the investment policy, based upon assessments of expected loan demand, expected cash flows, FHLB advance opportunities, market yields and the objectives of our asset/liability management program. Base levels of liquidity have generally been invested in interest-earning overnight and time deposits with the Federal Home Loan Bank of Indianapolis. Funds for which a demand is not foreseen in the near future are invested in investment and other securities for the purpose of yield enhancement and asset/liability management.

Our current internal policy for liquidity is 4%. Our liquidity ratio at December 31, 2008 was 5.07% as a percentage of total assets.

We anticipate that we will have sufficient funds available to meet current loan commitments. At December 31, 2008 we had outstanding commitments to originate loans and available lines of credit totaling \$41.3 million and commitments to provide borrowers the funds needed to complete current construction projects in the amount of \$4.2 million. Certificates of deposit that will mature in one year or less at December 31, 2008 totaled \$128.0 million. Based on our experience, our certificates of deposit have been a relatively stable source of long-term funds as such certificates are generally renewed upon maturity since we have established long-term banking relationships with

our customers. Therefore, we believe a significant portion of such deposits will remain with us, although that cannot be assured. An exception to this rule would be the brokered certificates of deposit. Of the certificates maturing in one year or less at December 31, 2008, \$39.8 million were brokered deposits which will be leaving the bank at maturity. However, there is no reason to expect that replacement funds would not be available in the brokered market.

LSB Financial also has a need for, and sources of, liquidity. Liquidity is required to fund our operating expenses and fund stock repurchase programs, as well as for the payment of dividends to shareholders. At December 31, 2008, LSB Financial had \$10,000 in liquid assets on hand. The primary source of liquidity on an ongoing basis is dividends from Lafayette Savings. Dividends totaling \$1.6 million were paid from the Bank to LSB Financial during the year ended December 31, 2008. For the year ended December 31, 2008, LSB Financial paid dividends to shareholders totaling \$1.6 million.

Regulatory agencies have established capital adequacy standards which are used in their monitoring and control of the industry. These standards relate capital to levels of risk by assigning different weightings to assets and certain off-balance-sheet activity. As shown in Note 11 to the Consolidated Financial Statements (“Regulatory Matters”), our capital levels exceed the requirements to be considered well capitalized at December 31, 2008.

#### **Off-Balance-Sheet Arrangements**

As of the date of this Annual Report, we do not have any off-balance-sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, change in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors. The term “off-balance-sheet arrangement” generally means any transaction, agreement, or other contractual arrangement to which any entity unconsolidated with the Company is a party and under which the Company has (i) any obligation arising under a guarantee contract, derivative instrument or variable interest or (ii) a retained or contingent interest in assets transferred to such entity or similar arrangement that serves as credit, liquidity or market risk support for such assets.

See Note 16 to the Consolidated Financial Statements regarding off-balance-sheet commitments.

## **Future Accounting Matters**

Statement of Financial Accounting Standards No. 141 (Revised 2007), Business Combinations (“SFAS 141(R)”). During December 2007, the FASB issued SFAS 141(R). This Statement replaces SFAS 141 “Business Combinations” (“Statement 141”). SFAS 141(R) retains the fundamental requirements in Statement 141 that the acquisition method of accounting (called the ‘purchase method’) be used for all business combinations and for an acquirer to be identified for each business combination. This Statement defines the acquirer as the entity that obtains control of one or more businesses, including those sometimes referred to as “true mergers” or “mergers of equals” and combinations achieved without the transfer of consideration, for example, by contract alone or through the lapse of minority veto rights. This is broader than in Statement 141 which applied only to business combinations in which control was obtained by transferring consideration. This Statement requires an acquirer to recognize the assets acquired, liabilities assumed and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date. SFAS 141(R) recognizes and measures the goodwill acquired in the business combination and defines a bargain purchase as a business combination in which the total acquisition-date fair value of the identifiable net assets acquired exceeds the fair value of the consideration transferred plus any noncontrolling interest in the acquiree, and it requires the acquirer to recognize that excess as a gain attributable to the acquirer. In contrast, Statement 141 required the “negative goodwill” amount to be allocated as a pro rata reduction of the amounts assigned to assets acquired. SFAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after December 15, 2008. An entity may not apply it before that date.

Statement of Financial Accounting Standards No. 158, Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans (“SFAS 158”). In September 2006, the FASB issued SFAS 158. Except for the measurement requirement, the Corporation adopted this accounting guidance as of December 31, 2006. Additional information regarding the adoption of SFAS 158 is included in Note 1 to the Consolidated Financial Statements (“Summary of Significant Accounting Policies”). The requirement to measure plan assets and benefit obligations as of the end of an employer’s fiscal year is effective for years ending after December 15, 2008 (December 31, 2008 for the Corporation). Adoption of this guidance did not have a material effect on the Corporation’s financial condition or results of operations.

Statement of Financial Accounting Standards No. 160, Noncontrolling Interests in Consolidated Financial Statements — an amendment of ARB No. 51 (“SFAS 160”). During December 2007, the FASB issued SFAS 160 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statement, but separate from the parent’s equity. Before the Statement was issued these so-called minority interests were reported in the consolidated

statement of financial position as liabilities or in the mezzanine section between liabilities and equity. The amount of consolidated net income attributable to the parent and to the noncontrolling interest must be clearly identified and presented in the consolidated statement of income. This Statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. Management does not anticipate that this Statement will have a material impact on the Corporation's consolidated financial condition or results of operations.

Statement of Financial Accounting Standards No. 161, Disclosures about Derivative Instruments and Hedging Activities — an amendment of FASB Statement No. 133 (“SFAS 161”). During March 2008, the FASB issued SFAS 161. SFAS 161 amends and expands the disclosure requirement of SFAS 133 No. 133 “Accounting for Derivative Instruments and Hedging Activities” (“SFAS 133”) with the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments; (b) how derivative instrument and related hedged items are accounted for under SFAS 133 and its related interpretations; and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. To meet those objectives, SFAS 161 requires qualitative disclosures about objectives and strategies for using derivative, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Early application is encouraged.

Statement of Financial Accounting Standards, The Hierarchy of Generally Accepted Accounting Principles (“SFAS 162”). During May 2008, the FASB issued SFAS 162. This Statement identifies the sources of account principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States. This Statement is effective 60 days following the SEC approval of the Public Company Accounting Oversight Board amendments to AU Section 411, “The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.” Adoption of SFAS 162 will not be a change in the Corporation's current accounting practices; therefore, it will not have a material impact on the Corporation's consolidated financial condition or results of operations.

FASB Staff Position EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities (“FSP EITF 03-6-1”).

During June 2008, the FASB issued FSP EITF 03-6-1. FSP EITF 03-6-1 clarifies whether instruments, such as restricted stock, granted in share-based payments are participating securities prior to vesting. Such participating securities must be included in the computation of earnings per share under the two-class method as described in SFAS No. 128, “Earnings per Share.” FSP EITF 03-6-1 requires companies to treat unvested share-based payment awards that have non-forfeitable rights to dividend or

dividend equivalents as a separate class of securities in calculating earnings per share. FSP EITF 03-6-1 is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008, and requires a company to retrospectively adjust its earnings per share data. Early adoption is not permitted. It is not expected that the adoption of FSP EITF 03-6-1 will have a material effect on consolidated results of operations or earnings per share.

## Impact of Inflation and Changing Prices

The Consolidated Financial Statements presented herein have been prepared in accordance with generally accepted accounting principles. These principles require the measurement of financial position and operating results in terms of historical dollars, without considering changes in the relative purchasing power of money over time due to inflation.

The Company's primary assets and liabilities are monetary in nature. As a result, interest rates have a more significant impact on our performance than the effects of general levels of inflation. Interest rates, however, do not necessarily move in the same direction or with the same magnitude as the price of goods and services, since such prices are affected by inflation. In a period of rapidly rising interest rates, the liquidity and maturities structures of our assets and liabilities are critical to the maintenance of acceptable performance levels.

The principal effect of inflation, as distinct from levels of interest rates, on earnings is in the area of noninterest expense. Such expense items as employee compensation, employee benefits and occupancy and equipment costs may be subject to increases as a result of inflation. An additional effect of inflation is the possible increase in the dollar value of the collateral securing loans that the Company has made. The Company is unable to determine the extent, if any, to which properties securing our loans have appreciated in dollar value due to inflation.

## Quarterly Results of Operations

Quarter Ending	Interest Income	Interest Expense	Net Interest Income	Provision For Loan Losses	Net Income	Basic Earnings Per Share	Diluted Earnings Per Share
2008							
March	\$ 5,421	\$ 2,878	\$ 2,543	\$ 250	\$ 515	\$ 0.33	\$ 0.33
June	5,374	2,774	2,600	250	521	0.34	0.33
September	5,295	2,855	2,440	352	392	0.25	0.25
December	<u>5,229</u>	<u>2,779</u>	<u>2,450</u>	<u>250</u>	<u>312</u>	<u>0.20</u>	<u>0.20</u>
	<u>\$ 21,319</u>	<u>\$ 11,286</u>	<u>\$ 10,033</u>	<u>\$ 1,102</u>	<u>\$ 1,740</u>		
2007							
March	\$ 5,869	\$ 2,903	\$ 2,966	\$ 250	\$ 779	\$ 0.49	\$ 0.48
June	5,728	2,854	2,874	490	451	0.28	0.28
September	5,769	2,929	2,840	180	717	0.46	0.46
December	<u>5,516</u>	<u>2,969</u>	<u>2,547</u>	<u>650</u>	<u>(373)</u>	<u>(0.24)</u>	<u>(0.24)</u>
	<u>\$ 22,882</u>	<u>\$ 11,655</u>	<u>\$ 11,227</u>	<u>\$ 1,570</u>	<u>\$ 1,574</u>		

## DISCLOSURE REGARDING FORWARD-LOOKING STATEMENTS

This document, including information included or incorporated by reference, contains, and future filings by LSB Financial on Form 10-K, Form 10-Q and Form 8-K and future oral and written statements by LSB Financial and our management may contain, forward-looking statements about LSB Financial and its subsidiaries which we believe are within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, without limitation, statements with respect to anticipated future operating and financial performance, growth opportunities, interest rates, cost savings and funding advantages expected or anticipated to be realized by management. Words such as may, could, should, would, believe, anticipate, estimate, expect, intend, plan and similar expressions are intended to identify forward-looking statements. Forward-looking statements by LSB Financial and its management are based on beliefs, plans, objectives, goals, expectations, anticipations, estimates and intentions of management and are not guarantees of future performance. We disclaim any obligation to update or revise any forward-looking statements based on the occurrence of future events, the receipt of new information or otherwise. The important factors we discuss below and elsewhere in this document, as well as other factors discussed under the caption “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in this document and identified in our filings with the SEC and those presented elsewhere by our management from time to time, could cause actual results to differ materially from those indicated by the forward-looking statements made in this document.

The following factors, many of which are subject to change based on various other factors beyond our control, could cause our financial performance to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements:

- the strength of the United States economy in general and the strength of the local economies in which we conduct our operations;
- the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Federal Reserve Board;
- financial market, monetary and interest rate fluctuations, particularly the relative relationship of short-term interest rates to long-term interest rates;
- the timely development of and acceptance of new products and services of Lafayette Savings and the perceived overall value of these products and services by users, including the features, pricing and quality compared to competitors’ products and services;
- the willingness of users to substitute competitors’ products and services for our products and services;
- the impact of changes in financial services laws and regulations (including laws concerning taxes, accounting standards, banking, securities and insurance);
- the impact of technological changes;
- acquisitions;
- changes in consumer spending and saving habits; and
- our success at managing the risks involved in the foregoing.

# **LSB Financial Corp.**

Accountants' Report and Consolidated Financial Statements

December 31, 2008 and 2007

**LSB Financial Corp.**  
**December 31, 2008 and 2007**

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## **Report of Independent Registered Public Accounting Firm**

Audit Committee, Board of Directors and Stockholders  
LSB Financial Corp.  
Lafayette, Indiana

We have audited the accompanying consolidated balance sheets of LSB Financial Corp. as of December 31, 2008 and 2007, and the related consolidated statements of income, stockholders' equity and cash flows for the years then ended. The Company's management is responsible for these financial statements. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing auditing procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. Our audits also included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management and 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 LSB Financial Corp. as of December 31, 2008 and 2007, 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.

As discussed in Note 15, the Company changed its method of accounting for fair value measurements in accordance with Statement of Financial Accounting Standards No. 157 in 2008.

**BKD, LLP**

Indianapolis, Indiana  
March 16, 2009

**LSB Financial Corp.**  
**Consolidated Balance Sheets**  
**December 31, 2008 and 2007**  
(Dollars in Thousands, Except Per Share Data)

**Assets**

	<b>2008</b>	<b>2007</b>
Cash and due from banks	\$ 2,046	\$ 1,644
Short-term investments	<u>9,179</u>	<u>4,846</u>
Cash and cash equivalents	11,225	6,490
Available-for-sale securities	11,853	13,221
Loans held for sale	1,342	—
Loans, net of allowance for loan losses of \$3,697 and \$3,702	325,297	296,908
Premises and equipment, net	6,461	6,815
Federal Home Loan Bank stock	3,997	3,997
Interest receivable and other assets	6,996	8,966
Bank-owned life insurance	<u>5,841</u>	<u>5,613</u>
Total assets	<u>\$ 373,012</u>	<u>\$ 342,010</u>

**Liabilities and Stockholders' Equity**

**Liabilities**

Deposits	\$ 258,587	\$ 232,030
Federal Home Loan Bank advances	78,500	74,256
Interest payable and other liabilities	<u>1,850</u>	<u>1,792</u>
Total liabilities	<u>338,937</u>	<u>308,078</u>

**Commitments and Contingencies**

**Stockholders' Equity**

Common stock, \$.01 par value; authorized 7,000,000 shares; issued and outstanding 2008 - 1,553,525 shares, 2007 - 1,557,968 shares	15	15
Additional paid-in capital	10,983	11,066
Retained earnings	22,961	22,777
Accumulated other comprehensive income	<u>116</u>	<u>74</u>
Total stockholders' equity	<u>34,075</u>	<u>33,932</u>
Total liabilities and stockholders' equity	<u>\$ 373,012</u>	<u>\$ 342,010</u>

**LSB Financial Corp.**  
**Consolidated Statements of Income**  
**Years Ended December 31, 2008 and 2007**  
(Dollars in Thousands, Except Per Share Data)

	<u>2008</u>	<u>2007</u>
<b>Interest and Dividend Income</b>		
Loans	\$ 20,492	\$ 21,894
Securities		
Taxable	463	550
Tax-exempt	273	264
Other	<u>91</u>	<u>174</u>
Total interest and dividend income	<u>21,319</u>	<u>22,882</u>
<b>Interest Expense</b>		
Deposits	7,681	8,085
Borrowings	<u>3,605</u>	<u>3,570</u>
Total interest expense	<u>11,286</u>	<u>11,655</u>
<b>Net Interest Income</b>	10,033	11,227
<b>Provision for Loan Losses</b>	<u>1,102</u>	<u>1,570</u>
<b>Net Interest Income After Provision for Loan Losses</b>	<u>8,931</u>	<u>9,657</u>
<b>Noninterest Income</b>		
Deposit account service charges and fees	1,736	1,838
Net gains on loan sales	117	201
Net realized gains on calls of available-for-sale securities	—	6
Net loss on other real estate owned	(156)	(1,097)
Other	<u>1,194</u>	<u>1,098</u>
Total noninterest income	<u>2,891</u>	<u>2,046</u>
<b>Noninterest Expense</b>		
Salaries and employee benefits	4,585	4,488
Net occupancy and equipment expense	1,382	1,330
Computer service	549	493
Advertising	294	299
Other	<u>2,476</u>	<u>2,712</u>
Total noninterest expense	<u>9,286</u>	<u>9,322</u>
<b>Income Before Income Tax</b>	2,536	2,381
<b>Provision for Income Taxes</b>	<u>796</u>	<u>807</u>
<b>Net Income</b>	<u>\$ 1,740</u>	<u>\$ 1,574</u>
<b>Basic Earnings Per Share</b>	<u>\$ 1.12</u>	<u>\$ 1.00</u>
<b>Diluted Earnings Per Share</b>	<u>\$ 1.12</u>	<u>\$ 0.99</u>

See Notes to Consolidated Financial Statements

**LSB Financial Corp.**  
**Consolidated Statements of Stockholders' Equity**  
**Years Ended December 31, 2008 and 2007**  
(Dollars in Thousands, Except Per Share Data)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
<b>Balance, January 1, 2007</b>	\$ 15	\$ 12,227	\$ 22,623	\$ (25)	\$ 34,840
Comprehensive income					
Net income			1,574		1,574
Change in unrealized appreciation on available-for-sale securities, net of reclassifications and taxes				99	99
Total comprehensive income					1,673
Dividends on common stock, \$.90 per share			(1,420)		(1,420)
Purchase and retirement of stock (47,500 shares)		(1,212)			(1,212)
Stock options exercised (2,259 shares)		34			34
Tax benefit related to stock options exercised		3			3
Amortization of stock option compensation		14			14
<b>Balance, December 31, 2007</b>	15	11,066	22,777	74	33,932
Comprehensive income					
Net income			1,740		1,740
Change in unrealized appreciation on available-for-sale securities, net of taxes				42	42
Total comprehensive income					1,782
Dividends on common stock, \$1.00 per share			(1,556)		(1,556)
Purchase and retirement of stock (8,900 shares)		(165)			(165)
Stock options exercised (4,457 shares)		68			68
Tax benefit related to stock options exercised		6			6
Amortization of stock option compensation		8			8
<b>Balance, December 31, 2008</b>	<u>\$ 15</u>	<u>\$ 10,983</u>	<u>\$ 22,961</u>	<u>\$ 116</u>	<u>\$ 34,075</u>

See Notes to Consolidated Financial Statements

**LSB Financial Corp.**  
**Consolidated Statements of Cash Flows**  
**Years Ended December 31, 2008 and 2007**  
(Dollars in Thousands, Except Per Share Data)

	<b>2008</b>	<b>2007</b>
<b>Operating Activities</b>		
Net income	\$ 1,740	\$ 1,574
Items not requiring (providing) cash		
Depreciation	561	522
Provision for loan losses	1,102	1,570
Amortization of premiums and discounts on securities	21	18
Deferred income taxes	12	(328)
Gain on called available-for-sale securities	—	(6)
Loss on other real estate owned	156	1,097
Gain on sale of loans	(117)	(201)
Loans originated for sale	(11,488)	(18,558)
Proceeds on loans sold	10,247	19,735
Compensation cost of stock options	8	14
Tax benefit related to stock options exercised	(6)	(3)
Changes in		
Interest receivable and other assets	(789)	(141)
Interest payable and other liabilities	58	154
Net cash provided by operating activities	1,505	5,447
<b>Investing Activities</b>		
Purchases of available-for-sale securities	—	(2,357)
Proceeds from maturities of available-for-sale securities	1,417	5,606
Net change in loans	(31,779)	14,887
Proceeds from sale of real estate owned	4,645	2,148
Purchase of premises and equipment	(207)	(737)
Net cash provided by (used in) investing activities	(25,924)	19,547
<b>Financing Activities</b>		
Net change in demand deposits, money market, NOW and savings accounts	5,602	663
Net change in certificates of deposit	20,955	(23,937)
Proceeds from Federal Home Loan Bank advances	40,000	60,000
Repayment of Federal Home Loan Bank advances	(35,756)	(62,362)
Proceeds from stock options exercised	68	34
Tax benefit related to stock options exercised	6	3
Repurchase of stock	(165)	(1,212)
Dividends paid	(1,556)	(1,420)
Net cash provided by (used in) financing activities	29,154	(28,231)
<b>Increase (Decrease) in Cash and Cash Equivalents</b>	4,735	(3,237)
<b>Cash and Cash Equivalents, Beginning of Year</b>	6,490	9,727
<b>Cash and Cash Equivalents, End of Year</b>	\$ 11,225	\$ 6,490
<b>Supplemental Cash Flows Information</b>		
Interest paid	\$ 11,390	\$ 11,726
Income taxes paid	387	1,647
<b>Supplemental Non-Cash Disclosures</b>		
Capitalization of mortgage servicing rights	\$ 16	\$ 16
Loans transferred to other real estate	2,288	3,334

See Notes to Consolidated Financial Statements

**LSB Financial Corp.**  
**Notes to Consolidated Financial Statements**  
**December 31, 2008 and 2007**  
(Dollars in Thousands, Except Per Share Data)

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

***Nature of Operations***

LSB Financial Corp. ("Company") is a thrift holding company whose principal activity is the ownership and management of its wholly owned subsidiary, Lafayette Savings Bank (the "Bank"). The Bank is primarily engaged in providing a full range of banking and financial services to individual and corporate customers in Tippecanoe and surrounding counties in Indiana. The Bank is subject to competition from other financial institutions. The Bank is subject to the regulation of certain federal and state agencies and undergoes periodic examinations by those regulatory authorities.

The Bank's wholly owned subsidiaries, LSB Service Corporation (LSBSC) and Lafayette Insurance and Investments, Inc. (LI&I) provide various financial services to its customers. A substantial portion of the loan portfolio is secured by single and multi-family residential mortgages.

***Principles of Consolidation***

The consolidated financial statements include the accounts of the Company, the Bank, LSBSC and LI&I. All significant intercompany accounts and transactions have been eliminated in consolidation.

***Use of Estimates***

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.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, fair value of servicing rights and financial instruments. In connection with the determination of the allowance for loan losses, management obtains independent appraisals for significant properties.

***Cash Equivalents***

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

# **LSB Financial Corp.**

## **Notes to Consolidated Financial Statements**

**December 31, 2008 and 2007**

(Dollars in Thousands, Except Per Share Data)

### ***Securities***

Available-for-sale securities, which include any security for which the Company has no immediate plan to sell but which may be sold in the future, are carried at fair value. Unrealized gains and losses are recorded, net of related income tax effects, in other comprehensive income.

Amortization of premiums and accretion of discounts are recorded 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.

### ***Loans Held for Sale***

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or fair value in the aggregate. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income.

### ***Loans***

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoffs are reported at their outstanding principal balances adjusted for any charge-offs, the allowance for loan losses, any deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans. Interest income is reported on the interest method and includes amortization of net deferred loan fees and costs over the loan term. Generally, loans are placed on non-accrual status at ninety days past due and interest is considered a loss, unless the loan is well-secured. Accrued interest for loans placed on non-accrual status is reversed against interest income.

### ***Allowance for Loan Losses***

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to income. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

**LSB Financial Corp.**  
**Notes to Consolidated Financial Statements**  
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A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogenous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment measurements.

***Premises and Equipment***

Depreciable assets are stated at cost less accumulated depreciation. Depreciation is charged to expense using the straight-line and accelerated methods over the estimated useful lives of the assets ranging from 3 to 39 years.

***Federal Home Loan Bank Stock***

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

***Foreclosed Assets Held for Sale***

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in net income or expense from foreclosed assets.

**LSB Financial Corp.**  
**Notes to Consolidated Financial Statements**  
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***Servicing Rights***

Servicing rights on originated loans that have been sold are initially recorded at fair value. Capitalized servicing rights are amortized in proportion to and over the period of estimated servicing revenues. Impairment of mortgage servicing rights is assessed based on the fair value of those rights. Fair values are estimated using discounted cash flows based on a current market interest rate. For purposes of measuring impairment, the rights are stratified based on the predominant risk characteristics of the underlying loans. The predominant characteristic currently used for stratification is type of loan. The amount of impairment recognized is the amount by which the capitalized mortgage servicing rights for a stratum exceed their fair value and is recorded through a valuation allowance.

***Stock Options***

At December 31, 2006, the Company has a stock-based employee compensation plan, which is described more fully in Note 13. Effective January 1, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment*.

***Income Taxes***

Deferred tax assets and liabilities are recognized for the tax effects of differences between the financial statement and tax bases of assets and liabilities. A valuation allowance is established to reduce deferred tax assets if it is more likely than not that a deferred tax asset will not be realized. The Company files consolidated income tax returns with its subsidiary.

***Earnings Per Share***

Earnings per share have been computed based upon the weighted-average common shares outstanding during each year.

***Operating Segments***

While the chief decision-makers monitor the revenue streams of the various products and services, the identifiable segments are not material and operations are managed and financial performance is evaluated on a Company-wide basis. Accordingly, all of the financial service operations are considered by management to be aggregated in one reportable operating segment.

***Adoption of Accounting Standards***

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting standards and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The adoption of SFAS No. 157 was not significant to our financial condition or results of operations.

**LSB Financial Corp.**  
**Notes to Consolidated Financial Statements**  
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**Current Economic Conditions**

The current economic environment presents financial institutions with unprecedented circumstances and challenges which in some cases have resulted in large declines in the fair values of investments and other assets, constraints on liquidity and significant credit quality problems, including severe volatility in the valuation of real estate and other collateral supporting loans. The financial statements have been prepared using values and information currently available to the Company.

Given the volatility of current economic conditions, the values of assets and liabilities recorded in the financial statements could change rapidly, resulting in material future adjustments in asset values, the allowance for loan losses and capital that could negatively impact the Company's ability to meet regulatory capital requirements and maintain sufficient liquidity.

**Note 2: Restriction on Cash and Due From Banks**

The Bank is required to maintain reserve funds in cash and/or on deposit with the Federal Reserve Bank. The reserve required at December 31, 2008 was \$1,085.

**Note 3: Securities**

The amortized cost and approximate fair values of securities are as follows:

	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Approximate Fair Value</b>
<b>Available-for-sale Securities:</b>				
December 31, 2008				
U.S. Government sponsored agencies	\$ 500	\$ 9	\$ —	\$ 509
Mortgage-backed securities	3,661	61	(17)	3,705
State and political subdivision	<u>7,498</u>	<u>151</u>	<u>(10)</u>	<u>7,639</u>
	<u>\$ 11,659</u>	<u>\$ 221</u>	<u>\$ (27)</u>	<u>\$ 11,853</u>
December 31, 2007				
U.S. Government sponsored agencies	\$ 500	\$ 3	\$ —	\$ 503
Mortgage-backed securities	4,782	78	(2)	4,858
State and political subdivision	<u>7,815</u>	<u>55</u>	<u>(10)</u>	<u>7,860</u>
	<u>\$ 13,097</u>	<u>\$ 136</u>	<u>\$ (12)</u>	<u>\$ 13,221</u>

**LSB Financial Corp.**  
**Notes to Consolidated Financial Statements**  
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The amortized cost and fair value of available-for-sale securities at December 31, 2008, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Fair Value
Within one year	\$ 810	\$ 812
One to five years	3,228	3,301
Five to ten years	3,465	3,517
After ten years	495	518
	7,998	8,148
Mortgage-backed securities	3,661	3,705
Totals	\$ 11,659	\$ 11,853

Certain investments in debt securities are reported in the financial statements at an amount less than their historical cost. Total fair value of these investments at December 31, 2008 and 2007 was \$2,162 and \$2,025, which is approximately 18% and 15% of the Company's available-for-sale investment portfolio.

Based on evaluation of available evidence, including recent changes in market interest rates, credit rating information and information obtained from regulatory filings, management believes the declines in fair value for these securities are temporary.

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 December 31, 2008:

Description of Securities	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities	\$ 1,757	\$ 16	\$ 59	\$ 1	\$ 1,816	\$ 17
State and political subdivisions	346	10	—	—	346	10
Total temporarily impaired securities	\$ 2,103	\$ 26	\$ 59	\$ 1	\$ 2,162	\$ 27

**LSB Financial Corp.**  
**Notes to Consolidated Financial Statements**  
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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 December 31, 2007:

Description of Securities	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities	\$ 59	\$ —	\$ 289	\$ 2	\$ 348	\$ 2
State and political subdivisions	—	—	1,677	10	1,677	10
Total temporarily impaired securities	\$ 59	\$ —	\$ 1,966	\$ 12	\$ 2,025	\$ 12

**Note 4: Loans and Allowance for Loan Losses**

Categories of loans at December 31, include:

	2008	2007
Real Estate		
One-to-four family residential	\$ 144,100	\$ 137,611
Multi-family residential	39,892	29,764
Commercial real estate	90,606	71,601
Construction and land development	29,192	27,808
Commercial	14,277	19,307
Consumer and other	1,843	2,439
Home equity lines of credit	13,611	14,018
Total loans	333,521	302,548
Less		
Net deferred loan fees, premiums and discounts	(346)	(357)
Undisbursed portion of loans	(4,180)	(1,581)
Allowance for loan losses	(3,697)	(3,702)
Net loans	\$ 325,297	\$ 296,908

Activity in the allowance for loan losses was as follows:

	2008	2007
Balance, beginning of year	\$ 3,702	\$ 2,770
Provision charged to expense	1,102	1,570
Losses charged off, net of recoveries of \$77 for 2008 and \$38 for 2007	(1,107)	(638)
Balance, end of year	\$ 3,697	\$ 3,702

**LSB Financial Corp.**  
**Notes to Consolidated Financial Statements**  
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Loan balances to related parties at December 31, 2007 were \$1,749 reduced by paydowns of \$268 and increased by new debt of \$644. Loans to related parties at December 31, 2008 totaled \$2,125.

Impaired loans totaled \$5,740 and \$7,528 at December 31, 2008 and 2007, respectively. An allowance for loan losses of \$811 and \$1,367 relates to impaired loans of \$5,490 and \$7,528 at December 31, 2008 and 2007, respectively.

Interest of \$234 and \$764 was recognized on average impaired loans of \$6,243 and \$8,721 for 2008 and 2007, respectively. Interest of \$234 and \$451 was recognized on impaired loans on a cash basis during 2008 and 2007, respectively.

At December 31, 2008 and 2007, accruing loans delinquent 90 days or more totaled \$0 and \$59, respectively. Non-accruing loans at December 31, 2008 and 2007 were \$7,976 and \$9,935, respectively.

**Note 5: Premises and Equipment**

Major classifications of premises and equipment, stated at cost, are as follows:

	2008	2007
Land	\$ 1,681	\$ 1,681
Buildings and improvements	6,386	6,444
Equipment	3,584	3,714
	11,651	11,839
Less accumulated depreciation	(5,190)	(5,024)
Net premises and equipment	\$ 6,461	\$ 6,815

**Note 6: Loan Servicing**

Mortgage loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balances of mortgage loans serviced for others was \$114,612 and \$131,157 at December 31, 2008 and 2007, respectively.

**LSB Financial Corp.**  
**Notes to Consolidated Financial Statements**  
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Comparable market values and a valuation model that calculates the present value of future cash flows were used to estimate fair value. For purposes of measuring impairment, risk characteristics including product type, investor type and interest rates, were used to stratify the originated mortgage servicing rights.

	<u>2008</u>	<u>2007</u>
Mortgage servicing rights		
Balance, beginning of year	\$ 1,132	\$ 1,261
Additions	16	16
Amortization of servicing rights	<u>(157)</u>	<u>(145)</u>
Balance, end of year	<u>\$ 991</u>	<u>\$ 1,132</u>

The fair value of servicing rights subsequently measured using the amortization method was as follows:

	<u>2008</u>	<u>2007</u>
Fair value, beginning of period	\$ 1,354	\$ 1,445
Fair value, end of period	1,340	1,354

**Note 7: Deposits**

Deposits at year-end are summarized as follows:

	<u>2008</u>		<u>2007</u>	
	Amount	Percent	Amount	Percent
Non interest-bearing deposits	\$ 16,739	6.47%	\$ 18,823	8.11%
NOW accounts	42,006	16.24	36,919	15.92
Savings accounts	<u>22,796</u>	<u>8.82</u>	<u>20,196</u>	<u>8.70</u>
	<u>81,541</u>	<u>31.53</u>	<u>75,938</u>	<u>32.73</u>
Certificates of deposit				
0.00% to 1.99%	3,037	1.17	305	.13
2.00% to 3.99%	105,400	40.76	35,925	15.48
4.00% to 5.99%	68,590	26.53	119,844	51.65
6.00% to 7.99%	<u>19</u>	<u>.01</u>	<u>18</u>	<u>.01</u>
	<u>177,046</u>	<u>68.47</u>	<u>156,092</u>	<u>67.27</u>
	<u>\$ 258,587</u>	<u>100.00%</u>	<u>\$ 232,030</u>	<u>100.00%</u>

**LSB Financial Corp.**  
**Notes to Consolidated Financial Statements**  
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At December 31, 2008, scheduled maturities of certificates of deposit are as follows:

2009	\$ 128,022
2010	34,253
2011	9,074
2012	2,147
Thereafter	<u>3,550</u>
	<u>\$ 177,046</u>

Time deposits of \$100 or more, including brokered deposits, were \$103,470 and \$85,082 at December 31, 2008 and 2007.

Deposits from related parties held by the Company at December 31, 2008 and 2007 totaled \$1,296 and \$1,700, respectively.

Total brokered deposits totaled approximately \$61,001 and \$52,266 at December 31, 2008 and 2007, respectively.

**Note 8: Federal Home Loan Bank Advances**

Federal Home Loan Bank advances totaled \$78,500 and \$74,256 at December 31, 2008 and 2007. At December 31, 2008, the advances range in interest rates from 0.65% to 6.03% and are secured by mortgage loans totaling \$137,183.

Aggregate annual maturities of the advance at December 31, 2008, are:

2009	\$ 34,500
2010	35,500
2011	8,500
2012	—
Thereafter	<u>—</u>
	<u>\$ 78,500</u>

Advances totaling \$12,500 may, at certain dates, be converted to adjustable rate advances by the FHLB. If converted, the advances may be prepaid without penalty.

**LSB Financial Corp.**  
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**Note 9: Income Taxes**

The provision for income taxes includes these components:

	<b>2008</b>	<b>2007</b>
Taxes currently payable	\$ 784	\$ 1,135
Deferred income taxes	12	(328)
Income tax expense	\$ 796	\$ 807

A reconciliation of income tax expense at the statutory rate to the Company's actual income tax expense is shown below:

	<b>2008</b>	<b>2007</b>
Computed at the statutory rate (34%)	\$ 862	\$ 810
Increase (decrease) resulting from		
Tax exempt interest	(85)	(76)
State income taxes	62	78
Other	(43)	(5)
Actual tax expense	\$ 796	\$ 807

The tax effects of temporary differences related to deferred taxes shown on the balance sheets were:

	<b>2008</b>	<b>2007</b>
Deferred tax assets		
Allowance for loan losses	\$ 1,115	\$ 1,212
Non-accrual loan income	90	141
Other	143	123
	1,348	1,476
Deferred tax liabilities		
Depreciation	181	240
Mortgage servicing rights	417	476
FHLB stock dividends	164	164
Unrealized gain on available-for-sale securities	77	50
Other	174	172
	1,013	1,102
Net deferred tax asset	\$ 335	\$ 374

**LSB Financial Corp.**  
**Notes to Consolidated Financial Statements**  
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Retained earnings at December 31, 2008 and 2007, include approximately \$1,861 for which no deferred federal income tax liability has been recognized. This amount represents an allocation of income to bad debt deductions for tax purposes only. Reduction of amounts so allocated for purposes other than tax bad debt losses or adjustments arising from carryback of net operating losses would create income for tax purposes only, which would be subject to the then-current corporate income tax rate. The deferred income tax liabilities on the preceding amounts that would have been recorded if they were expected to reverse into taxable income in the foreseeable future were approximately \$737 at December 31, 2008 and 2007.

**Note 10: Other Comprehensive Income**

Other comprehensive income components and related taxes were as follows:

	<u>2008</u>	<u>2007</u>
Unrealized gains on available-for-sale securities	\$ 70	\$ 170
Less: reclassification adjustment for gain realized in the income statement	<u>—</u>	<u>6</u>
Net unrealized gains on available-for-sale securities	70	164
Tax expense	<u>28</u>	<u>65</u>
Other comprehensive income	<u>\$ 42</u>	<u>\$ 99</u>

The only component of accumulated other comprehensive income was unrealized gains on securities available for sale.

**Note 11: Regulatory Matters**

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

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Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below). Management believes, as of December 31, 2008 and 2007, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2008, the most recent notification from the Office of Thrift Supervision categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category.

The Bank's actual capital amounts and ratios are also presented in the table.

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2008						
Total risk-based capital (to risk-weighted assets)	\$ 36,409	12.8%	\$ 22,763	8.0%	\$ 28,453	10.0%
Tier I capital (to risk-weighted assets)	33,763	11.9	11,381	4.0	17,072	6.0
Tier I capital (to adjusted total assets)	33,763	9.1	11,158	3.0	18,597	5.0
Tier I capital (to adjusted tangible assets)	33,763	9.1	7,439	2.0	N/A	N/A
Tangible capital (to adjusted tangible assets)	33,763	9.1	5,579	1.5	N/A	N/A
As of December 31, 2007						
Total risk-based capital (to risk-weighted assets)	\$ 36,320	13.9%	\$ 20,954	8.0%	\$ 26,192	10.0%
Tier I capital (to risk-weighted assets)	33,444	12.8	10,477	4.0	15,716	6.0
Tier I capital (to adjusted total assets)	33,444	9.8	10,249	3.0	17,081	5.0
Tier I capital (to adjusted tangible assets)	33,444	9.8	6,833	2.0	N/A	N/A
Tangible capital (to adjusted tangible assets)	33,444	9.8	5,124	1.5	N/A	N/A

The Bank is subject to certain restrictions on the amount of dividends that it may declare without prior regulatory approval. At December 31, 2008, regulatory approval was required for all dividend declarations.

LSB converted from a mutual to a stock institution, and a "liquidation account" was established at \$8,066, which was net worth reported in the conversion prospectus. Eligible depositors who have maintained their accounts, less annual reduction to the extent they have reduced their deposits, would receive a distribution from this account if the Bank liquidated. Dividends may not reduce shareholders' equity below the required liquidation account balance.

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**Note 12: Employee Benefits**

The Bank maintains an ESOP, which purchased 8% of the stock offered in the conversion using funds provided by an \$824 loan from LSB, which was repaid by contributions to the ESOP by the Bank. Dividends paid on allocated shares are charged to retained earnings.

There was no ESOP expense recorded for 2008 and 2007.

	2008	2007
ESOP shares allocated	96,098	96,013

The Company has a retirement savings 401(k) plan covering substantially all employees. Employees may contribute up to 100% of their compensation with the Company matching 100% of the employee's contribution on the first 4% of the employee's compensation. Employer contributions charged to expense for 2008 and 2007 were \$97 and \$100, respectively.

**Note 13: Stock Option Plan**

The Company's Incentive Stock Option Plan (Plan), which is shareholder approved, permits the grant of stock options to its directors, officers and other key employees. The Plan authorized the grant of options for up to 81,000 shares of the Company's common stock, which generally vest at a rate of 20 percent a year and have a 10-year contractual term. The Company believes that such awards better align the interests of its directors and employees with those of its shareholders. Option awards are generally granted with an exercise price equal to the market price of the Company's stock at the date of grant. Certain option awards provide for accelerated vesting if there is a change in control (as defined in the Plans). The Company generally issues shares from its authorized shares to satisfy option exercises.

A summary of option activity under the Plan as of December 31, 2008, and changes during the years then ended, is presented below:

	Shares	Weighted-Average Exercise Price	2008 Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding, beginning of year	41,316	\$ 18.52		
Granted	—	—		
Exercised	(4,457)	15.48		
Forfeited or expired	(1,158)	22.48		
Outstanding, end of year	35,701	\$ 18.77	5.46 years	\$ —
Exercisable, end of year	20,202	\$ 15.47	6.05 years	\$ —

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The total intrinsic value of options exercised during the years ended December 31, 2008 and 2007 was \$16 and \$10, respectively.

As of December 31, 2008, there was \$2 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized over the next year.

**Note 14: Earnings Per Share**

Earnings per share (EPS) were computed as follows:

	<b>Year Ended December 31, 2008</b>		
	<b>Income</b>	<b>Weighted-Average Shares</b>	<b>Per Share Amount</b>
Net income	\$ 1,740	1,555,206	
Basic earnings per share			
Income available to common stockholders			\$ <u>1.12</u>
Effect of dilutive securities			
Stock options	<u>          </u>	<u>963</u>	
Diluted earnings per share			
Income available to common stockholders and assumed conversions	\$ <u>1,740</u>	<u>1,556,169</u>	\$ <u>1.12</u>

23,140 options outstanding at December 31, 2008 were considered anti-dilutive.

	<b>Year Ended December 31, 2007</b>		
	<b>Income</b>	<b>Weighted-Average Shares</b>	<b>Per Share Amount</b>
Net income	\$ 1,574	1,579,792	
Basic earnings per share			
Income available to common stockholders			\$ <u>1.00</u>
Effect of dilutive securities			
Stock options	<u>          </u>	<u>8,978</u>	
Diluted earnings per share			
Income available to common stockholders and assumed conversions	\$ <u>1,574</u>	<u>1,588,770</u>	\$ <u>0.99</u>

There were no options outstanding at December 31, 2007 that were considered anti-dilutive.

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**Note 15: Disclosures About Fair Value of Financial Instruments**

Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standards No. 157 (FAS 157), *Fair Value Measurements*. FAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. FAS 157 has been applied prospectively as of the beginning of the year.

FAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. FAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

- Level 1** Quoted prices in active markets for identical assets or liabilities.
- Level 2** Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities
- Level 3** Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities

Following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis and recognized in the accompanying consolidated balance sheet, as well as the general classification of such instruments pursuant to the valuation hierarchy.

**Available-for-Sale Securities**

Where quoted market prices are not available, fair values are estimated by using pricing models, quoted prices of securities with similar characteristics or discounted cash flows. Level 2 securities include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions. All of our available-for-sale securities are Level 2 securities.

	Fair Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-sale securities	\$ 11,853	\$ —	\$ 11,853	\$ —

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Following is a description of the valuation methodologies used for instruments measured at fair value on a non-recurring basis and recognized in the accompanying balance sheet, as well as the general classification of those instruments under the valuation hierarchy.

**Impaired Loans**

Loan impairment is reported when scheduled payments under contractual terms are deemed uncollectible. Impaired loans are carried at the present value of estimated future cash flows using the loan's existing rate, or the fair value of collateral if the loan is collateral dependent. A portion of the allowance for loan losses is allocated to impaired loans if the value of such loans is deemed to be less than the unpaid balance. If these allocations cause the allowance for loan losses to increase, such increase is reported as a component of the provision for loan losses. Loan losses are charged against the allowance when management believes the uncollectability of the loan is confirmed. During the nine months of 2008, impaired loans were partially charged-off or re-evaluated. This valuation would be considered Level 3, consisting of appraisals of underlying collateral and discounted cash flow analysis.

The following table presents the fair value measurements of assets and liabilities recognized in the accompanying consolidated balance sheet measured at fair value on a nonrecurring basis and the level within the FAS 157 fair value hierarchy in which the fair value measurements fall at December 31, 2008:

	Fair Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	\$ 4,803	\$ —	\$ —	\$ 4,803

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The following table presents estimated fair values of the Company's financial instruments recognized in the accompanying balance sheets at amounts other than fair value. The fair values of certain of these instruments were calculated by discounting expected cash flows, which involves significant judgments by management and uncertainties. Because no market exists for certain of these financial instruments and because management does not intend to sell these financial instruments, the Company does not know whether the fair values shown below represent values at which the respective financial instruments could be sold individually or in the aggregate.

	<b>December 31, 2008</b>		<b>December 31, 2007</b>	
	<b>Carrying Amount</b>	<b>Fair Value</b>	<b>Carrying Amount</b>	<b>Fair Value</b>
<b>Financial assets</b>				
Cash and cash equivalents	\$ 11,225	\$ 11,225	\$ 6,490	\$ 6,490
Available-for-sale securities	11,853	11,853	13,221	13,221
Loans including loans held for sale, net of allowance for loan losses	326,639	336,892	296,908	300,755
Federal Home Loan Bank stock	3,997	3,997	3,997	3,997
Interest receivable	1,627	1,627	1,641	1,641
<b>Financial liabilities</b>				
Deposits	258,587	264,228	232,030	233,566
Federal Home Loan Bank advances	78,500	80,556	74,256	75,248
Interest payable	317	317	421	421

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

***Cash and Cash Equivalents, Interest-Bearing Deposits and Federal Home Loan Bank Stock***

The carrying amount approximates fair value.

***Securities***

Fair values equal quoted market prices, if available. If quoted market prices are not available, fair value is estimated based on quoted market prices of similar securities.

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***Loans***

The fair value of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. Loans with similar characteristics were aggregated for purposes of the calculations.

***Deposits***

Deposits include demand deposits, savings accounts, NOW accounts and certain money market deposits. The carrying amount approximates fair value. The fair value of fixed-maturity time deposits is estimated using a discounted cash flow calculation that applies the rates currently offered for deposits of similar remaining maturities.

***Interest Receivable and Interest Payable***

The carrying amount approximates fair value.

***Federal Home Loan Bank Advances***

Rates currently available to the Company for debt with similar terms and remaining maturities are used to estimate the fair value of existing debt.

***Commitments to Originate Loans, Letters of Credit and Lines of Credit***

Loan commitments and letters-of-credit generally have short-term, variable rate features and contain clauses which limit the Bank's exposure to changes in customer credit quality. Accordingly, their carrying values, which are immaterial at the respective balance sheet dates, are reasonable estimates of fair value.

**Note 16: Commitments and Contingent Liabilities**

Some financial instruments, such as loan commitments, credit lines, letters of credit and overdraft protection, are issued to meet customer financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments may expire without being used. Off-balance-sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at exercise of the commitment.

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At year-end, these financial instruments are summarized as follows:

	<u>2008</u>	<u>2007</u>
Commitments to extend credit		
Fixed rate	\$ 7,678	\$ 9,215
Variable rate	2,803	830
Unused portions of lines of credit	31,039	26,355
Letters of credit	238	829

The commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established under the contract. Generally, such commitments are for no more than 60 days. At December 31, 2007, the fixed rate loan commitments were at rates ranging from 4.63 to 7.25%. Unused portions of lines of credit include balances available on commercial and home equity loans and are variable rate.

**Note 17: 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**

	<u>December 31</u>	
	<u>2008</u>	<u>2007</u>
<b>Assets</b>		
Cash	\$ 10	\$ 38
Securities available-for-sale	171	184
Investment in the Bank	33,880	33,565
Other assets	<u>35</u>	<u>166</u>
Total assets	\$ <u>34,096</u>	\$ <u>33,953</u>
<b>Liabilities</b>	\$ 21	\$ 21
<b>Stockholders' Equity</b>	<u>34,075</u>	<u>33,932</u>
Total liabilities and stockholders' equity	\$ <u>34,096</u>	\$ <u>33,953</u>

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**Condensed Statements of Income**

	<b>Years Ending December 31</b>	
	<b>2008</b>	<b>2007</b>
<b>Income</b>		
Dividends from the Bank	\$ 1,606	\$ 2,275
Other income	<u>10</u>	<u>11</u>
Total income	1,616	2,286
<b>Expenses</b>	<u>(231)</u>	<u>(251)</u>
<b>Income Before Income Tax and Equity in Undistributed</b>		
<b>Income of Subsidiaries</b>	1,385	2,035
<b>Income Tax Benefit</b>	<u>90</u>	<u>98</u>
<b>Income Before Equity in Undistributed Income of</b>		
<b>Subsidiaries</b>	1,475	2,133
<b>Equity in Undistributed Income of Subsidiaries</b>	<u>265</u>	<u>(559)</u>
<b>Net Income</b>	\$ <u>1,740</u>	\$ <u>1,574</u>

**Condensed Statements of Cash Flows**

	<b>Years Ending December 31</b>	
	<b>2008</b>	<b>2007</b>
<b>Operating Activities</b>		
Net income	\$ 1,740	\$ 1,574
Equity in undistributed (distributions in excess of) income of the Bank	(265)	559
Change in other assets	<u>131</u>	<u>443</u>
Net cash provided by operating activities	<u>1,606</u>	<u>2,576</u>
<b>Investing Activities</b>		
Proceeds from paydowns of securities	13	11
Proceeds from ESOP loan repayment	<u>—</u>	<u>—</u>
Net cash provided by investing activities	<u>13</u>	<u>11</u>
<b>Financing Activities</b>		
Dividends paid	(1,556)	(1,420)
Stock options exercised	74	37
Repurchase of stock	<u>(165)</u>	<u>(1,212)</u>
Net cash used in financing activities	<u>(1,647)</u>	<u>(2,595)</u>
<b>Net Change in Cash</b>	(28)	(8)
<b>Cash at Beginning of Year</b>	<u>38</u>	<u>46</u>
<b>Cash at End of Year</b>	\$ <u>10</u>	\$ <u>38</u>

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**Note 18: Recent Accounting Pronouncements**

***Future Accounting Matters***

Statement of Financial Accounting Standards No. 141 (Revised 2007), *Business Combinations* (SFAS 141(R)). During December 2007, the FASB issued SFAS 141(R). This Statement replaces SFAS 141, *Business Combinations* (Statement 141). SFAS 141(R) retains the fundamental requirements in Statement 141 that the acquisition method of accounting (called the “purchase method”) be used for all business combinations and for an acquirer to be identified for each business combination. This Statement defines the acquirer as the entity that obtains control of one or more businesses, including those sometimes referred to as “true mergers” or “mergers of equals” and combinations achieved without the transfer of consideration, for example, by contract alone or through the lapse of minority veto rights. This is broader than in Statement 141, which applied only to business combinations in which control was obtained by transferring consideration. This Statement requires an acquirer to recognize the assets acquired, liabilities assumed and any noncontrolling interest in the acquiree at the acquisition date, measured at their fair values as of that date. SFAS 141(R) recognizes and measures the goodwill acquired in the business combination and defines a bargain purchase as a business combination in which the total acquisition-date fair value of the identifiable net assets acquired exceeds the fair value of the consideration transferred plus any noncontrolling interest in the acquiree, and it requires the acquirer to recognize that excess as a gain attributable to the acquirer. In contrast, Statement 141 required the “negative goodwill” amount to be allocated as a pro rata reduction of the amounts assigned to assets acquired. SFAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after December 15, 2008. An entity may not apply it before that date.

Statement of Financial Accounting Standards No. 160 (SFAS 160), *Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51*. During December 2007, the FASB issued SFAS 160 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statement, but separate from the parent’s equity. Before the Statement was issued, these so-called minority interests were reported in the consolidated statement of financial position as liabilities or in the mezzanine section between liabilities and equity. The amount of consolidated net income attributable to the parent and to the noncontrolling interest must be clearly identified and presented in the consolidated statement of income. This Statement requires that a parent recognize a gain or loss in net income when a subsidiary is deconsolidated. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. Management does not anticipate that this Statement will have a material impact on the Company consolidated financial condition or results of operations.

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Statement of Financial Accounting Standards No. 161 (SFAS 161), *Disclosures About Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133*. During March 2008, the FASB issued SFAS 161. SFAS 161 amends and expands the disclosure requirement of SFAS No. 133 (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities*, with the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments; (b) how derivative instrument and related hedged items are accounted for under SFAS 133 and its related interpretations; and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. To meet those objectives, SFAS 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Early application is encouraged.

Statement of Financial Accounting Standards (SFAS 162), *The Hierarchy of Generally Accepted Accounting Principles*. During May 2008, the FASB issued SFAS 162. This Statement identifies the sources of account principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States. This Statement is effective 60 days following the SEC approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. Adoption of SFAS 162 will not be a change in the Company's current accounting practices; therefore, it will not have a material impact on the Company's consolidated financial condition or results of operations.

FASB Staff Position EITF 03-6-1 (FSP EITF 03-6-1), *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities*. During June 2008, the FASB issued FSP EITF 03-6-1. FSP EITF 03-6-1 clarifies whether instruments, such as restricted stock, granted in share-based payments are participating securities prior to vesting. Such participating securities must be included in the computation of earnings per share under the two-class method as described in SFAS No. 128, *Earnings per Share*. FSP EITF 03-6-1 requires companies to treat unvested share-based payment awards that have non-forfeitable rights to dividend or dividend equivalents as a separate class of securities in calculating earnings per share. FSP EITF 03-6-1 is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008, and requires a company to retrospectively adjust its earning per share data. Early adoption is not permitted. It is not expected that the adoption of FSP EITF 03-6-1 will have a material effect on consolidated results of operations or earnings per share.

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**Note 19: Federal Deposit Insurance Corporation (FDIC) Special Assessment**

Subsequent to December 31, 2008, the Board of Directors of the FDIC voted to adopt an interim rule that would impose a special assessment on insured institutions on outstanding deposits as of June 30, 2009. This assessment is to be collected on September 30, 2009. The interim rule would also permit the Board to impose an emergency special assessment after June 30, 2009, of up to 10 basis points on outstanding deposits, if deemed necessary by the Board. Assuming that deposit levels remain constant, we anticipate that the special assessment for the Bank would total approximately \$517 at the 20 basis points level, but if the FDIC is able to reduce the special assessment to 10 basis points, the Bank's assessment would total approximately \$258.

# LSB FINANCIAL CORP.

and

# LAFAYETTE SAVINGS BANK, FSB

## DIRECTORS AND EXECUTIVE OFFICERS

### *Directors*

Randolph F. Williams  
*President and Chief Executive Officer,  
LSB Financial and Lafayette Savings*

Mariellen M. Neudeck  
*Chairman of the Board, LSB Financial and  
Lafayette Savings  
Vice President, Greater Lafayette  
Health Services, Inc., retired*

James A. Andrew  
*President and Owner, Henry Poor Lumber  
Co. and Homeworks*

Kenneth P. Burns  
*Executive Vice President and Treasurer,  
Purdue University, retired*

Mary Jo David  
*Vice President, Chief Financial Officer  
and Secretary-Treasurer of LSB Financial  
and Lafayette Savings*

Philip W. Kemmer  
*Transportation Supervisor,  
Lafayette School Corp., retired*

Thomas R. McCully  
*Partner, Stuart & Branigin*

Peter Neisel  
*Owner, President and CEO, Schwab Corp.,  
retired*

Jeffrey A. Poxon  
*Senior Vice President, Investments and  
Chief Investment Officer, The Lafayette Life  
Insurance Company*

Charles W. Shook  
*President and Owner, The Shook Agency*

### *Executive Officers*

Randolph F. Williams  
*President and Chief Executive Officer*

Mary Jo David  
*Vice President, Chief Financial Officer  
and Secretary-Treasurer*

## DIRECTORS AND OFFICERS

*James A. Andrew.* Mr. Andrew is President and owner of Henry Poor Lumber Co. and Homeworks, retailers of building materials. He is also involved in residential and commercial land development.

*Kenneth P. Burns.* Mr. Burns served as Executive Vice President and the Treasurer of Purdue University prior to his retirement on August 31, 2005.

*Philip W. Kemmer.* Mr. Kemmer is currently employed by Greater Lafayette Public Transportation Corporation. Formerly he served as Transportation Supervisor for the Lafayette School Corp. until his retirement from that position in July 2003. Prior to joining the Lafayette School Corp., Mr. Kemmer was the business administrator for the Assembly of God Church from July 1995 through December 1999.

*Randolph F. Williams.* Mr. Williams is President and Chief Executive Officer of LSB Financial and its wholly-owned subsidiary, Lafayette Savings. Mr. Williams was appointed to the Board of Directors of LSB Financial in September 2001. He was appointed President of LSB Financial in September 2001 and Chief Executive Officer in January 2002. Mr. Williams served as President and Chief Operating Officer of Delaware Place Bank in Chicago, Illinois from 1996 until joining LSB Financial. Mr. Williams has over 25 years of banking-related experience.

*Mary Jo David.* Ms. David is Vice President, Chief Financial Officer and Secretary of LSB Financial and Lafayette Savings. She has held these positions with LSB Financial since its formation in 1994 and with Lafayette Savings since 1992 and was elected a Director of LSB Financial and Lafayette Savings in 1999.

*Thomas R. McCully.* Mr. McCully is a partner in the law firm of Stuart & Branigin LLP and has worked there since 1966.

*Mariellen M. Neudeck.* Ms. Neudeck, retired as of June 30, 2001, was a Vice President of Greater Lafayette Health Services, Inc. where she was responsible for 18 professional services departments operating in two hospitals. She was elected as Chairman of the Board of Lafayette Savings in 1993 and of LSB Financial in 1994.

*Peter Neisel.* Mr. Neisel, retired as of December 31, 2002, was the Owner, President and Chief Executive Officer of Schwab Corp., a manufacturer and seller of office equipment.

*Jeffrey A. Poxon.* Mr. Poxon is the Senior Vice President-Investments and Chief Investment Officer of The Lafayette Life Insurance Company.

*Charles W. Shook.* Mr. Shook is the President and owner of the Shook Agency, a residential and commercial real estate brokerage firm based in Lafayette, Indiana.

## SHAREHOLDER INFORMATION

### Corporate Office

101 Main Street  
Lafayette, Indiana 47902

### Branch Offices

1020A Sagamore Park Centre  
West Lafayette, IN 47906

1501 Sagamore Parkway North  
Lafayette, Indiana 47905

833 Twyckenham Boulevard  
Lafayette, Indiana 47905

3510 S.R. 38 E  
Lafayette, Indiana 47905

### Independent Auditors

*BKD, LLP*  
201 N. Illinois Street, Suite 700  
P.O. Box 44998  
Indianapolis, Indiana 46244-0998

### Transfer Agent

*Computershare Investor Services*  
350 Indiana Street, Suite 800  
Golden, Colorado 80401

### Local Counsel

*Stuart & Branigin LLP*  
300 Main Street, Suite 800  
Lafayette, Indiana 47902

### Special Counsel

*Barnes & Thornburg LLP*  
11 South Meridian Street  
Indianapolis, Indiana 46204

### Form 10-K Report

**A copy of LSB Financial's Annual Report on Form 10-K without exhibits for the fiscal year ended December 31, 2008, as filed with the SEC, will be furnished without charge to shareholders of LSB Financial upon written request to the Secretary, LSB Financial Corp., 101 Main Street, P.O. Box 1628, Lafayette, Indiana 47902, or by calling (765) 742-1064. Copies of the exhibits filed with the Form 10-K may be obtained by shareholders at a charge of \$0.25 per page.**

## Common Stock

As of February 22, 2008, there were approximately 985 holders of record of LSB Financial Common Stock and 1,553,525 shares of issued and outstanding common stock. LSB Financial's stock is quoted on the Nasdaq National Stock Market under the symbol "LSBI."

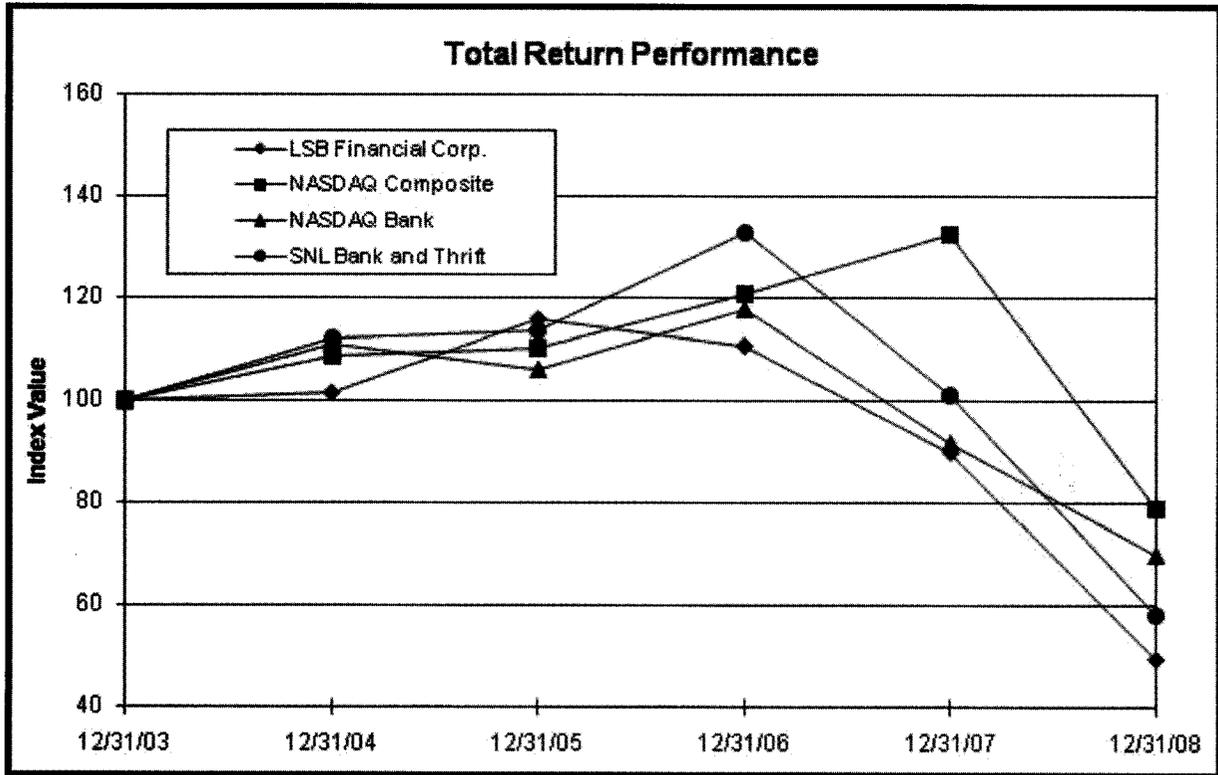
The following table sets forth, for the periods shown, the high and low sale price of the common stock and cash dividends per share declared. All amounts have been adjusted to reflect stock dividends and stock splits declared by the Company to date. The last stock dividend was declared in 2006.

<u>Quarter Ended</u>	<u>High</u>	<u>Low</u>	<u>Cash Dividends Declared</u>
March 31, 2007	26.90	24.25	0.20
June 30, 2007	26.00	24.80	0.20
September 30, 2007	26.515	23.00	0.25
December 31, 2007	24.85	18.41	0.25
March 31, 2008	19.94	18.15	0.25
June 30, 2008	19.35	16.21	0.25
September 30, 2008	19.50	14.52	0.25
December 31, 2008	17.00	9.94	0.25

Dividend payment decisions are made with consideration of a variety of factors including earnings, financial condition, market considerations and regulatory restrictions. Restrictions on dividend payments are described in Note 11 of the Notes to Consolidated Financial Statements included in this Annual Report.

### Performance Graph

The following graph shows the performance of the Company's common stock since December 31, 2003 in comparison to the NASDAQ Composite Index, the NASDAQ Bank Index and the SNL Bank and Thrift Index.





*The Holding Company of Lafayette Savings Bank*

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