

FS Bancorp, Inc.  
Form 10-Q  
November 12, 2013  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q  
(Mark One)

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

For the quarterly period ended September 30, 2013 OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 333-177125

FS BANCORP, INC.

(Exact name of registrant as specified in its charter)

Washington

(State or other jurisdiction of incorporation or organization)

45-4585178

(IRS Employer Identification No.)

6920 220th Street SW, Mountlake Terrace, Washington 98043

(Address of principal executive offices; Zip Code)

(425) 771-5299

(Registrant's telephone number, including area code)

None

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

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

Large accelerated filer

Accelerated filer

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Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

**APPLICABLE ONLY TO CORPORATE ISSUERS:**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: As of November 8, 2013, there were 3,240,125 outstanding shares of the registrant's common stock.

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As used in this report, the terms "we," "our," and "us," and "Company" refer to FS Bancorp, Inc. and its consolidated subsidiary, unless the context indicates otherwise. When we refer to "Bank" in this report, we are referring to 1st Security Bank of Washington, the wholly owned subsidiary of FS Bancorp, Inc.

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Item 1. Financial Statements  
 FS BANCORP, INC. AND SUBSIDIARY  
 CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except share data) (Unaudited)

|  | September 30,<br>2013 | December 31,<br>2012 |
|--|-----------------------|----------------------|
| <b>ASSETS</b>  |                       |                      |
| Cash and due from banks  | \$2,017               | \$4,003              |
| Interest-bearing deposits at other financial institutions  | 25,323                | 5,410                |
| Securities available-for-sale, at fair value   | 47,131                | 43,313               |
| Federal Home Loan Bank stock, at cost  | 1,717                 | 1,765                |
| Loans held for sale, at fair value   | 8,389                 | 8,870                |
| Loans receivable, net  | 283,794               | 274,949              |
| Accrued interest receivable  | 1,333                 | 1,223                |
| Premises and equipment, net  | 13,705                | 12,663               |
| Other real estate owned ("OREO")   | 2,259                 | 2,127                |
| Deferred tax asset   | 752                   | 1,927                |
| Bank owned life insurance ("BOLI")   | 6,038                 | —                    |
| Other assets   | 3,608                 | 2,780                |
| <b>TOTAL ASSETS</b>  | <b>\$396,066</b>      | <b>\$359,030</b>     |
| <b>LIABILITIES</b>   |                       |                      |
| Deposits   |                       |                      |
| Interest-bearing accounts  | \$274,289             | \$254,784            |
| Noninterest-bearing accounts   | 42,579                | 34,165               |
| Total deposits   | 316,868               | 288,949              |
| Borrowings   | 13,664                | 6,840                |
| Other liabilities  | 3,300                 | 3,344                |
| Total liabilities  | 333,832               | 299,133              |
| <b>COMMITMENTS AND CONTINGENCIES (NOTE 9)</b>  |                       |                      |
| <b>STOCKHOLDERS' EQUITY</b>  |                       |                      |
| Preferred stock, \$.01 par value; 5,000,000 shares authorized; None issued or outstanding  | —                     | —                    |
| Common stock, \$.01 par value; 45,000,000 shares authorized; 3,240,125 shares issued and outstanding at September 30, 2013 and December 31, 2012, respectively | 32                    | 32                   |
| Additional paid-in capital   | 30,029                | 29,894               |
| Retained earnings  | 34,828                | 31,746               |
| Accumulated other comprehensive income (loss)  | (481                  | ) 597                |
| Unearned shares - Employee Stock Ownership Plan ("ESOP")   | (2,174                | ) (2,372             |
| Total stockholders' equity   | 62,234                | 59,897               |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>  | <b>\$396,066</b>      | <b>\$359,030</b>     |

See accompanying notes to these consolidated financial statements.



Table of ContentsFS BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF INCOME

(Dollars in thousands, except earnings per share data) (Unaudited)

|   | Three Months Ended<br>September 30, |         | Nine Months Ended<br>September 30, |                    |   |
|---|-------------------------------------|---------|------------------------------------|--------------------|---|
|   | 2013                                | 2012    | 2013                               | 2012               |   |
| <b>INTEREST INCOME</b>  |                                     |         |                                    |                    |   |
| Loans receivable  | \$5,365                             | \$4,647 | \$15,536                           | \$13,121           |   |
| Interest and dividends on investment securities and cash and cash equivalents | 232                                 | 193     | 672                                | 521                |   |
| Total interest income   | 5,597                               | 4,840   | 16,208                             | 13,642             |   |
| <b>INTEREST EXPENSE</b>   |                                     |         |                                    |                    |   |
| Deposits  | 502                                 | 543     | 1,438                              | 1,715              |   |
| Borrowings  | 56                                  | 28      | 142                                | 117                |   |
| Total interest expense  | 558                                 | 571     | 1,580                              | 1,832              |   |
| NET INTEREST INCOME   | 5,039                               | 4,269   | 14,628                             | 11,810             |   |
| PROVISION FOR LOAN LOSSES   | 520                                 | 630     | 1,720                              | 1,695              |   |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES                           | 4,519                               | 3,639   | 12,908                             | 10,115             |   |
| <b>NONINTEREST INCOME</b>   |                                     |         |                                    |                    |   |
| Service charges and fee income  | 473                                 | 499     | 1,420                              | 1,494              |   |
| Gain on sale of loans   | 1,537                               | 915     | 5,316                              | 1,466              |   |
| Gain on sale of investment securities   | —                                   | —       | 264                                | 106                |   |
| Other noninterest income  | 153                                 | 65      | 357                                | 258                |   |
| Total noninterest income  | 2,163                               | 1,479   | 7,357                              | 3,324              |   |
| <b>NONINTEREST EXPENSE</b>  |                                     |         |                                    |                    |   |
| Salaries and benefits   | 2,578                               | 2,162   | 8,190                              | 5,723              |   |
| Operations  | 752                                 | 630     | 2,268                              | 1,761              |   |
| Occupancy   | 372                                 | 286     | 1,074                              | 889                |   |
| Data processing   | 285                                 | 254     | 817                                | 762                |   |
| OREO fair value write-downs, net of loss on sales                             | 151                                 | 82      | 347                                | 728                |   |
| OREO expenses   | 41                                  | 57      | 79                                 | 155                |   |
| Loan costs  | 362                                 | 213     | 1,007                              | 550                |   |
| Professional and board fees   | 331                                 | 178     | 894                                | 481                |   |
| FDIC insurance  | 62                                  | 66      | 186                                | 185                |   |
| Marketing and advertising   | 107                                 | 80      | 350                                | 200                |   |
| Impairment (recovery) of loss on servicing rights                             | (2                                  | ) 108   | (102                               | ) 105              |   |
| Total noninterest expense   | 5,039                               | 4,116   | 15,110                             | 11,539             |   |
| INCOME BEFORE PROVISION (BENEFIT) FOR INCOME TAX                              | 1,643                               | 1,002   | 5,155                              | 1,900              |   |
| PROVISION (BENEFIT) FOR INCOME TAX  | 581                                 | (2,323  | ) 1,772                            | (2,323             | ) |
| NET INCOME  | \$1,062                             | \$3,325 | \$3,383                            | \$4,223            |   |
| Basic earnings per share  | \$0.35                              | \$1.03  | \$1.12                             | n/a <sup>(1)</sup> |   |
| Diluted earnings per share  | \$0.35                              | \$1.03  | \$1.12                             | n/a <sup>(1)</sup> |   |

(1): Earnings per share calculations are not available (n/a) as the Company completed its stock conversion and became a public company on July 9, 2012.

See accompanying notes to these consolidated financial statements.





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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands) (Unaudited)

|   | Three Months Ended |          | Nine Months Ended |          |
|---|--------------------|----------|-------------------|----------|
|   | September 30,      |          | September 30,     |          |
|   | 2013               | 2012     | 2013              | 2012     |
| Net Income  | \$ 1,062           | \$ 3,325 | \$ 3,383          | \$ 4,223 |
| Other comprehensive gain (loss), net of tax:                                  |                    |          |                   |          |
| Unrealized gain (loss) on securities available-for-sale:                      |                    |          |                   |          |
| Unrealized holding gain (loss) arising during period                          | 193                | 521      | (1,063            | ) 864    |
| Reclassification adjustment for realized gains included in net income         | —                  | —        | (264              | ) (106 ) |
| Income tax benefit (provision) related to realized and unrealized gain (loss) | (65                | ) 365    | 249               | 365      |
| Other comprehensive gain (loss), net of tax                                   | 128                | 886      | (1,078            | ) 1,123  |
| COMPREHENSIVE INCOME  | \$ 1,190           | \$ 4,211 | \$ 2,305          | \$ 5,346 |

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
(Dollars in thousands, except share data) (Unaudited)

|  | Common Stock |        | Additional      | Retained Earnings | Accumulated Other           | Unearned    | Total Equity |
|--|--------------|--------|-----------------|-------------------|-----------------------------|-------------|--------------|
|  | Shares       | Amount | Paid-in Capital |                   | Comprehensive Income (Loss) | ESOP Shares |              |
| BALANCE, January 1, 2012                       | —            | \$—    | \$—             | \$26,451          | \$316                       | \$—         | \$26,767     |
| Net income                                     | —            | —      | —               | 4,223             | —                           | —           | 4,223        |
| Other comprehensive income                     | —            | —      | —               | —                 | 1,123                       | —           | 1,123        |
| Proceeds from public offering, net of expenses | 3,240,125    | 32     | 29,863          | —                 | —                           | —           | 29,895       |
| Unearned employee stock ownership plan shares  | —            | —      | —               | —                 | —                           | (2,636 )    | (2,636 )     |
| BALANCE, September 30, 2012                    | 3,240,125    | \$32   | \$29,863        | \$30,674          | \$1,439                     | \$(2,636 )  | \$59,372     |
| BALANCE, January 1, 2013                       | 3,240,125    | \$32   | \$29,894        | \$31,746          | \$597                       | \$(2,372 )  | \$59,897     |
| Net income                                     | —            | —      | —               | 3,383             | —                           | —           | 3,383        |
| Dividends paid (\$0.10 per share)              | —            | —      | —               | (301 )            | —                           | —           | (301 )       |
| Other comprehensive loss, net of tax           | —            | —      | —               | —                 | (1,078 )                    | —           | (1,078 )     |
| ESOP shares allocated                          | —            | —      | 135             | —                 | —                           | 198         | 333          |
| BALANCE, September 30, 2013                    | 3,240,125    | \$32   | \$30,029        | \$34,828          | \$(481 )                    | \$(2,174 )  | \$62,234     |

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In thousands) (Unaudited)

|   | Nine Months Ended<br>September 30, |          |
|---|------------------------------------|----------|
|   | 2013                               | 2012     |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                               |                                    |          |
| Net income  | \$3,383                            | \$4,223  |
| Adjustments to reconcile net income to net cash from operating activities |                                    |          |
| Provision for loan losses   | 1,720                              | 1,695    |
| Depreciation, amortization and accretion                                  | 1,286                              | 688      |
| ESOP compensation expense for allocated shares                            | 333                                | —        |
| Provision for deferred income taxes                                       | 1,512                              | 307      |
| Valuation allowance on deferred income taxes                              | —                                  | (2,630)  |
| Increase in cash surrender value of BOLI                                  | (38)                               | —        |
| Gain on sale of loans held for sale                                       | (4,933)                            | (1,466)  |
| Gain on sale of portfolio loans   | (383)                              | —        |
| Origination of loans held for sale  | (193,123)                          | (78,901) |
| Proceeds from sale of loans held for sale                                 | 197,396                            | 71,260   |
| Gain on sale of investment securities                                     | (264)                              | (106)    |
| Loss on sale of OREO  | —                                  | 35       |
| Impairment (recovery) of loss on servicing rights                         | (102)                              | 105      |
| Impairment loss on other real estate owned                                | 347                                | 693      |
| Changes in operating assets and liabilities                               |                                    |          |
| Accrued interest receivable   | (110)                              | (263)    |
| Other assets  | 213                                | 216      |
| Other liabilities   | 34                                 | 1,209    |
| Net cash from (used by) operating activities                              | 7,271                              | (2,935)  |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                               |                                    |          |
| Activity in securities available-for-sale:                                |                                    |          |
| Proceeds from sale of investment securities                               | 8,786                              | —        |
| Maturities, prepayments, and calls  | 3,971                              | 11,572   |
| Purchases   | (18,223)                           | (22,587) |
| Loan originations and principal collections, net                          | (18,964)                           | (44,624) |
| Proceeds from sale of portfolio loans                                     | 8,195                              | —        |
| Proceeds from sale of OREO  | 163                                | 2,496    |
| Purchase bank owned life insurance  | (6,000)                            | —        |
| Purchase of premises and equipment  | (1,714)                            | (3,201)  |
| Net cash used by investing activities                                     | (23,786)                           | (56,344) |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                               |                                    |          |
| Net increase in deposits  | 27,919                             | 28,406   |
| Proceeds from borrowings  | 101,454                            | 13,000   |
| Repayments of borrowings  | (94,630)                           | (17,800) |
| Dividends paid  | (301)                              | —        |
| Purchase ESOP shares  | —                                  | (2,636)  |
| Proceeds from issuance of common stock, net                               | —                                  | 31,233   |
| Net cash from financing activities  | 34,442                             | 52,203   |

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|   |            |          |
|---|------------|----------|
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS                                  | 17,927     | (7,076 ) |
| CASH AND CASH EQUIVALENTS, beginning of period  | 6,787      | 19,253   |
| CASH AND CASH EQUIVALENTS, end of period  | \$24,714   | \$12,177 |
| SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION                                    |            |          |
| Cash paid during the period for:  |            |          |
| Interest  | \$1,574    | \$1,839  |
| Income taxes  | \$260      | \$—      |
| SUPPLEMENTARY DISCLOSURES OF NONCASH OPERATING, INVESTING<br>AND FINANCING ACTIVITIES |            |          |
| Change in unrealized gain (loss) on investment securities                             | \$(1,634 ) | \$1,123  |
| Property taken in settlement of loans   | \$642      | \$921    |
| See accompanying notes to these consolidated financial statements.                    |            |          |

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FS BANCORP, INC. AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations – FS Bancorp, Inc. (the “Company”) was incorporated in September 2011 as the proposed holding company for 1st Security Bank of Washington (the “Bank”) in connection with the Bank's conversion from the mutual to stock form of ownership which was completed on July 9, 2012. The Bank is a community-based stock owned savings bank with seven branches in suburban communities in the greater Puget Sound area. The Bank provides loan and deposit services to customers who are predominantly small and middle-market businesses and individuals.

Financial Statement Presentation – The accompanying unaudited consolidated interim financial statements do not contain all necessary disclosures required by Generally Accepted Accounting Principles in the United States of America (“U.S. GAAP”) for complete financial statements and, therefore, should be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 filed with the Securities and Exchange Commission (“SEC”) on April 1, 2013. These unaudited financial statements include all normal and recurring adjustments that management believes are necessary in order to conform to U.S. GAAP and have been reflected as required by Article 10 of Regulation S-X as promulgated by the SEC. The results for the three and nine months ended September 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013 or any other future period. Amounts presented in the financial statements and footnote tables are rounded and presented in thousands of dollars. In the narrative footnote discussion amounts are rounded and presented in millions of dollars to one decimal point if the amounts are above \$1.0 million. Amounts below \$1.0 million are rounded and presented in dollars to the nearest thousands. Certain prior year amounts have been reclassified to conform to the 2013 presentation with no change to net income or stockholders' equity previously reported.

Conversion and Change in Corporate Form – On July 9, 2012, in accordance with a Plan of Conversion (the “Plan”) adopted by its Board of Directors and as approved by its depositors and borrower members, the Bank (i) converted from a mutual savings bank to a stock savings bank, and (ii) became the wholly-owned subsidiary of FS Bancorp, Inc., a bank holding company registered with the Board of Governors of the Federal Reserve System (“FRB”). In connection with the conversion, FS Bancorp, Inc. issued an aggregate of 3,240,125 shares of common stock at an offering price of \$10.00 per share for gross proceeds of \$32.4 million. From the proceeds, FS Bancorp, Inc. made a capital contribution of \$15.5 million to the Bank. The Bank intends to use this additional capital for future lending and investment activities and for general and other corporate purposes subject to regulatory limitations. The cost of conversion and the issuance of capital stock was approximately \$2.5 million, which was deducted from the proceeds of the offering.

Pursuant to the Plan, the Company's Board of Directors adopted an ESOP plan which purchased 8% of the common stock in the open market or 259,210 shares. As provided for in the Plan, the Bank also established a liquidation account in the amount of retained earnings as of December 31, 2011. The liquidation account will be maintained for the benefits of eligible savings account holders as of June 30, 2007 and supplemental eligible account holders as of March 31, 2012 who maintain deposit accounts at the Bank after the conversion. The conversion was accounted for as a change in corporate form with the historic basis of the Company's assets, liabilities, and equity unchanged as a result.

Use of Estimates – The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements. Actual results could differ from these estimates. Material estimates that are particularly susceptible to change in the near term are allowances for

loan losses, fair value of measurements, and the estimated realizability related to the deferred tax asset.

**Principles of Consolidation** – The consolidated financial statements include the accounts of FS Bancorp, Inc. and its wholly owned subsidiary, 1st Security Bank of Washington. All material intercompany accounts have been eliminated in consolidation.

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FS BANCORP, INC. AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 – BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES  
(Continued)

Subsequent Events – The Company has evaluated events and transactions subsequent to September 30, 2013 for potential recognition or disclosure.

Cash and Cash Equivalents – Cash and cash equivalents include cash and due from banks, and interest-bearing balances due from other banks and the Federal Reserve Bank of San Francisco. Cash and cash equivalents have a maturity of 90 days or less at the time of purchase. As of September 30, 2013 and December 31, 2012, the Company had cash deposits at other financial institutions in excess of Federal Deposit Insurance Corporation ("FDIC") insured limits. However, as the Company places these deposits with major financial institutions and monitors the financial condition of these institutions, management believes the risk of loss to be minimal.

Deposits in Other Financial Institutions – The Company held interest-bearing deposits at other financial institutions with a cost basis of \$25.3 million and \$5.4 million as of September 30, 2013 and December 31, 2012, respectively. Certificates of deposits in the amount of \$2.6 million with original maturity dates greater than 90 days were excluded from cash and cash equivalents as of September 30, 2013 and December 31, 2012.

RECENT ACCOUNTING PRONOUNCEMENTS

In July 2013, the FASB issued Accounting Standards Update No. 2013-11, Presentation of Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (Topic 740). ASU No. 2013-11 requires an entity to present an unrecognized tax benefit, or a portion of an unrecognized tax benefit, as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except to the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. No new recurring disclosures are required. The amendments are effective for annual and interim reporting periods beginning on or after December 15, 2013 and are to be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. The adoption of ASU No. 2013-11 is not expected to have a material impact on the Company's consolidated financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 2 – SECURITIES AVAILABLE-FOR-SALE

The carrying amount of securities available-for-sale and their approximate fair values at September 30, 2013 and December 31, 2012 were as follows:

|                                     | September 30, 2013 |                              |   |   |                             |
|-------------------------------------|--------------------|------------------------------|---|---|-----------------------------|
|                                     | Amortized<br>Cost  | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses (less<br>than 1 year) | Gross<br>Unrealized<br>Losses (more<br>than 1 year) | Estimated<br>Fair<br>Values |
| Securities available-for-sale       |                    |                              |   |   |                             |
| Federal agency securities           | \$9,796            | \$33                         | \$(455)   | ) \$—   | \$9,374                     |
| Municipal bonds                     | 10,428             | 176                          | (154)   | ) —   | 10,450                      |
| Corporate securities                | 3,503              | 4                            | (44)  | ) —   | 3,463                       |
| Mortgage-backed securities          | 24,133             | 107                          | (396)   | ) —   | 23,844                      |
| Total securities available-for-sale | \$47,860           | \$320                        | \$(1,049)   | ) \$—   | \$47,131                    |
|                                     | December 31, 2012  |                              |   |   |                             |
|                                     | Amortized<br>Cost  | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses (less<br>than 1 year) | Gross<br>Unrealized<br>Losses (more<br>than 1 year) | Estimated<br>Fair<br>Values |
| Securities available-for-sale       |                    |                              |   |   |                             |
| Federal agency securities           | \$12,287           | \$281                        | \$(16)  | ) \$—   | \$12,552                    |
| Municipal bonds                     | 8,863              | 202                          | (5)   | ) —   | 9,060                       |
| Corporate securities                | 2,492              | —                            | (4)   | ) —   | 2,488                       |
| Mortgage-backed securities          | 18,766             | 447                          | —   | ) —   | 19,213                      |
| Total securities available-for-sale | \$42,408           | \$930                        | \$(25)  | ) \$—   | \$43,313                    |

There were twenty-six investments with unrealized losses of less than one year as of September 30, 2013. There were nine investments with unrealized losses of less than one year as of December 31, 2012. The unrealized losses associated with these investments are believed to be caused by changing market conditions that are considered to be temporary and the Company has the intent and ability to hold these securities until recovery, and is not likely to be required to sell these securities. No other-than-temporary impairment write-downs were recorded for the nine months ended September 30, 2013 or the year ended December 31, 2012.





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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 2 - SECURITIES AVAILABLE-FOR-SALE (Continued)

The contractual maturities of securities available-for-sale at September 30, 2013 were as follows:

|  | September 30,<br>2013 |               |
|--|-----------------------|---------------|
|  | Amortized<br>Cost     | Fair<br>Value |
| No contractual maturity                | \$—                   | \$—           |
| Due in one year or less                | 2,282                 | 2,302         |
| Due after one year through five years  | 3,597                 | 3,643         |
| Due after five years through ten years | 15,758                | 15,290        |
| Due after ten years                    | 26,223                | 25,896        |
| Total                                  | \$47,860              | \$47,131      |

The proceeds and resulting gains, computed using specific identification, from sales of securities available-for-sale were as follows for the periods ended:

|                               | Three Months Ended<br>September 30, 2013 |             |              | Nine Months Ended<br>September 30, 2013 |             |              |
|-------------------------------|--|-------------|--------------|---|-------------|--------------|
|                               | Proceeds                                 | Gross Gains | Gross Losses | Proceeds                                | Gross Gains | Gross Losses |
| Securities available-for-sale | \$—                                      | \$—         | \$—          | \$8,786                                 | \$264       | \$—          |

  

|                               | Three Months Ended<br>September 30, 2012 |             |              | Nine Months Ended<br>September 30, 2012 |             |              |
|-------------------------------|--|-------------|--------------|---|-------------|--------------|
|                               | Proceeds                                 | Gross Gains | Gross Losses | Proceeds                                | Gross Gains | Gross Losses |
| Securities available-for-sale | \$—                                      | \$—         | \$—          | \$2,432                                 | \$106       | \$—          |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 3 – LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

The composition of the loan portfolio was as follows at September 30, 2013 and December 31, 2012:

|  | September 30,<br>2013 | December 31,<br>2012 |
|--|-----------------------|----------------------|
| <b>REAL ESTATE LOANS</b>                 |                       |                      |
| Commercial                               | \$37,327              | \$33,250             |
| Construction and development             | 43,088                | 31,893               |
| Home equity                              | 16,253                | 15,474               |
| One-to-four-family                       | 18,854                | 13,976               |
| Multi-family                             | 4,723                 | 3,202                |
| Total real estate loans                  | 120,245               | 97,795               |
| <b>CONSUMER LOANS</b>                    |                       |                      |
| Indirect home improvement                | 99,838                | 86,249               |
| Marine                                   | 20,631                | 17,226               |
| Automobile                               | 1,222                 | 2,416                |
| Recreational                             | 584                   | 742                  |
| Home improvement                         | 495                   | 651                  |
| Other                                    | 1,310                 | 1,386                |
| Total consumer loans                     | 124,080               | 108,670              |
| <b>COMMERCIAL BUSINESS LOANS</b>         |                       |                      |
| Total loans                              | 289,444               | 279,930              |
| Allowance for loan losses                | (5,310)               | (4,698)              |
| Deferred costs, fees, and discounts, net | (340)                 | (283)                |
| Total loans receivable, net              | \$283,794             | \$274,949            |

The Company has defined its loan portfolio into three segments that reflect the structure of the lending function, the Company's strategic plan and the manner in which management monitors performance and credit quality. The three loan portfolio segments are: (a) Real Estate Loans, (b) Consumer Loans and (c) Commercial Business Loans. Each of these segments is disaggregated into classes based on the risk characteristics of the borrower and/or the collateral type securing the loan. The following is a summary of each of the Company's loan portfolio segments and classes:

**Real Estate Loans**

**Commercial Lending.** Loans originated by the Company primarily secured by income producing properties, including retail centers, warehouses and office buildings located in our Puget Sound market area.

**Construction and Development Lending.** Loans originated by the Company for the construction of and secured by commercial real estate and one-to-four-family residences and tracts of land for development, primarily in our Puget Sound market area.

**Home Equity Lending.** Loans originated by the Company secured by second mortgages on one-to-four-family residences, primarily in our Puget Sound market area.



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NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

One-to-Four-Family Real Estate Lending. Loans originated by the Company secured by first mortgages on one-to-four-family residences, primarily in our Puget Sound market area.

Multi-family Lending. Apartment lending (more than four units) to current banking customers and community reinvestment loans for low to moderate income individuals in our Puget Sound market area.

Consumer Lending

Indirect Home Improvement. Fixture secured loans are originated by the Company for home improvement and are secured by the personal property installed in, on or at the borrower's real property, and may be perfected with a UCC-2 financing statement filed in the county of the borrower's residence. The Company originates indirect home improvement loans throughout the states of Washington, Oregon and California.

Marine, Automobile and Recreational. Loans originated by the Company secured by boats, automobiles and RVs to borrowers in our Puget Sound market area.

Other Consumer and Home Improvement Loans. Loans originated by the Company, including direct home improvement loans, loans on deposits and other consumer loans to borrowers in the Puget Sound market area.

Commercial Business Loans

Commercial Business Lending. Commercial business loans originated by the Company to local small and mid-sized businesses in the Puget Sound market area are secured by accounts receivable, inventory or personal property, plant and equipment. Commercial business loans are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business.



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## NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following table details activity in the allowance for loan losses by loan categories:

|   | At or For the Three Months Ended September 30, 2013 |           |                        |             |           |
|---|---|-----------|------------------------|-------------|-----------|
| ALLOWANCE FOR LOAN LOSSES                   | Real Estate   | Consumer  | Commercial<br>Business | Unallocated | Total     |
| Beginning balance                           | \$2,495   | \$1,736   | \$580                  | \$465       | \$5,276   |
| Provision for loan losses                   | 280   | 64        | (195 )                 | 371         | 520       |
| Charge-offs                                 | (275 )  | (375 )    | —                      | —           | (650 )    |
| Recoveries                                  | —   | 154       | 10                     | —           | 164       |
| Net charge-offs                             | (275 )  | (221 )    | 10                     | —           | (486 )    |
| Ending balance                              | \$2,500   | \$1,579   | \$395                  | \$836       | \$5,310   |
| Period end amount allocated to:             |   |           |                        |             |           |
| Loans individually evaluated for impairment | \$303   | \$—       | \$28                   | \$—         | \$331     |
| Loans collectively evaluated for impairment | 2,197   | 1,579     | 367                    | 836         | 4,979     |
| Ending balance                              | \$2,500   | \$1,579   | \$395                  | \$836       | \$5,310   |
| <b>LOANS RECEIVABLE</b>                     |   |           |                        |             |           |
| Loans individually evaluated for impairment | \$3,337   | \$—       | \$172                  | \$—         | \$3,509   |
| Loans collectively evaluated for impairment | 116,908   | 124,080   | 44,947                 | —           | 285,935   |
| Ending balance                              | \$120,245   | \$124,080 | \$45,119               | \$—         | \$289,444 |
|   | At or For the Nine Months Ended September 30, 2013  |           |                        |             |           |
| ALLOWANCE FOR LOAN LOSSES                   | Real Estate   | Consumer  | Commercial<br>Business | Unallocated | Total     |
| Beginning balance                           | \$1,690   | \$2,158   | \$815                  | \$35        | \$4,698   |
| Provision for loan losses                   | 1,252   | 55        | (388 )                 | 801         | 1,720     |
| Charge-offs                                 | (477 )  | (1,233 )  | (44 )                  | —           | (1,754 )  |
| Recoveries                                  | 35  | 599       | 12                     | —           | 646       |
| Net charge-offs                             | (442 )  | (634 )    | (32 )                  | —           | (1,108 )  |
| Ending balance                              | \$2,500   | \$1,579   | \$395                  | \$836       | \$5,310   |
| Period end amount allocated to:             |   |           |                        |             |           |
| Loans individually evaluated for impairment | \$303   | \$—       | \$28                   | \$—         | \$331     |
| Loans collectively evaluated for impairment | 2,197   | 1,579     | 367                    | 836         | 4,979     |
| Ending balance                              | \$2,500   | \$1,579   | \$395                  | \$836       | \$5,310   |
| <b>LOANS RECEIVABLE</b>                     |   |           |                        |             |           |
| Loans individually evaluated for impairment | \$3,337   | \$—       | \$172                  | \$—         | \$3,509   |
| Loans collectively evaluated for impairment | 116,908   | 124,080   | 44,947                 | —           | 285,935   |
| Ending balance                              | \$120,245   | \$124,080 | \$45,119               | \$—         | \$289,444 |

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## NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

|   | At or For the Three Months Ended September 30, 2012 |           |                        |             |           |
|---|---|-----------|------------------------|-------------|-----------|
| ALLOWANCE FOR LOAN LOSSES                   | Real Estate   | Consumer  | Commercial<br>Business | Unallocated | Total     |
| Beginning balance                           | \$1,123   | \$2,178   | \$660                  | \$371       | \$4,332   |
| Provision for loan losses                   | 634   | 384       | (36)                   | (352)       | 630       |
| Charge-offs                                 | (226)   | (563)     | (11)                   | —           | (800)     |
| Recoveries                                  | 1   | 196       | —                      | —           | 197       |
| Net charge-offs                             | (225)   | (367)     | (11)                   | —           | (603)     |
| Ending balance                              | \$1,532   | \$2,195   | \$613                  | \$19        | \$4,359   |
| Period end amount allocated to:             |   |           |                        |             |           |
| Loans individually evaluated for impairment | \$167   | \$—       | \$28                   | \$—         | \$195     |
| Loans collectively evaluated for impairment | 1,365   | 2,195     | 585                    | 19          | 4,164     |
| Ending balance                              | \$1,532   | \$2,195   | \$613                  | \$19        | \$4,359   |
| LOANS RECEIVABLE                            |   |           |                        |             |           |
| Loans individually evaluated for impairment | \$3,521   | \$—       | \$266                  | \$—         | \$3,787   |
| Loans collectively evaluated for impairment | 80,168  | 118,166   | 61,222                 | —           | 259,556   |
| Ending balance                              | \$83,689  | \$118,166 | \$61,488               | \$—         | \$263,343 |
|   | At or For the Nine Months Ended September 30, 2012  |           |                        |             |           |
| ALLOWANCE FOR LOAN LOSSES                   | Real Estate   | Consumer  | Commercial<br>Business | Unallocated | Total     |
| Beginning balance                           | \$803   | \$2,846   | \$511                  | \$185       | \$4,345   |
| Provision for loan losses                   | 1,215   | 434       | 212                    | (166)       | 1,695     |
| Charge-offs                                 | (490)   | (1,868)   | (110)                  | —           | (2,468)   |
| Recoveries                                  | 4   | 783       | —                      | —           | 787       |
| Net charge-offs                             | (486)   | (1,085)   | (110)                  | —           | (1,681)   |
| Ending balance                              | \$1,532   | \$2,195   | \$613                  | \$19        | \$4,359   |
| Period end amount allocated to:             |   |           |                        |             |           |
| Loans individually evaluated for impairment | \$167   | \$—       | \$28                   | \$—         | \$195     |
| Loans collectively evaluated for impairment | 1,365   | 2,195     | 585                    | 19          | 4,164     |
| Ending balance                              | \$1,532   | \$2,195   | \$613                  | \$19        | \$4,359   |
| LOANS RECEIVABLE                            |   |           |                        |             |           |
| Loans individually evaluated for impairment | \$3,521   | \$—       | \$266                  | \$—         | \$3,787   |
| Loans collectively evaluated for impairment | 80,168  | 118,166   | 61,222                 | —           | 259,556   |
| Ending balance                              | \$83,689  | \$118,166 | \$61,488               | \$—         | \$263,343 |





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## NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

Information pertaining to aging analysis of past due loans are summarized as follows:

|                                      | September 30, 2013                |               |                                |                   |             |           |                           |
|--------------------------------------|-----------------------------------|---------------|--------------------------------|-------------------|-------------|-----------|---------------------------|
|                                      | Loans Past Due and Still Accruing |               |                                |                   |             |           |                           |
|                                      | 30-59<br>Days                     | 60-89<br>Days | 90 Days<br>or More<br>Past Due | Total<br>Past Due | Non-Accrual | Current   | Total Loans<br>Receivable |
| <b>REAL ESTATE LOANS</b>             |                                   |               |                                |                   |             |           |                           |
| Commercial                           | \$—                               | \$—           | \$—                            | \$—               | \$ 611      | \$36,716  | \$37,327                  |
| Construction and development         | —                                 | —             | —                              | —                 | —           | 43,088    | 43,088                    |
| Home equity                          | 389                               | 249           | —                              | 638               | 114         | 15,501    | 16,253                    |
| One-to-four-family                   | 1,104                             | —             | —                              | 1,104             | 340         | 17,410    | 18,854                    |
| Multi-family                         | —                                 | —             | —                              | —                 | —           | 4,723     | 4,723                     |
| Total real estate loans              | 1,493                             | 249           | —                              | 1,742             | 1,065       | 117,438   | 120,245                   |
| <b>CONSUMER</b>                      |                                   |               |                                |                   |             |           |                           |
| Indirect home improvement            | 582                               | 379           | —                              | 961               | 341         | 98,536    | 99,838                    |
| Marine                               | 66                                | —             | —                              | 66                | —           | 20,565    | 20,631                    |
| Automobile                           | 36                                | 1             | —                              | 37                | 2           | 1,183     | 1,222                     |
| Recreational                         | 4                                 | —             | —                              | 4                 | —           | 580       | 584                       |
| Home improvement                     | 7                                 | —             | —                              | 7                 | —           | 488       | 495                       |
| Other                                | 20                                | —             | —                              | 20                | —           | 1,290     | 1,310                     |
| Total consumer loans                 | 715                               | 380           | —                              | 1,095             | 343         | 122,642   | 124,080                   |
| <b>COMMERCIAL<br/>BUSINESS LOANS</b> |                                   |               |                                |                   |             |           |                           |
|                                      | —                                 | —             | —                              | —                 | 116         | 45,003    | 45,119                    |
| Total                                | \$2,208                           | \$629         | \$—                            | \$2,837           | \$ 1,524    | \$285,083 | \$289,444                 |

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## NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

|                              | December 31, 2012                 |               |                                |                   | Non-Accrual | Current   | Total<br>Loans<br>Receivable |
|------------------------------|-----------------------------------|---------------|--------------------------------|-------------------|-------------|-----------|------------------------------|
|                              | Loans Past Due and Still Accruing |               |                                |                   |             |           |                              |
|                              | 30-59<br>Days                     | 60-89<br>Days | 90 Days<br>or More<br>Past Due | Total<br>Past Due |             |           |                              |
| <b>REAL ESTATE LOANS</b>     |                                   |               |                                |                   |             |           |                              |
| Commercial                   | \$—                               | \$—           | \$—                            | —                 | \$ 783      | \$32,467  | 33,250                       |
| Construction and development | —                                 | —             | —                              | —                 | —           | 31,893    | 31,893                       |
| Home equity                  | 192                               | 484           | —                              | 676               | 248         | 14,550    | 15,474                       |
| One-to-four-family           | —                                 | —             | —                              | —                 | 344         | 13,632    | 13,976                       |
| Multi-family                 | —                                 | —             | —                              | —                 | —           | 3,202     | 3,202                        |
| Total real estate loans      | 192                               | 484           | —                              | 676               | 1,375       | 95,744    | 97,795                       |
| <b>CONSUMER</b>              |                                   |               |                                |                   |             |           |                              |
| Indirect home improvement    | 653                               | 300           | —                              | 953               | 295         | 85,001    | 86,249                       |
| Marine                       | 84                                | 2             | —                              | 86                | —           | 17,140    | 17,226                       |
| Automobile                   | 68                                | 1             | —                              | 69                | 10          | 2,337     | 2,416                        |
| Recreational                 | 44                                | —             | —                              | 44                | —           | 698       | 742                          |
| Home improvement             | —                                 | —             | —                              | —                 | 32          | 619       | 651                          |
| Other                        | 8                                 | 11            | —                              | 19                | —           | 1,367     | 1,386                        |
| Total consumer loans         | 857                               | 314           | —                              | 1,171             | 337         | 107,162   | 108,670                      |
| <b>COMMERCIAL</b>            |                                   |               |                                |                   |             |           |                              |
| BUSINESS LOANS               | —                                 | —             | —                              | —                 | 194         | 73,271    | 73,465                       |
| Total                        | \$1,049                           | \$798         | \$—                            | \$1,847           | \$ 1,906    | \$276,177 | \$279,930                    |

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## NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following tables provide additional information about our impaired loans that have been segregated to reflect loans for which an allowance for credit losses has been provided and loans for which no allowance has been provided:

At or For the Nine Months Ended September 30, 2013

|   | Unpaid<br>Principal<br>Balance | Write-<br>downs | Recorded<br>Investment | Specific<br>Reserve | Adjusted<br>Recorded<br>Investment | YTD<br>Average<br>Recorded<br>Investment | YTD<br>Interest<br>Income<br>Recognized |
|---|--------------------------------|-----------------|------------------------|---------------------|------------------------------------|--|---|
| <b>WITH NO RELATED<br/>ALLOWANCE<br/>RECORDED</b> |                                |                 |                        |                     |                                    |  |   |
| Commercial  | \$—                            | \$—             | \$—                    | \$—                 | \$—                                | \$—                                      | \$—                                     |
| Construction and<br>development                   | —                              | —               | —                      | —                   | —                                  | —  | —                                       |
| Home equity                                       | —                              | —               | —                      | —                   | —                                  | —  | —                                       |
| One-to-four-family                                | 1,136                          | (169 )          | 967                    | —                   | 967                                | 956                                      | 45                                      |
| Multi-family                                      | —                              | —               | —                      | —                   | —                                  | —  | —                                       |
| Indirect home<br>improvement                      | —                              | —               | —                      | —                   | —                                  | —  | —                                       |
| Marine  | —                              | —               | —                      | —                   | —                                  | —  | —                                       |
| Automobile  | —                              | —               | —                      | —                   | —                                  | —  | —                                       |
| Recreational                                      | —                              | —               | —                      | —                   | —                                  | —  | —                                       |
| Home improvement                                  | —                              | —               | —                      | —                   | —                                  | —  | —                                       |
| Other   | —                              | —               | —                      | —                   | —                                  | —  | —                                       |
| Commercial business<br>loans                      | 166                            | (72 )           | 94                     | —                   | 94                                 | 94                                       | —                                       |
| Subtotal loans                                    | 1,302                          | (241 )          | 1,061                  | —                   | 1,061                              | 1,050                                    | 45                                      |
| <b>WITH AN<br/>ALLOWANCE<br/>RECORDED</b>         |                                |                 |                        |                     |                                    |  |   |
| Commercial  | 2,248                          | (109 )          | 2,139                  | (244 )              | 1,895                              | 2,183                                    | 62                                      |
| Construction and<br>development                   | —                              | —               | —                      | —                   | —                                  | —  | —                                       |
| Home equity                                       | 90                             | —               | 90                     | (38 )               | 52                                 | 90                                       | —                                       |
| One-to-four-family                                | 159                            | (18 )           | 141                    | (21 )               | 120                                | 157                                      | —                                       |
| Multi-family                                      | —                              | —               | —                      | —                   | —                                  | —  | —                                       |
| Indirect home<br>improvement                      | —                              | —               | —                      | —                   | —                                  | —  | —                                       |
| Marine  | —                              | —               | —                      | —                   | —                                  | —  | —                                       |
| Automobile  | —                              | —               | —                      | —                   | —                                  | —  | —                                       |
| Recreational                                      | —                              | —               | —                      | —                   | —                                  | —  | —                                       |
| Home improvement                                  | —                              | —               | —                      | —                   | —                                  | —  | —                                       |
| Other   | —                              | —               | —                      | —                   | —                                  | —  | —                                       |

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|                           |         |        |           |        |           |         |       |
|---------------------------|---------|--------|-----------|--------|-----------|---------|-------|
| Commercial business loans | 81      | (3     | ) 78      | (28    | ) 50      | 68      | 1     |
| Subtotal loans            | 2,578   | (130   | ) 2,448   | (331   | ) 2,117   | 2,498   | 63    |
| Total                     | \$3,880 | \$(371 | ) \$3,509 | \$(331 | ) \$3,178 | \$3,548 | \$108 |

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## NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

|   | At or For the Year Ended December 31, 2012 |                 |                        |                     |                                    |  |   |
|---|--|-----------------|------------------------|---------------------|------------------------------------|--|---|
|   | Unpaid<br>Principal<br>Balance             | Write-<br>downs | Recorded<br>Investment | Specific<br>Reserve | Adjusted<br>Recorded<br>Investment | YTD<br>Average<br>Recorded<br>Investment | YTD<br>Interest<br>Income<br>Recognized |
| <b>WITH NO RELATED<br/>ALLOWANCE<br/>RECORDED</b> |  |                 |                        |                     |                                    |  |   |
| Commercial  | \$—  | \$—             | \$—                    | \$—                 | \$—                                | \$—                                      | \$—                                     |
| Construction and<br>development                   | —  | —               | —                      | —                   | —                                  | —  | —                                       |
| Home equity                                       | 111  | —               | 111                    | —                   | 111                                | 112                                      | 3                                       |
| One-to-four-family                                | 1,295                                      | (170 )          | 1,125                  | —                   | 1,125                              | 1,172                                    | 30                                      |
| Multi-family                                      | —  | —               | —                      | —                   | —                                  | —  | —                                       |
| Indirect home<br>improvement                      | —  | —               | —                      | —                   | —                                  | —  | —                                       |
| Marine  | —  | —               | —                      | —                   | —                                  | —  | —                                       |
| Automobile  | —  | —               | —                      | —                   | —                                  | —  | —                                       |
| Recreational                                      | —  | —               | —                      | —                   | —                                  | —  | —                                       |
| Home improvement                                  | —  | —               | —                      | —                   | —                                  | —  | —                                       |
| Other   | —  | —               | —                      | —                   | —                                  | —  | —                                       |
| Commercial business<br>loans                      | 241  | (111 )          | 130                    | —                   | 130                                | 172                                      | —                                       |
| Subtotal loans                                    | 1,647                                      | (281 )          | 1,366                  | —                   | 1,366                              | 1,456                                    | 33                                      |
| <b>WITH AN<br/>ALLOWANCE<br/>RECORDED</b>         |  |                 |                        |                     |                                    |  |   |
| Commercial  | 950  | (167 )          | 783                    | (39 )               | 744                                | 893                                      | 7                                       |
| Construction and<br>development                   | —  | —               | —                      | —                   | —                                  | —  | —                                       |
| Home equity                                       | 1,625                                      | (38 )           | 1,587                  | (79 )               | 1,508                              | 1,616                                    | 68                                      |
| One-to-four-family                                | —  | —               | —                      | —                   | —                                  | —  | —                                       |
| Multi-family                                      | —  | —               | —                      | —                   | —                                  | —  | —                                       |
| Indirect home<br>improvement                      | —  | —               | —                      | —                   | —                                  | —  | —                                       |
| Marine  | —  | —               | —                      | —                   | —                                  | —  | —                                       |
| Automobile  | —  | —               | —                      | —                   | —                                  | —  | —                                       |
| Recreational                                      | —  | —               | —                      | —                   | —                                  | —  | —                                       |
| Home improvement                                  | —  | —               | —                      | —                   | —                                  | —  | —                                       |
| Other   | —  | —               | —                      | —                   | —                                  | —  | —                                       |

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|                           |         |        |   |         |        |   |         |         |       |
|---------------------------|---------|--------|---|---------|--------|---|---------|---------|-------|
| Commercial business loans | 67      | (3     | ) | 64      | (7     | ) | 57      | 68      | 5     |
| Subtotal loans            | 2,642   | (208   | ) | 2,434   | (125   | ) | 2,309   | 2,577   | 80    |
| Total                     | \$4,289 | \$(489 | ) | \$3,800 | \$(125 | ) | \$3,675 | \$4,033 | \$113 |

The average recorded investment in impaired loans was unchanged at \$3.5 million and \$3.8 million for the three and nine months ended September 30, 2013, and 2012, respectively. For the three and nine months ended September 30, 2013, the Company recognized interest income on impaired loans of \$28,000 and \$108,000, respectively, compared to \$96,000 and \$100,000, respectively, for same periods a year ago.

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FS BANCORP, INC. AND SUBSIDIARY  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

Credit Quality Indicators

As part of the Company's on-going monitoring of credit quality of the loan portfolio, management tracks certain credit quality indicators including trends related to (i) the risk grading of loans, (ii) the level of classified loans, (iii) net charge-offs, (iv) non-performing loans and (v) the general economic conditions in the Company's market.

The Company utilizes a risk grading matrix to assign a risk grade to its real estate and commercial business loans. Loans are graded on a scale of 1 to 10, with loans in risk grades 1 to 6 considered "Pass" and loans in risk grades 7 to 10 are reported as classified loans in the Company's allowance for loan loss analysis.

A description of the 10 risk grades is as follows:

• Grades 1 and 2 – These grades include loans to very high quality borrowers with excellent or desirable business credit.

• Grade 3 – This grade includes loans to borrowers of good business credit with moderate risk.

• Grades 4 and 5 – These grades include "Pass" grade loans to borrowers of average credit quality and risk.

• Grade 6 – This grade includes loans on management's "Watch" list and is intended to be utilized on a temporary basis for "Pass" grade borrowers where frequent and thorough monitoring is required due to credit weaknesses and where significant risk-modifying action is anticipated in the near term.

• Grade 7 – This grade is for "Other Assets Especially Mentioned (OAEM)" in accordance with regulatory guidelines and includes borrowers where performance is poor or significantly less than expected.

• Grade 8 – This grade includes "Substandard" loans in accordance with regulatory guidelines which represent an unacceptable business credit where a loss is possible if loan weakness is not corrected.

• Grade 9 – This grade includes "Doubtful" loans in accordance with regulatory guidelines where a loss is highly probable.

• Grade 10 – This grade includes "Loss" loans in accordance with regulatory guidelines for which total loss is expected and when identified are charged off.

Consumer, Home Equity and One-to-Four-Family Real Estate Loans

Homogeneous loans are risk rated based upon the FDIC's Uniform Retail Credit Classification and Account Management Policy. Loans classified under this policy at the Company are consumer loans which include indirect home improvement, recreational, automobile, direct home improvement and other, and one-to-four-family first and second liens. Under the Uniform Retail Credit Classification Policy, loans that are current or less than 90 days past due are graded "Pass" and risk graded "4" internally. Loans that are past due more than 90 days are classified "Substandard" and risk graded "8" internally. At 120 days past due, homogeneous loans are charged off based on the value of the collateral less cost to sell.





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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

The following tables summarize risk rated loan balances by category:

|                              | September 30, 2013 |              |                           |                    |             |              |           |
|------------------------------|--------------------|--------------|---------------------------|--------------------|-------------|--------------|-----------|
|                              | Pass (1 -<br>5)    | Watch<br>(6) | Special<br>Mention<br>(7) | Substandard<br>(8) | Doubtful(9) | Loss<br>(10) | Total     |
| <b>REAL ESTATE LOANS</b>     |                    |              |                           |                    |             |              |           |
| Commercial                   | \$35,187           | \$—          | \$—                       | \$2,140            | \$ —        | \$—          | \$37,327  |
| Construction and development | 43,088             | —            | —                         | —                  | —           | —            | 43,088    |
| Home equity                  | 16,139             | —            | —                         | 114                | —           | —            | 16,253    |
| One-to-four-family           | 17,746             | —            | —                         | 1,108              | —           | —            | 18,854    |
| Multi-family                 | 4,723              | —            | —                         | —                  | —           | —            | 4,723     |
| Total real estate loans      | 116,883            | —            | —                         | 3,362              | —           | —            | 120,245   |
| <b>CONSUMER</b>              |                    |              |                           |                    |             |              |           |
| Indirect home improvement    | 99,497             | —            | —                         | 341                | —           | —            | 99,838    |
| Marine                       | 20,631             | —            | —                         | —                  | —           | —            | 20,631    |
| Automobile                   | 1,220              | —            | —                         | 2                  | —           | —            | 1,222     |
| Recreational                 | 584                | —            | —                         | —                  | —           | —            | 584       |
| Home improvement             | 495                | —            | —                         | —                  | —           | —            | 495       |
| Other                        | 1,310              | —            | —                         | —                  | —           | —            | 1,310     |
| Total consumer loans         | 123,737            | —            | —                         | 343                | —           | —            | 124,080   |
| COMMERCIAL BUSINESS LOANS    | 44,157             | 790          | —                         | 150                | —           | 22           | 45,119    |
| Total                        | \$284,777          | \$790        | \$—                       | \$3,855            | \$ —        | \$22         | \$289,444 |
| <b>December 31, 2012</b>     |                    |              |                           |                    |             |              |           |
|                              | Pass (1 -<br>5)    | Watch<br>(6) | Special<br>Mention<br>(7) | Substandard<br>(8) | Doubtful(9) | Loss<br>(10) | Total     |
| <b>REAL ESTATE LOANS</b>     |                    |              |                           |                    |             |              |           |
| Commercial                   | \$29,145           | \$3,322      | \$—                       | \$783              | \$ —        | \$—          | \$33,250  |
| Construction and development | 30,306             | —            | —                         | 1,587              | —           | —            | 31,893    |
| Home equity                  | 15,226             | —            | —                         | 248                | —           | —            | 15,474    |
| One-to-four-family           | 12,851             | —            | —                         | 1,125              | —           | —            | 13,976    |
| Multi-family                 | 3,202              | —            | —                         | —                  | —           | —            | 3,202     |
| Total real estate loans      | 90,730             | 3,322        | —                         | 3,743              | —           | —            | 97,795    |
| <b>CONSUMER</b>              |                    |              |                           |                    |             |              |           |
| Indirect home improvement    | 85,954             | —            | —                         | 295                | —           | —            | 86,249    |
| Marine                       | 17,226             | —            | —                         | —                  | —           | —            | 17,226    |
| Automobile                   | 2,406              | —            | —                         | 10                 | —           | —            | 2,416     |
| Recreational                 | 742                | —            | —                         | —                  | —           | —            | 742       |
| Home improvement             | 619                | —            | —                         | 32                 | —           | —            | 651       |
| Other                        | 1,386              | —            | —                         | —                  | —           | —            | 1,386     |
| Total consumer loans         | 108,333            | —            | —                         | 337                | —           | —            | 108,670   |

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|                           |           |         |       |         |      |     |           |
|---------------------------|-----------|---------|-------|---------|------|-----|-----------|
| COMMERCIAL BUSINESS LOANS | 72,596    | —       | 675   | 194     | —    | —   | 73,465    |
| Total                     | \$271,659 | \$3,322 | \$675 | \$4,274 | \$ — | \$— | \$279,930 |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

## Troubled Debt Restructured Loans

The Company had five and three troubled debt restructured ("TDR") loans still on accrual and included in impaired loans at September 30, 2013 and at December 31, 2012, respectively. In addition, at September 30, 2013 and December 31, 2012 the Company had one and three loans on non-accrual of \$44,000 and \$892,000, respectively. The one non-accrual loan at September 30, 2013 was a home equity loan. The Company had no commitments to lend additional funds on these restructured loans.

A summary of TDR loans at the dates indicated is as follows:

|   | September 30,<br>2013 | December 31,<br>2012 |
|---|-----------------------|----------------------|
| Troubled debt restructured loans still on accrual | \$2,353               | \$2,368              |
| Troubled debt restructured loans on non-accrual   | 44                    | 892                  |
| Total troubled debt restructured loans            | \$2,397               | \$3,260              |

The following tables present loans that became TDRs during the following periods:

|       | At or For the Three Months Ended September 30,<br>2013 |                        |                             |                                    | 2012                      |                        |                             |                                    |
|-------|--|------------------------|-----------------------------|------------------------------------|---------------------------|------------------------|-----------------------------|------------------------------------|
|       | Number<br>of<br>Contracts                              | Recorded<br>Investment | Increase<br>in<br>Allowance | Charge-offs<br>to the<br>Allowance | Number<br>of<br>Contracts | Recorded<br>Investment | Increase<br>in<br>Allowance | Charge-offs<br>to the<br>Allowance |
| Total | —  | \$—                    | \$—                         | \$—                                | —                         | \$—                    | \$—                         | \$—                                |
|       | —  | \$—                    | \$—                         | \$—                                | —                         | \$—                    | \$—                         | \$—                                |

|                        | At or For the Nine Months Ended September 30,<br>2013 |                        |                                 |                                    | 2012                      |                        |                             |                                    |
|------------------------|---|------------------------|---------------------------------|------------------------------------|---------------------------|------------------------|-----------------------------|------------------------------------|
|                        | Number<br>of<br>Contracts                             | Recorded<br>Investment | Increase in<br>the<br>Allowance | Charge-offs<br>to the<br>Allowance | Number<br>of<br>Contracts | Recorded<br>Investment | Increase<br>in<br>Allowance | Charge-offs<br>to the<br>Allowance |
| Commercial<br>Business | 1   | \$35                   | \$—                             | \$35                               | 1                         | \$70                   | \$7                         | \$2                                |
| Total                  | 1   | \$35                   | \$—                             | \$35                               | 1                         | \$70                   | \$7                         | \$2                                |

There were no TDRs recorded in the twelve months prior to September 30, 2013 and 2012, that subsequently defaulted in the nine months ended September 30, 2013 and 2012, respectively.

The recorded investments in the tables above are period end balances that are inclusive of all partial pay-downs and charge-offs since the modification date. Loans modified in a TDR that were fully paid down, charged off, or

foreclosed upon by the period end are not included.

TDRs in the tables above were the result of interest rate modifications and extended payment terms. The Company has not forgiven any principal on the above loans.

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## NOTE 4 – MORTGAGE, COMMERCIAL AND CONSUMER SERVICING RIGHTS

Loans serviced for others are not included on the consolidated balance sheets. The unpaid principal balances of mortgage, commercial and consumer loans serviced for others were \$230.0 million and \$130.5 million at September 30, 2013 and December 31, 2012, respectively. The fair market value of the mortgage, commercial and consumer servicing rights' asset at September 30, 2013 and December 31, 2012 was \$2.3 million and \$1.1 million, respectively, included in other assets. Fair value adjustments to mortgage, commercial and consumer servicing rights were mainly due to market based assumptions associated with loan prepayment speeds and changes in interest rates.

The following table summarizes mortgage, commercial and consumer servicing rights activity for the three and nine months ended September 30, 2013 and 2012:

|  | At or For the Three Months Ended<br>September 30, |       |
|--|---|-------|
|  | 2013  | 2012  |
| Beginning balance  | \$1,785   | \$425 |
| Additions  | 350   | 327   |
| Mortgage, commercial and consumer servicing rights amortized | (110)   | (36)  |
| (Impairment) recovery of loss on servicing rights            | 2   | (108) |
| Ending balance   | \$2,027   | \$608 |

  

|  | At or For the Nine Months Ended<br>September 30, |       |
|--|--|-------|
|  | 2013   | 2012  |
| Beginning balance  | \$1,064  | \$200 |
| Additions  | 1,141  | 596   |
| Mortgage, commercial and consumer servicing rights amortized | (280)  | (83)  |
| (Impairment) recovery of loss on servicing rights            | 102  | (105) |
| Ending balance   | \$2,027  | \$608 |

## NOTE 5 - DERIVATIVES

The Company regularly enters into commitments to originate and sell loans held for sale. The Company has established a hedging strategy to protect itself against the risk of loss associated with interest rate movements on loan commitments. The Company enters into contracts to sell forward To-Be-Announced ("TBA") mortgage-backed securities. These commitments and contracts are considered derivatives but have not been designated as hedging instruments. Rather, they are accounted for as free-standing derivatives, or economic hedges, with changes in the fair value of the derivatives reported in noninterest income. The Company recognizes all derivative instruments as either other assets or other liabilities on the consolidated balance sheet and measures those instruments at fair value.

As of September 30, 2013, the Company had fallout adjusted interest rate lock commitments with customers of \$17.0 million, with a fair value of \$642,000. The Company also had mandatory and best effort forward commitments with investors with a notional balance of \$4.4 million, and a fair market value of (\$53,000), included in other liabilities.

The Company had forward TBA mortgage-backed securities of \$19.5 million at September 30, 2013, with a fair value of (\$398,000). The Company also had TBA mortgage-backed securities forward sales that had been paired off with

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## NOTE 5 - DERIVATIVES (Continued)

investors of \$11.0 million, with the fair value of these pair off commitments of \$13,000 at September 30, 2013 included in other assets.

The income on derivatives from fair value changes recognized in other noninterest income on the consolidated statements of operations, included in gain on sale of loans was \$42,000 and none for the three months ended September 30, 2013 and 2012, respectively and \$1.4 million and none for the nine months ended September 30, 2013 and 2012, respectively.

Derivatives were considered to be immaterial for the year ended December 31, 2012.

## NOTE 6 – OTHER REAL ESTATE OWNED

The following table presents the activity related to OREO for the three and nine months ended September 30, 2013 and 2012:

|                        | For the Three Months Ended<br>September 30, |         | For the Nine Months Ended<br>September 30, |          |
|------------------------|---|---------|--|----------|
|                        | 2013  | 2012    | 2013                                       | 2012     |
| Beginning balance      | \$1,805                                     | \$2,950 | \$2,127                                    | \$4,589  |
| Additions              | 605   | —       | 642  | 921      |
| Fair value write-downs | (151 )                                      | (99 )   | (347 )                                     | (693 )   |
| Disposition of assets  | —   | (530 )  | (163 )                                     | (2,496 ) |
| Ending balance         | \$2,259                                     | \$2,321 | \$2,259                                    | \$2,321  |

At September 30, 2013, OREO consisted of five properties located in Washington, with balances ranging from \$36,000 to \$797,000. For the three months ended September 30, 2013 and 2012, the Company recorded no net loss, and for the nine months ended September 30, 2013 and 2012, the Company recorded no net loss and a \$35,000 net loss, respectively, on disposals of OREO. Holding costs associated with OREO were \$41,000 and \$57,000, for the three months ended September 30, 2013 and 2012, and \$79,000 and \$155,000, for the nine months ended September 30, 2013 and 2012, respectively.





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## NOTE 7 – DEPOSITS

Deposits are summarized as follows as of September 30, 2013 and December 31, 2012:

|  | September 30,<br>2013 | December 31,<br>2012 |
|--|-----------------------|----------------------|
| Interest-bearing checking                                      | \$27,836              | \$24,348             |
| Noninterest-bearing checking                                   | 42,579                | 34,165               |
| Savings  | 14,821                | 11,812               |
| Money market   | 115,652               | 114,246              |
| Certificates of deposits of less than \$100,000 <sup>(1)</sup> | 42,893                | 40,119               |
| Certificates of deposits of \$100,000 through \$250,000        | 48,722                | 43,810               |
| Certificates of deposits of more than \$250,000                | 24,365                | 20,449               |
| Total  | \$316,868             | \$288,949            |

(1): Includes \$16.9 million and \$13.9 million of brokered deposits as of September 30, 2013 and December 31, 2012, respectively.

Scheduled maturities of time deposits for future periods ending were as follows:

|            | As of September 30,<br>2013 |
|------------|-----------------------------|
| 2013       | \$ 15,605                   |
| 2014       | 47,961                      |
| 2015       | 34,953                      |
| 2016       | 8,768                       |
| 2017       | 5,007                       |
| Thereafter | 3,686                       |
| Total      | \$ 115,980                  |

The Bank pledged two securities held at the Federal Home Loan Bank ("FHLB") of Seattle with a fair value of \$1.2 million to secure Washington State public deposits of \$250,000 with a collateral requirement of \$117,000, at September 30, 2013.

Federal Reserve regulations require that the Bank maintain reserves in the form of cash on hand and deposit balances with the FRB, based on a percentage of deposits. The amounts of such balances at September 30, 2013 and December 31, 2012 were \$1.4 million and \$1.3 million, respectively and were in compliance with FRB regulations.

Interest expense by deposit category for the three and nine months ended September 30, 2013 and 2012 was as follows:

|                           | For Three Months Ended<br>September 30, |       | For Nine Months Ended<br>September 30, |         |
|---------------------------|---|-------|--|---------|
|                           | 2013                                    | 2012  | 2013                                   | 2012    |
| Interest-bearing checking | \$9                                     | \$11  | \$25                                   | \$41    |
| Savings and money market  | 138                                     | 136   | 396                                    | 447     |
| Certificates of deposit   | 355                                     | 396   | 1,017                                  | 1,227   |
| Total                     | \$502                                   | \$543 | \$1,438                                | \$1,715 |



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## NOTE 8 – INCOME TAXES

The Company recorded a provision for income taxes of \$1.8 million during the nine months ended September 30, 2013. During the nine months ended September 30, 2012, the Company recorded a net \$2.3 million income tax benefit which was the result of reversing substantially all of the deferred tax asset valuation allowance.

At September 30, 2013, the Company had net operating loss carryforwards of approximately \$963,000, which begin to expire in 2028. The Company files a consolidated U.S. Federal income tax return, which is subject to examinations by tax authorities for years 2010 and later. At September 30, 2013, the Company had no uncertain tax positions. The Company recognizes interest and penalties in tax expense and at September 30, 2013, the Company had recognized no interest and penalties.

The Company may also be subject to certain limitations under Section 382 of the Internal Revenue Code that relates to the utilization of the net operating losses and other tax benefits following an ownership change.

## NOTE 9 – COMMITMENTS AND CONTINGENCIES

Commitments – The Company is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized on the balance sheet.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

A summary of the Company's commitments at September 30, 2013 and December 31, 2012 were as follows:

|                              | September 30,<br>2013 | December 31,<br>2012 |
|------------------------------|-----------------------|----------------------|
| COMMITMENTS TO EXTEND CREDIT |                       |                      |
| REAL ESTATE LOANS            |                       |                      |
| Construction and development | \$29,462              | \$27,347             |
| One-to-four-family           | 24,154                | 19,313               |
| Home equity                  | 11,187                | 11,928               |
| Commercial/Multi-family      | 518                   | 3,241                |
| Total real estate loans      | 65,321                | 61,829               |
| CONSUMER LOANS               |                       |                      |
| Indirect home improvement    | 388                   | 568                  |
| Other                        | 6,206                 | 6,225                |
| Total consumer loans         | 6,594                 | 6,793                |

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|                                    |            |            |
|------------------------------------|------------|------------|
| COMMERCIAL BUSINESS LOANS          | 58,231     | 41,025     |
| Total commitments to extend credit | \$ 130,146 | \$ 109,647 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the party. Collateral held varies, but may include

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NOTE 9 – COMMITMENTS AND CONTINGENCIES (Continued)

accounts receivable, inventory, property and equipment, residential real estate, and income-producing commercial properties.

Unfunded commitments under commercial lines-of-credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines-of-credit are uncollateralized and usually do not contain a specified maturity date and ultimately may not be drawn upon to the total extent to which the Company is committed. The Company has established reserves for estimated losses from unfunded commitments of \$58,000 and \$49,000 as of September 30, 2013 and December 31, 2012, respectively. One-to-four-family commitments listed above are accounted for as fair value derivatives and do not carry an associated loss reserve.

The Company has entered into a severance agreement (the “Agreement”) with its Chief Executive Officer. The Agreement, subject to certain requirements, generally includes a lump sum payment to the Chief Executive Officer equal to 24 months of base compensation in the event his employment is involuntarily terminated, other than for cause or the executive terminates his employment with good reason, as defined in the Agreement.

The Company has entered into change of control agreements (the “Agreements”) with its Chief Financial Officer and the Chief Operating Officer. The Agreements, subject to certain requirements, generally remain in effect until canceled by either party upon at least 24 months prior written notice. Under the Agreements the executive generally will be entitled to a change of control payment from the Company if they are involuntarily terminated within six months preceding or 12 months after a change in control (as defined in the Agreements). In such an event, the executives would each be entitled to receive a cash payment in an amount equal to 12 months of their then current salary, subject to certain requirements in the Agreements.

Because of the nature of our activities, the Company is subject to various pending and threatened legal actions, which arise in the ordinary course of business. From time to time, subordination liens may create litigation which requires us to defend our lien rights. In the opinion of management, liabilities arising from these claims, if any, will not have a material effect on our financial position.

In the ordinary course of business, the Company sells loans without recourse that may have to subsequently be repurchased due to defects that occurred during the origination of the loan. The defects are categorized as documentation errors, underwriting errors, early payment defaults, breach of representation or warranty, and fraud. When a loan sold to an investor without recourse fails to perform according to its contractual terms, the investor will typically review the loan file to determine whether defects in the origination process occurred. If a defect is identified, the Company may be required to either repurchase the loan or indemnify the investor for losses sustained. If there are no such defects, the Company has no commitment to repurchase the loan. The Company has recorded a \$159,000 reserve to cover loss exposure related to these guarantees for one-to-four-family loans sold into the secondary market at September 30, 2013.

In the third quarter of 2013, the Company sold a portion of the consumer loan portfolio with an unpaid principal balance of approximately \$5.2 million. Under the terms of this sale, the Company had recourse for loans that become past due more than 50 days before March 31, 2014 and had recorded a reserve of \$42,000 for this potential past due recourse.

NOTE 10 – SIGNIFICANT CONCENTRATION OF CREDIT RISK

Most of the Company's business activity is primarily with customers located in the greater Puget Sound area. The Company originates real estate and consumer loans and has concentrations in these areas. Generally loans are secured by deposit accounts, personal property, or real estate. Rights to collateral vary and are legally documented to the extent practicable. Local economic conditions may affect borrowers' ability to meet the stated repayment terms.

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## NOTE 11 – REGULATORY CAPITAL

FS Bancorp, Inc. and its subsidiary bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory – and possibly additional discretionary – actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines of the regulatory framework for prompt corrective

action, the Company must meet specific capital adequacy guidelines that involve quantitative measures of the Company's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's capital classification is also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

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

As of September 30, 2013 and December 31, 2012, the Bank was categorized as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total Risk-Based, Tier 1 Risk-Based, and Tier 1 Leverage ratios as set forth in the table below. There are no conditions or events since that notification that management believes have changed the Bank's category. At September 30, 2013, the Bank exceeded all regulatory capital requirements with Tier 1 Leverage-Based Capital, Tier 1 Risk-Based Capital and Total Risk-Based Capital ratios of 12.7%, 15.6%, and 16.9%, respectively.

The Bank's actual capital amounts and ratios at September 30, 2013 and December 31, 2012 are also presented in the table.

|  | Actual   |       | For Capital |          | To be Well Capitalized  |                   |   |
|--|----------|-------|-------------|----------|-------------------------|-------------------|---|
|  | Amount   | Ratio | Adequacy    | Purposes | Under Prompt Corrective | Action Provisions |   |
|  |          |       | Amount      | Ratio    | Amount                  | Ratio             |   |
| As of September 30, 2013                               |          |       |             |          |                         |                   |   |
| Total Risk-Based Capital<br>(to Risk-weighted Assets)  | \$54,521 | 16.86 | % \$25,868  | 8.00     | % \$32,335              | 10.00             | % |
| Tier 1 Risk-Based Capital<br>(to Risk-weighted Assets) | \$50,460 | 15.61 | % \$12,934  | 4.00     | % \$19,401              | 6.00              | % |
| Tier 1 Leverage Capital<br>(to Average Assets)         | \$50,460 | 12.74 | % \$15,840  | 4.00     | % \$19,800              | 5.00              | % |
| As of December 31, 2012                                |          |       |             |          |                         |                   |   |
| Total Risk-Based Capital<br>(to Risk-weighted Assets)  | \$50,591 | 16.00 | % \$25,294  | 8.00     | % \$31,617              | 10.00             | % |
| Tier 1 Risk-Based Capital<br>(to Risk-weighted Assets) | \$46,627 | 14.75 | % \$12,647  | 4.00     | % \$18,970              | 6.00              | % |



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|  |          |       |   |          |      |   |          |      |   |
|--|----------|-------|---|----------|------|---|----------|------|---|
| Tier 1 Leverage Capital<br>(to Average Assets) | \$46,627 | 13.26 | % | \$14,066 | 4.00 | % | \$17,583 | 5.00 | % |
|--|----------|-------|---|----------|------|---|----------|------|---|

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 11 – REGULATORY CAPITAL (Continued)

Regulatory capital levels reported above differ from the Company's total equity, computed in accordance with U.S. GAAP.

|  | Company               |                      | Bank                  |                      |
|--|-----------------------|----------------------|-----------------------|----------------------|
|  | September 30,<br>2013 | December 31,<br>2012 | September 30,<br>2013 | December 31,<br>2012 |
| Equity   | \$62,234              | \$59,897             | \$50,182              | \$47,836             |
| Unrealized loss (gain) on securities<br>available-for-sale             | 481                   | (597)                | ) 481                 | (597)                |
| Disallowed deferred tax assets   | —                     | (506)                | ) —                   | (506)                |
| Disallowed servicing assets  | (203)                 | ) (106)              | ) (203)               | ) (106)              |
| Total Tier 1 capital   | 62,512                | 58,688               | 50,460                | 46,627               |
| Allowance for loan and lease losses for<br>regulatory capital purposes | 4,061                 | 3,964                | 4,061                 | 3,964                |
| Total risk-based capital   | \$66,573              | \$62,652             | \$54,521              | \$50,591             |

The Company exceeded all regulatory capital requirements as of September 30, 2013. The regulatory capital ratios calculated for the Company as of September 30, 2013 were 15.9% for Tier 1 Leverage-Based Capital, 19.3% for Tier 1 Risk-Based Capital and 20.6% for Total Risk-Based Capital.

## NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS

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

Level 1 – Inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 – Inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 – Inputs to the valuation methodology are unobservable and significant to the fair value measurement.

## Determination of Fair Market Values:

Securities - Securities available-for-sale are recorded at fair value on a recurring basis. The fair value of investments and mortgage-backed securities are provided by a third-party pricing service. These valuations are based on market data using pricing models that vary by asset class and incorporate available current trade, bid and other market

information, and for structured securities, cash flow and loan performance data. The pricing processes utilize benchmark curves, benchmarking of similar securities, sector groupings, and matrix pricing. Option adjusted spread models are also used to assess the impact of changes in interest rates and to develop prepayment scenarios. All models and processes used take into account market convention (Level 2).

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Derivative Instruments - The fair value of the interest rate lock commitments and forward sales commitments are estimated using quoted or published market prices for similar instruments, adjusted for factors such as pull-through rate assumptions based on historical information, where appropriate. TBA mortgage-backed securities are fair valued on similar contracts in active markets (Level 2) while locks and forwards with customers and investors are valued using a similar contracts in the market and changes in the market interest rates (Level 3).

Impaired Loans – Fair value adjustments to impaired collateral dependent loans are recorded to reflect partial write-downs based on the current appraised value of the collateral or internally developed models, which contain management’s assumptions (Level 3).

Other Real Estate Owned – Fair value adjustments to OREO are recorded at the lower of carrying amount of the loan or fair value less selling costs. Any write-downs based on the asset’s fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, management periodically performs valuations such that the real estate is carried at the lower of its new cost basis or fair value, net of estimated costs to sell (Level 3).

Mortgage, Commercial and Consumer Servicing Rights - The fair value of mortgage, commercial and consumer servicing rights are estimated using net present value of expected cash flows using a third party model that incorporates assumptions used in the industry to value such rights, adjusted for factors such as weighted average prepayments speeds based on historical information, where appropriate (Level 3).

The following tables present securities available-for-sale measured at fair value on a recurring basis:

|                            | Securities Available-for-Sale |          |         | Total    |
|----------------------------|-------------------------------|----------|---------|----------|
|                            | Level 1                       | Level 2  | Level 3 |          |
| September 30, 2013         |                               |          |         |          |
| Federal agency securities  | \$—                           | \$9,374  | \$—     | \$9,374  |
| Municipal bonds            | —                             | 10,450   | —       | 10,450   |
| Corporate securities       | —                             | 3,463    | —       | 3,463    |
| Mortgage-backed securities | —                             | 23,844   | —       | 23,844   |
| Total                      | \$—                           | \$47,131 | \$—     | \$47,131 |

|                           | Securities Available-for-Sale |          |         | Total    |
|---------------------------|-------------------------------|----------|---------|----------|
|                           | Level 1                       | Level 2  | Level 3 |          |
| December 31, 2012         |                               |          |         |          |
| Federal agency securities | \$—                           | \$12,552 | \$—     | \$12,552 |
| Municipal bonds           | —                             | 9,060    | —       | 9,060    |
| Corporate securities      | —                             | 2,488    | —       | 2,488    |

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|                            |     |          |     |          |
|----------------------------|-----|----------|-----|----------|
| Mortgage-backed securities | —   | 19,213   | —   | 19,213   |
| Total                      | \$— | \$43,313 | \$— | \$43,313 |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The following tables present the fair value of interest rate lock commitments with customers, forward sale commitments with investors and paired off commitments with investors measured at their fair value on a recurring basis at September 30, 2013 and December 31, 2012.

|                    | Interest Rate Lock Commitments with Customers |         |         |          |
|--------------------|---|---------|---------|----------|
|                    | Level 1                                       | Level 2 | Level 3 | Total    |
| September 30, 2013 | \$—   | \$—     | \$642   | \$642    |
| December 31, 2012  | \$—   | \$—     | \$45    | \$45     |
|                    | Forward Sale Commitments with Investors       |         |         |          |
|                    | Level 1                                       | Level 2 | Level 3 | Total    |
| September 30, 2013 | \$—   | \$(398  | ) \$(53 | ) \$(451 |
| December 31, 2012  | \$—   | \$—     | \$48    | \$48     |
|                    | Paired Off Commitments with Investors         |         |         |          |
|                    | Level 1                                       | Level 2 | Level 3 | Total    |
| September 30, 2013 | \$—   | \$13    | \$—     | \$13     |
| December 31, 2012  | \$—   | \$—     | \$—     | \$—      |

The following table presents the impaired loans measured at fair value on a nonrecurring basis and the total valuation allowance or charge-offs on these loans, which represents fair value adjustments for the nine months ended September 30, 2013 and the year ended December 31, 2012.

|                    | Impaired Loans |         |         |         | Total Impairment |
|--------------------|----------------|---------|---------|---------|------------------|
|                    | Level 1        | Level 2 | Level 3 | Total   |                  |
| September 30, 2013 | \$—            | \$—     | \$3,509 | \$3,509 | \$(331)          |
| December 31, 2012  | \$—            | \$—     | \$3,800 | \$3,800 | \$(125)          |



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## NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The following table presents OREO measured at fair value on a nonrecurring basis at September 30, 2013 and December 31, 2012, and the total losses on these assets, which represents fair value adjustments and other losses for the nine months ended September 30, 2013 and the year ended December 31, 2012.

|                    | OREO    |         |         |         | Total<br>Impairment |
|--------------------|---------|---------|---------|---------|---------------------|
|                    | Level 1 | Level 2 | Level 3 | Total   |                     |
| September 30, 2013 | \$—     | \$—     | \$2,259 | \$2,259 | \$(347 )            |
| December 31, 2012  | \$—     | \$—     | \$2,127 | \$2,127 | \$(812 )            |

The following table presents mortgage, commercial and consumer servicing rights measured at carrying value on a nonrecurring basis at September 30, 2013 and December 31, 2012, and the total (recoveries)/losses on these assets, which represents fair value adjustments and other (recoveries)/losses for the nine months ended September 30, 2013 and the year ended December 31, 2012.

|                    | Mortgage, Commercial and Consumer Servicing Rights |         |         |         | Total<br>Impairment/<br>(Recovery) |
|--------------------|--|---------|---------|---------|------------------------------------|
|                    | Level 1  | Level 2 | Level 3 | Total   |                                    |
| September 30, 2013 | \$—  | \$—     | \$2,027 | \$2,027 | \$(102 )                           |
| December 31, 2012  | \$—  | \$—     | \$1,064 | \$1,064 | \$112                              |





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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Quantitative Information about Level 3 Fair Value Measurements – The fair value of financial instruments measured under a Level 3 unobservable input on a recurring and nonrecurring basis at September 30, 2013 is shown in the following table.

| Level 3 Fair Value Instrument                      | Valuation Technique                 | Significant Unobservable Inputs            | Range<br>(Weighted Average) | Weighted<br>Average Rate |
|--|-------------------------------------|--|-----------------------------|--------------------------|
| <b>RECURRING</b>                                   |                                     |  |                             |                          |
| Interest rate lock commitments with customers      | Quoted market prices                | Pull-through expectations                  | 80% - 99%                   | 90.0%                    |
| Forward sale commitments with investors            | Quoted market prices                | Pull-through expectations                  | 80% - 99%                   | 90.0%                    |
| <b>NONRECURRING</b>                                |                                     |  |                             |                          |
| Impaired loans                                     | Fair value of underlying collateral | Discount applied to the obtained appraisal | 0% - 10%                    | 9.5%                     |
| OREO   | Fair value of collateral            | Discount applied to the obtained appraisal | 9% - 19%                    | 14.9%                    |
| Mortgage, commercial and consumer servicing rights | Discounted cash flow                | Weighted average prepayment speed          | 7.5% - 10.5%                | 7.5%                     |

Fair Values of Financial Instruments – The following methods and assumptions were used by the Company in estimating the fair values of financial instruments disclosed in these financial statements:

Cash, and Due from Banks and Interest-Bearing Deposits at Other Financial Institutions – The carrying amounts of cash and short-term instruments approximate their fair value (Level 1).

Loans Held for Sale - The fair value of loans held for sale reflects the value of commitments with investors (Level 2).

Federal Home Loan Bank Stock – The carrying value of FHLB stock approximates its fair value (Level 2).

Accrued Interest – The carrying amounts of accrued interest approximate their fair value (Level 2).

Loans Receivable, Net – For variable rate loans that re-price frequently and have no significant change in credit risk, fair values are based on carrying values. Fair values for fixed rate loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers or similar credit quality (Level 3).

Deposits – The fair value of deposits with no stated maturity date is included at the amount payable on demand. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flow calculation on interest rates currently offered on similar certificates (Level 2).

Borrowings – The carrying amounts of advances maturing within 90 days approximate their fair values. The fair values of long-term advances are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements (Level 2).

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NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Off-Balance Sheet Instruments – The fair value of commitments to extend credit are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreement and the present creditworthiness of the customers. The majority of the Company’s off-balance sheet instruments consist of non-fee producing, variable-rate commitments, the Company has determined they do not have a distinguishable fair value. The fair value of loan lock commitments with customers and investors reflect an estimate of value based upon the interest rate lock date, the expected pull through percentage for the commitment, and the interest rate at year end (Level 3).

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## NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

|   | September 30,<br>2013 |               | December 31,<br>2012 |               |
|---|-----------------------|---------------|----------------------|---------------|
|   | Carrying<br>Amount    | Fair<br>Value | Carrying<br>Amount   | Fair<br>Value |
| Financial Assets  |                       |               |                      |               |
| Level 1 inputs:   |                       |               |                      |               |
| Cash, due from banks, and interest-bearing deposits at other financial institutions | \$27,340              | \$27,340      | \$9,413              | \$9,413       |
| Level 2 inputs:   |                       |               |                      |               |
| Securities available-for-sale   | 47,131                | 47,131        | 43,313               | 43,313        |
| Loans held for sale   | 8,389                 | 8,389         | 8,870                | 8,870         |
| FHLB stock  | 1,717                 | 1,717         | 1,765                | 1,765         |
| Accrued interest receivable   | 1,333                 | 1,333         | 1,223                | 1,223         |
| Forward sale commitments with investors   | —                     | —             | —                    | —             |
| Paired off commitments with investors   | 13                    | 13            | —                    | —             |
| Level 3 inputs:   |                       |               |                      |               |
| Loans receivable, net   | 283,794               | 311,705       | 274,949              | 306,695       |
| Mortgage, commercial and consumer servicing rights                                  | 2,027                 | 2,297         | 1,064                | 1,064         |
| Fair value interest rate locks with customers                                       | 642                   | 642           | 79                   | 79            |
| Forward sale commitments with investors   | —                     | —             | 54                   | 54            |
| Financial Liabilities   |                       |               |                      |               |
| Level 2 inputs:   |                       |               |                      |               |
| Deposits  | 316,868               | 330,964       | 288,949              | 304,257       |
| Borrowings  | 13,664                | 13,614        | 6,840                | 7,059         |
| Accrued interest payable  | 18                    | 18            | 12                   | 12            |
| Forward sale commitments with investors   | 398                   | 398           | —                    | —             |
| Level 3 inputs:   |                       |               |                      |               |
| Fair value interest rate locks with customers                                       | —                     | —             | 34                   | 34            |
| Forward sale commitments with investors   | 53                    | 53            | 6                    | 6             |

## NOTE 13 - EMPLOYEE BENEFITS

## Employee Stock Ownership Plan

On January 1, 2012, the Company established an ESOP for eligible employees of the Company and the Bank. Employees of the Company and the Bank who have been credited with at least 1,000 hours of service during a

12-month period are eligible to participate in the ESOP.

The ESOP borrowed \$2.6 million from FS Bancorp, Inc. and used those funds to acquire 259,210 shares of FS Bancorp, Inc. common stock in the open market at an average price of \$10.17 per share. It is anticipated that the Bank will make

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## NOTE 13 - EMPLOYEE BENEFITS (Continued)

contributions to the ESOP in amounts necessary to amortize the ESOP loan payable to FS Bancorp, Inc. over a period of 10 years, bearing interest at 2.30%. Intercompany expenses associated with the ESOP are eliminated in consolidation.

Shares purchased by the ESOP with the loan proceeds are held in a suspense account and allocated to ESOP participants on a pro rata basis as principal and interest payments are made by the ESOP to FS Bancorp, Inc. The loan is secured by shares purchased with the loan proceeds and will be repaid by the ESOP with funds from the Bank's discretionary

contributions to the ESOP and earnings on the ESOP assets. Payments of principal and interest are due annually on December 31, the Company's fiscal year end. On December 31, 2012, the ESOP paid the first annual installment of principal in the amount of \$267,000, plus accrued interest of \$28,000 pursuant to the ESOP loan. No payment of principal or interest was made during the nine months ended September 30, 2013.

As shares are committed to be released from collateral, the Company reports compensation expense equal to the average daily market prices of the shares and the shares become outstanding for EPS computations. The compensation expense is accrued monthly throughout the year. Dividends on allocated ESOP shares are recorded as a reduction of retained earnings; dividends on unallocated ESOP shares are recorded as a reduction of debt and accrued interest.

Compensation expense related to the ESOP for the nine months ended September 30, 2013 and September 30, 2012 was \$333,000 and \$83,000, respectively.

Shares held by the ESOP as of September 30, 2013 were as follows:

|   | Balances |
|---|----------|
| Allocated shares                                | 25,921   |
| Committed to be released shares                 | 19,441   |
| Unallocated shares                              | 213,848  |
| Total ESOP shares                               | 259,210  |
| <br>  |          |
| Fair value of unallocated shares (in thousands) | \$3,661  |

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## NOTE 14 - EARNINGS PER SHARE

Basic earnings per share are computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity.

The following table presents a reconciliation of the components used to compute basic and diluted earnings per share for the three and nine months ended September 30, 2013 and 2012.

|  | At or For the Three Months<br>Ended<br>September 30,<br>2013 |           | At or For the Nine Months<br>Ended<br>September 30,<br>2012 |                    |
|--|--|-----------|---|--------------------|
| Numerator:   |  |           |   |                    |
| Net Income (in thousands)  | \$1,062  | \$3,325   | \$3,383   | \$4,223            |
| Denominator:   |  |           |   |                    |
| Denominator for basic earnings per share- weighted average common shares outstanding   | 3,026,277  | 3,240,125 | 3,026,277   | n/a <sup>(1)</sup> |
| Denominator for diluted earnings per share- weighted average common shares outstanding | 3,026,277  | 3,240,125 | 3,026,277   | n/a <sup>(1)</sup> |
| Basic earnings per share   | \$0.35   | \$1.03    | \$1.12  | n/a <sup>(1)</sup> |
| Diluted earnings per share   | \$0.35   | \$1.03    | \$1.12  | n/a <sup>(1)</sup> |

(1) Earnings per share and share calculations are not available (n/a) as the Company completed its stock conversion and became a public company on July 9, 2012.

The Company purchased 259,210 shares in the open market during the year ended December 31, 2012, for the ESOP. For earnings per share calculations, the ESOP shares, committed to be released shares are included as outstanding shares. There were 213,848 shares in the ESOP that were not committed to be released as of September 30, 2013. On September 18, 2013, the shareholders of FS Bancorp, Inc. approved an equity plan that authorizes up to 4% of outstanding shares (129,605) to be issued in restricted stock awards and up to 10% of outstanding shares (324,013) to be granted in stock options. As of September 30, 2013, none of the restricted stock or stock option grants have been issued.



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

Forward-Looking Statements

This report may contain forward-looking statements, which can be identified by the use of words such as “believes,” “expects,” “anticipates,” “estimates” or similar expressions. Forward-looking statements include, but are not limited to:

- statements of our goals, intentions and expectations;
- statements regarding our business plans, prospects, growth and operating strategies;
- statements regarding the quality of our loan and investment portfolios; and
- estimates of our risks and future costs and benefits.

These forward-looking statements are subject to significant risks and uncertainties. Actual results may differ materially from those contemplated by the forward-looking statements due to, among others, the following factors:

- general economic conditions, either nationally or in our market area, that are worse than expected;
- the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write offs and
- changes in our allowance for loan losses and provision for loan losses that may be impacted by deterioration in the housing and commercial real estate markets;
- fluctuations in the demand for loans, the number of unsold homes, land and other properties and fluctuations in real estate values in our market area;
- increases in premiums for deposit insurance;
- the use of estimates in determining fair value of certain of our assets, which estimates may prove to be incorrect and result in significant declines in valuation;
- changes in the interest rate environment that reduce our interest margins or reduce the fair value of financial instruments;
- increased competitive pressures among financial services companies;
- our ability to execute our plans to grow our residential construction lending, our mortgage banking operations and our warehouse lending and the geographic expansion of our indirect home improvement lending;
- our ability to attract and retain deposits;
- our ability to control operating costs and expenses;
- changes in consumer spending, borrowing and savings habits;
- our ability to successfully manage our growth;
- legislative or regulatory changes that adversely affect our business, or increase capital requirements, including the effect of the Dodd-Frank Wall Street Reform and Consumer Protection Act, changes in regulation policies and principles, or the interpretation of regulatory capital or other rules, including as a result of Basel III;
- adverse changes in the securities markets;
- changes in accounting policies and practices, as may be adopted by the bank regulatory agencies, the Public Company Accounting Oversight Board or the Financial Accounting Standards Board;
- costs and effects of litigation, including settlements and judgments;
- our ability to implement our branch expansion strategy;
- inability of key third-party vendors to perform their obligations to us; and

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other economic, competitive, governmental, regulatory and technical factors affecting our operations, pricing, products and services and other risks described elsewhere in this Form 10-Q and our other reports filed with the U.S. Securities and Exchange Commission, including our Annual Report on Form 10-K for the year ended December 31, 2012.

Any of the forward looking statements that we make in this Form 10-Q and in other public statements we make may turn out to be wrong because of inaccurate assumptions we might make, because of the factors illustrated above or because of other factors that we cannot foresee. Forward looking statements are based upon management's beliefs and assumptions at the time they are made. The Company undertakes no obligation to update or revise any forward-looking statement included in this report or to update the reasons why actual results could differ from those contained in such statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, the forward-looking statements discussed in this report might not occur and you should not put undue reliance on any forward looking statements.

### Overview

FS Bancorp, Inc. and its subsidiary bank, 1st Security Bank of Washington have been serving the Puget Sound area since 1936. Originally chartered as a credit union, previously known as Washington's Credit Union, the credit union served various select employment groups. On April 1, 2004, the credit union converted to a Washington state-chartered mutual savings bank. On July 9, 2012, the Bank converted from mutual to stock ownership and became the wholly owned subsidiary of FS Bancorp, Inc.

The Company is relationship-driven delivering banking and financial services to local families, local and regional businesses and industry niches within distinct Puget Sound area communities. The Company emphasizes long-term relationships with families and businesses within the communities served, working with them to meet their financial needs. The Company is also actively involved in community activities and events within these market areas, which further strengthens our relationships within these markets.

The Company is a diversified lender with a focus on the origination of indirect home improvement loans, also referred to as fixture secured loans, commercial real estate mortgage loans, home loans, commercial business loans and second mortgage/home equity loan products. Consumer loans, in particular indirect home improvement loans to finance window replacement, gutter replacement, siding replacement, and other improvement renovations, represent the largest portion of the loan portfolio and have traditionally been the mainstay of our lending strategy. As of September 30, 2013, consumer loans represented 42.9% of the Company's total portfolio, up from 38.8% at December 31, 2012 due to growth in the indirect home improvement channel, with indirect home improvement loans representing 80.5% of the total consumer loan portfolio.

Indirect home improvement lending is reliant on the Bank's relationships with home improvement contractors and dealers. The Company funded 1,061 loans during the quarter ended September 30, 2013 using its indirect home improvement contractor/dealer network located throughout Washington, Oregon and California with four contractors/dealers responsible for a majority or 64.1% of this loan volume. The Company began originating consumer indirect loans during the fourth quarter of 2012 in the State of California and since inception has originated \$16.8 million. During the three months ended September 30, 2013, the Company originated \$6.6 million of consumer loans in California, and as of September 30, 2013, the Company had \$9.4 million of consumer indirect loans outstanding that were originated in California. Management has established a limit of no more than 20% of the total consumer loan portfolio for loans in California, as of September 30, 2013, the limit would be \$24.8 million.

Going forward, the Company will focus on diversifying our lending products by expanding commercial real estate, home lending, commercial business and residential construction lending, while maintaining the current size of the Bank's consumer loan portfolio. The Company's lending strategies are intended to take advantage of: (1) the Bank's

historical strength in indirect consumer lending, (2) recent market dislocation that has created new lending opportunities and the availability of experienced bankers, and (3) strength in relationship lending. Retail deposits will continue to serve as a primary funding source.

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The Company is significantly affected by prevailing economic conditions, as well as government policies and regulations concerning, among other things, monetary and fiscal affairs. Deposit flows are influenced by a number of factors, including interest rates paid on time deposits, other investments, account maturities, and the overall level of personal income and savings. Lending activities are influenced by the demand for funds, the number and quality of lenders, and regional economic cycles. Sources of funds for lending activities include primarily deposits, including brokered deposits, borrowings, payments on loans and income provided from operations.

Earnings are primarily dependent upon the Company's net interest income, the difference between interest income and interest expense. Interest income is a function of the balances of loans and investments outstanding during a given period and the yield earned on these loans and investments. Interest expense is a function of the amount of deposits and borrowings outstanding during the same period and interest rates paid on these deposits and borrowings. The Company's earnings are also affected by the provision for loan losses, service charges and fees, gains from sales of assets, operating expenses and income taxes.

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act ("JOBS" Act), which establishes a new category of issuer called an emerging growth company. The Company is an "emerging growth company" as defined under the JOBS Act. The Company will remain an emerging growth company for up to five years, or until the earliest of (i) the last day of the first fiscal year in which our total annual gross revenues exceed \$1 billion, (ii) the date that we become a "large accelerated filer" as defined in Rule 12b-2 under the Securities Exchange Act of 1934, as amended (the "Exchange Act") which would occur if the market value of the Company's common stock that is held by non-affiliates exceeds \$700 million as of the last business day of the most recently completed second fiscal quarter or (iii) the date on which the Company has issued more than \$1 billion in non-convertible debt during the preceding three year period.

As an emerging growth company, the Company may take advantage of certain exemptions from various reporting requirements that are applicable to other public companies that are not "emerging growth companies" including, but not limited to:

not being required to comply with the auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act of 2002 (the Company also will not be subject to the auditor attestation requirements of Section 404(b) as long as the Company is a "smaller reporting company," which includes issuers that had a public float of less than \$75 million as of the last business day of their most recently completed second fiscal quarter);

- reduced disclosure obligations regarding executive compensation in periodic reports and proxy statements; and
- exemptions from the requirements of holding a nonbinding advisory vote on executive compensation and shareholder approval of any golden parachute payments not previously approved.

In addition, Section 107 of the JOBS Act provides that an emerging growth company can take advantage of the extended transition period provided in Section 7(a)(2)(B) of the Securities Act of 1933, as amended (the "Securities Act") for complying with new or revised accounting standards. Under this provision, an emerging growth company can delay the adoption of certain accounting standards until those standards would otherwise apply to private companies. However, the Company has elected to "opt out" of such extended transition period, and as a result, the Company will comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for non-emerging growth companies. Management's decision to opt out of the extended transition period for complying with new or revised accounting standards is irrevocable.

### Critical Accounting Policies and Estimates

Certain of the Company's accounting policies are important to the portrayal of the Company's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to

matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Facts and circumstances which could affect these judgments include, but are not

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limited to, changes in interest rates, changes in the performance of the economy and changes in the financial condition of borrowers. Management believes that its critical accounting policies to include the following:

**Allowance for Loan Loss.** The allowance for loan losses is the amount estimated by management as necessary to cover probable losses inherent in the loan portfolio at the balance sheet date. The allowance is established through the provision for loan losses, which is charged to income. Determining the amount of the allowance for loan losses necessarily involves a high degree of judgment. Among the material estimates required to establish the allowance are: loss exposure at default; the amount and timing of future cash flows on impacted loans; value of collateral; and determination of loss factors to be applied to the various elements of the portfolio. All of these estimates are susceptible to significant change. Management reviews the level of the allowance at least quarterly and establishes the provision for loan losses based upon an evaluation of the portfolio, past loss experience, current economic conditions and other factors related to the collectability of the loan portfolio. Although the Company believes it uses the best information available to establish the allowance for loan losses, future adjustments to the allowance may be necessary if economic conditions differ substantially from the assumptions used in making the evaluation. As the Company adds new products, increases the complexity of the loan portfolio, and expands the Company's market area, management intends to enhance and adapt our methodology to keep pace with the size and complexity of the loan portfolio. Changes in any of the above factors could have a significant effect on the calculation of the allowance for loan losses in any given period. Management believes that its systematic methodology continues to be appropriate given our size and level of complexity.

**Fair Value Accounting and Measurement.** Fair value measurements are used to record fair value adjustments to certain financial assets and liabilities and to determine fair value disclosures. The Notes to the Consolidated Financial Statements include information about the extent to which fair value is used to measure financial assets and liabilities, the valuation methodologies used and the impact on our results of operations and financial condition. Additionally, for financial instruments not recorded at fair value we disclose, where appropriate, our estimate of their fair value. For more information regarding fair value accounting, please refer to Note 12 in the Notes to the Consolidated Financial Statements in this report on Form 10-Q.

**Mortgage, Commercial and Consumer Servicing Rights.** Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of loans. Generally, purchased servicing rights are capitalized at the cost to acquire the rights. For sales of mortgage loans, the value of the servicing right is estimated and capitalized. Fair value is based on market prices for comparable mortgage servicing contracts. Capitalized servicing rights are reported in other assets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

**Other Real Estate Owned.** Property acquired by foreclosure or deed in lieu of foreclosure is recorded at fair value, less cost to sell. Development and improvement costs relating to the property are capitalized. The carrying value of the property is periodically evaluated by management and, if necessary, allowances are established to reduce the carrying value to net realizable value. Gains or losses at the time the property is sold are charged or credited to operations in the period in which they are realized. The amounts that will be ultimately realized from the sale of other real estate owned may differ substantially from the carrying value of the assets because of market factors beyond our control or because of changes in management's strategies for recovering the investment.

**Income Taxes.** Income taxes are reflected in the Company's consolidated financial statements to show the tax effects of the operations and transactions reported in the financial statements and consist of taxes currently payable plus deferred taxes. Accounting Standards Codification, ASC 740, "Accounting for Income Taxes," requires the asset and liability approach for financial accounting and reporting for deferred income taxes. Deferred tax assets and liabilities result from differences between the financial statement carrying amounts and the tax bases of assets and liabilities.

They are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled and are determined using the assets and liability method of accounting. The deferred income provision represents the difference between net deferred tax asset/liability at the beginning and end of the reported period. In formulating the deferred tax asset, the Company is required to estimate the income and taxes in the jurisdiction in which it operates. This process involves estimating actual current tax exposure for the reported period together with assessing temporary differences resulting from differing treatment of items, such as depreciation and the provision for loan losses, for tax and financial reporting purposes.

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Deferred tax assets are attributable to deductible temporary differences and carryforwards. After the deferred tax asset has been measured using the applicable enacted tax rate and provisions of the enacted tax law, it is then necessary to assess the need for a valuation allowance. A valuation allowance is needed when, based on the weight of the available evidence, it is more likely than not that some portion of the deferred tax asset will not be realized. As of September 30, 2013, and December 31, 2012, the Company had net deferred tax assets of \$752,000 and \$1.9 million, respectively and determined that no valuation allowance was required.

## Comparison of Financial Condition at September 30, 2013 and December 31, 2012

**Assets.** Total assets increased \$37.1 million, or 10.3%, to \$396.1 million at September 30, 2013 from \$359.0 million at December 31, 2012, primarily as a result of a \$17.9 million, or 190.4% increase in cash and interest-bearing deposits at other financial institutions, an \$8.9 million, or 3.2% increase in net loans receivable, a \$6.0 million purchase of bank owned life insurance, a \$3.8 million, or 8.8% increase in securities available-for-sale, at fair value, and a \$828,000, or 29.8% increase in other assets.

Net loans receivable increased \$8.9 million, or 3.2%, to \$283.8 million at September 30, 2013 from \$274.9 million at December 31, 2012. Real estate secured loans increased \$22.4 million, or 23.0% to \$120.2 million at September 30, 2013 from \$97.8 million at December 31, 2012, as a result of a \$11.2 million, or 35.1% increase in residential construction and development loans, a \$4.9 million, or 34.9% increase in one-to-four-family loans, a \$4.1 million, or 12.3% increase in commercial real estate loans, a \$1.5 million, or 47.5% increase in multi-family loans, and a \$779,000, or 5.0% increase in home equity loans. Consumer loans increased \$15.4 million, or 14.2%, to \$124.1 million at September 30, 2013 from \$108.7 million at December 31, 2012, primarily as a result of a \$13.6 million, or 15.8%, increase in indirect home improvement loans, and a \$3.4 million, or 19.8% increase in marine loans partially offset by a \$1.2 million, or 49.4%, decrease in automobile loans. Commercial business loans decreased \$28.4 million, or 38.6%, to \$45.1 million at September 30, 2013 from \$73.5 million at December 31, 2012. The period over period decrease in commercial business loans reflects the lower usage of warehouse lending lines as a result of the recent rise in mortgage interest rates and the planned runoff off two larger participations in the Shared National Credit Program totaling \$5.7 million. The utilization of warehouse lending lines as well as the Company's ability to generate loans held for sale has been adversely affected by the recent rise in mortgage interest rates, resulting in a decrease in refinancing activity.

Loans held for sale decreased slightly by \$481,000 to \$8.4 million at September 30, 2013 from \$8.9 million at December 31, 2012 as management continues to manage the holding period between the funding and sale date for loans held for sale during periods of volatile interest rates. The Company continues to expand its home lending operations by hiring additional lending staff and will continue selling one-to-four-family mortgage loans into the secondary market for asset/liability management purposes and to generate noninterest income. During the quarter ended September 30, 2013, the Company sold \$62.5 million of one-to-four-family mortgage loans compared to \$89.9 million for the preceding quarter and \$38.3 million for the same quarter one year ago. The Company also sold \$5.2 million in consumer loans and \$526,000 in commercial loans during the third quarter of 2013.

The allowance for loan losses at September 30, 2013 was \$5.3 million, or 1.8% of gross loans receivable, compared to \$4.7 million, or 1.7% of gross loans receivable, at December 31, 2012. Non-performing loans, consisting of non-accruing loans, decreased to \$1.5 million at September 30, 2013 from \$1.9 million at December 31, 2012. At September 30, 2013, non-performing loans consisted of \$611,000 of commercial real estate loans, \$340,000 of one-to-four-family loans, \$114,000 of home equity loans, \$343,000 of consumer loans, and \$116,000 of commercial business loans. Non-performing loans to total gross loans decreased to 0.5% at September 30, 2013 from 0.7% at December 31, 2012. OREO totaled \$2.3 million at September 30, 2013, compared to \$2.1 million at December 31,



2012. The \$132,000, or 6.2% increase in OREO reflects foreclosures of \$642,000 of OREO, write-downs to fair value of \$347,000, and OREO sales of \$163,000 during the period ended September 30, 2013. At September 30, 2013, the Company also had \$2.4 million in TDRs of which \$2.4 million were performing in accordance with their modified payment terms and \$44,000 were on non-accrual.

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A summary of non-performing assets as of September 30, 2013 and December 31, 2012:

|                             | September 30,<br>2013 | December 31,<br>2012 |
|-----------------------------|-----------------------|----------------------|
| Non-performing assets:      |                       |                      |
| Non-accrual loans           | \$ 1,524              | \$ 1,906             |
| Other real estate owned     | 2,259                 | 2,127                |
| Other assets                | 6                     | 31                   |
| Total non-performing assets | \$ 3,789              | \$ 4,064             |

Liabilities. Total liabilities increased \$34.7 million, or 11.6%, to \$333.8 million at September 30, 2013, from \$299.1 million at December 31, 2012. Deposits increased \$28.0 million, or 9.7%, to \$316.9 million at September 30, 2013 from \$288.9 million at December 31, 2012. The increase in deposits was due to an \$11.9 million, or 20.3% increase in interest and noninterest-bearing checking accounts, an \$11.6 million, or 11.1%, increase in time deposits including \$3.0 million of brokered deposits, and a \$4.4 million, or 3.5%, increase in money market and savings accounts. The Company continues its focus on relationship deposit growth with new and existing customers.

Total borrowings, which consisted of FHLB advances, increased \$6.9 million, or 99.8%, to \$13.7 million at September 30, 2013 from \$6.8 million at December 31, 2012 with the majority of this increase in fixed rate long-term borrowings of over three years. The increase in long-term borrowings is part of the Company's interest rate risk management strategy.

Stockholders' Equity. Total stockholders' equity increased \$2.3 million, or 3.9%, to \$62.2 million at September 30, 2013 from \$59.9 million at December 31, 2012. The increase in stockholders' equity was primarily a result of net income of \$3.4 million offset by a decline of \$1.1 million in accumulated other comprehensive income (loss), which includes the unrealized loss on securities available-for-sale, net of tax, and dividend payments of \$301,000. Book value per common share was \$20.56 at September 30, 2013 compared to \$19.92 at December 31, 2012.

#### Comparison of Results of Operations for the Three and Nine Months Ended September 30, 2013 and 2012

General. Net income for the three months ended September 30, 2013 was \$1.1 million compared to net income of \$3.3 million for the three months ended September 30, 2012, which included a \$2.3 million net tax impact from a deferred tax asset provision reversal. The decrease in net income was primarily attributable to a \$757,000, or 15.6%, increase in interest income, and a \$684,000, or 46.2%, increase in noninterest income partially offset by a \$923,000, or 22.4% increase in noninterest expense, and a \$2.9 million, or 125.0% increase in the provision for income taxes due to the \$2.3 million net tax benefit reversal of a majority of its deferred tax asset valuation allowance. The increase in interest income was primarily the result of a \$718,000 increase in interest on loans receivable, and the increase in noninterest income was primarily the result of a \$622,000 increase in gains on sale of loans from the Company's residential home lending operations. The increase in noninterest expense was primarily related to \$773,000 of expenses associated with expanding the lending channels.

Net income for the nine months ended September 30, 2013 was \$3.4 million compared to net income of \$4.2 million for the nine months ended September 30, 2012, which included a \$2.3 million net tax benefit. The decrease in net income was primarily attributable to a \$4.0 million, or 121.3%, increase in noninterest income and a \$2.8 million, or 23.9%, increase in net interest income partially offset by a \$3.6 million, or 30.9% increase in noninterest expense and a \$4.1 million, or 176.3% increase in the provision for income taxes due to the \$2.3 million tax benefit recognized in the third quarter of 2012. The increase in noninterest income was primarily the result of \$3.9 million in gains on sale of loans primarily from the Company's residential home lending operations. The increase in noninterest expense was

primarily related to \$3.6 million of expenses associated with expanding the Company's loan origination platforms through additional personnel and adding to the indirect home improvement dealer network.

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The following table sets forth the average balances of all major categories of interest-earning assets and interest-bearing liabilities.

|   | For the Three Months Ended |            | For the Nine Months Ended |            |
|---|----------------------------|------------|---------------------------|------------|
|   | September 30,              |            | September 30,             |            |
|   | 2013                       | 2012       | 2013                      | 2012       |
| <b>Assets</b>   |                            |            |                           |            |
| Loans receivable, net                                     | \$ 304,036                 | \$ 253,769 | \$ 295,575                | \$ 238,659 |
| Securities available-for-sale, at fair value              | 49,549                     | 38,718     | 46,500                    | 36,248     |
| Interest-bearing deposits at other financial institutions | 19,919                     | 22,437     | 18,614                    | 17,787     |
| Total interest-earning assets                             | 373,504                    | 314,924    | 360,689                   | 292,694    |
| Noninterest-earning assets                                | 21,138                     | 23,214     | 19,251                    | 19,104     |
| Total assets  | \$ 394,642                 | \$ 338,138 | \$ 379,940                | \$ 311,798 |
| <b>Liabilities and Stockholders' Equity</b>               |                            |            |                           |            |
| Interest-bearing deposits                                 | \$ 267,463                 | \$ 250,702 | \$ 260,568                | \$ 243,236 |
| Borrowings  | 21,272                     | 4,101      | 16,939                    | 6,396      |
| Total interest-bearing liabilities                        | 288,735                    | 254,803    | 277,507                   | 249,632    |
| Noninterest-bearing deposits                              | 41,703                     | 29,232     | 38,532                    | 24,346     |
| Other noninterest-bearing liabilities                     | 3,620                      | 3,274      | 3,304                     | 2,399      |
| Stockholders' equity                                      | 60,584                     | 50,829     | 60,597                    | 35,421     |
| Total liabilities and stockholders' equity                | \$ 394,642                 | \$ 338,138 | \$ 379,940                | \$ 311,798 |

Net Interest Income. Net interest income increased \$770,000, or 18.0%, to \$5.0 million for the three months ended September 30, 2013, from \$4.3 million for the three months ended September 30, 2012. The increase in net interest income was attributable to a \$757,000 increase in interest income resulting from an increase in the average balance of the loan portfolio as well as a shift of funds throughout the period from lower yielding cash and cash equivalents to higher yielding investment securities and loans, and a \$13,000 decrease in interest expense, primarily due to a reduction of the overall cost of funds.

Net interest income increased \$2.8 million, or 23.9%, to \$14.6 million for the nine months ended September 30, 2013, from \$11.8 million for the nine months ended September 30, 2012. The increase in net interest income was attributable to a \$2.6 million increase in interest income resulting from an increase in the average balance of the loan portfolio as well as a shift of funds throughout the period from lower yielding cash and cash equivalents to higher yielding investment securities and loans, and a \$252,000 decrease in interest expense, primarily due to a reduction of the cost of funds.

The net interest margin increased three basis points to 5.42% for the nine months ended September 30, 2013, from 5.39% for the same period of the prior year, primarily due to a shift in funds during the period from lower yielding cash and cash equivalents into higher yielding investment securities and loans and a lower level of non-performing loans, coupled with a 22 basis point decline in the cost of funds.

Interest Income. Interest income for the three months ended September 30, 2013 increased \$757,000, or 15.6%, to \$5.6 million from \$4.8 million for the three months ended September 30, 2012. The increase during the period was primarily attributable to the increase in the average balance of the loan portfolio to \$304.0 million for the three months ended September 30, 2013 compared to \$253.8 million for the three months ended September 30, 2012, as well as a shift of funds during the period from lower yielding cash and cash equivalents to higher yielding investment securities

and loans during the three months ended September 30, 2013 compared to the same period last year.

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Interest income for the nine months ended September 30, 2013 increased \$2.6 million, or 18.8%, to \$16.2 million, from \$13.6 million for the nine months ended September 30, 2012. The increase during the period was primarily attributable to the increase in the average balance of the loan portfolio to \$295.6 million for the nine months ended September 30, 2013 compared to \$238.7 million for the nine months ended September 30, 2012, as well as a shift of funds during the period from lower yielding cash and cash equivalents to higher yielding investment securities/loans during the nine months ended September 30, 2013 compared to the same period last year.

Interest Expense. Interest expense decreased \$13,000, or 2.3%, to \$558,000 for the three months ended September 30, 2013, from \$571,000 for the same period of the prior year. As a result of general decline in market rates, the average cost of funds for total interest-bearing liabilities decreased 12 basis points to 0.77% for the three months ended September 30, 2013, compared to 0.89% for the three months ended September 30, 2012. The decrease was due to a decline in rates paid on certificates of deposit, and a higher average balance in money market accounts which carry a lower cost of funds. The average balance of total interest-bearing liabilities increased \$33.9 million, or 13.3%, to \$288.7 million for the quarter ended September 30, 2013, from \$254.8 million for the quarter ended September 30, 2012.

Interest expense decreased \$252,000, or 13.8%, to \$1.6 million for the nine months ended September 30, 2013, from \$1.8 million for the same period of the prior year. As a result of general decline in market rates, the average cost of funds for total interest-bearing liabilities decreased 22 basis points to 0.76% for the nine months ended September 30, 2013, compared to 0.98% for the nine months ended September 30, 2012. The decrease was due to a decline in rates paid on certificates of deposit, and a higher average balance in money market accounts which carry a lower cost of funds. The average balance of total interest-bearing liabilities increased \$27.9 million, or 11.2%, to \$277.5 million for the nine months ended September 30, 2013, from \$249.6 million for the nine months ended September 30, 2012.

Provision for Loan Losses. The provision for loan losses was \$520,000 for the three months ended September 30, 2013, compared to \$630,000 for the three months ended September 30, 2012. The \$110,000 decrease in the provision during the current quarter over the comparable quarter last year primarily relates to improved asset quality performance, declining net charge-offs and stabilized loan growth during the quarter. During the three months ended September 30, 2013, net charge-offs totaled \$486,000, compared to \$603,000 during the same period last year.

The provision for loan losses was unchanged at \$1.7 million for each of the nine months ended September 30, 2013, and 2012. Non-performing loans were \$1.5 million or 0.5% of total loans at September 30, 2013, compared to \$2.1 million, or 0.8% of total loans at September 30, 2012. During the nine months ended September 30, 2013, net charge-offs totaled \$1.1 million compared to \$1.7 million during the nine months ended September 30, 2012.

Noninterest Income. Noninterest income increased \$684,000, or 46.2%, to \$2.2 million for the three months ended September 30, 2013, from \$1.5 million for the three months ended September 30, 2012. The increase during the period was primarily attributable to \$622,000 in gains associated primarily with the sale of mortgage loans in the secondary market as part of the home lending initiative. During the quarter ended September 30, 2013, the Company sold \$68.2 million of loans compared to \$38.3 million during the quarter ended September 30, 2012.

Noninterest income increased \$4.0 million, or 121.3%, to \$7.3 million for the nine months ended September 30, 2013, from \$3.3 million for the nine months ended September 30, 2012. The increase during the period was primarily due to \$3.9 million in gains associated primarily with the sale of mortgage loans in the secondary market as part of the home lending initiative. During the nine months ended September 30, 2013, the Company sold \$201.4 million of loans compared to \$69.0 million during the nine months ended September 30, 2012.

Noninterest Expense. Noninterest expense increased \$923,000, or 22.4% to \$5.0 million for the three months ended September 30, 2013, from \$4.1 million for the three months ended September 30, 2012. Changes in noninterest expense included a \$416,000, or 19.2%, increase in salaries and benefit costs including ESOP expense of \$115,000, a \$153,000 or 86.0% increase in legal fees associated with public company reporting obligations, a \$149,000, or 70.0% increase in loan costs associated with increased lending activities, and a \$122,000, or 19.4% increase in cost of operations, partially offset by a \$110,000, or 101.9% recovery from the mortgage servicing rights impairment.

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Noninterest expense increased \$3.6 million or 30.9% to \$15.1 million for the nine months ended September 30, 2013, from \$11.5 million for the nine months ended September 30, 2012. Changes in noninterest expense included a \$2.5 million, or 43.1%, increase in salaries and benefit costs partially as a result of variable commission based expenses of \$1.6 million related to increases in loan volume with the remainder associated with expanding lending channels by hiring additional production and support employees, a \$507,000 or 28.8% increase in cost of operations, a \$457,000, or 83.1% increase in loan costs associated with increased lending activities, a \$413,000, or 85.9% increase in professional and board fees, and a \$150,000, or 75.0% increase in marketing and advertising, partially offset by a \$381,000, or 52.3% decrease in write-downs of other real estate owned to fair value, and a \$207,000, or 197.1% recovery from the mortgage servicing rights impairment.

The efficiency ratio, which is noninterest expense as a percentage of net interest income and noninterest income, improved to 70.0% for the three months ended September 30, 2013 compared to 71.6% for the three months ended September 30, 2012 and was 68.7% for the nine months ended September 30, 2013 compared to 76.3% for the nine months ended September 30, 2012 primarily as a result of the increase in noninterest income.

Provision for Income Tax. For the three months ended September 30, 2013, the Company recorded a provision for income tax expense of \$581,000 on pre-tax income as compared to a tax benefit of \$2.3 million for the three months ended September 30, 2012. The effective tax rate for the three months ended September 30, 2013 was 35.4%. For the nine months ended September 30, 2013, the Company recorded a provision for income tax expense of \$1.8 million on pre-tax income as compared to a tax benefit of \$2.3 million for the nine months ended September 30, 2012. The effective tax rate for the nine months ended September 30, 2013 was 34.4%. In the prior year, the Company recorded a net \$2.3 million income tax benefit, which was the result of reversing substantially all of the deferred tax asset valuation allowance.

### Liquidity

Management maintains a liquidity position that it believes will adequately provide funding for loan demand and deposit runoff that may occur in the normal course of business. The Company relies on a number of different sources in order to meet our potential liquidity demands. The primary sources are increases in deposit accounts, FHLB advances, sale of securities available-for-sale, cash flows from loan payments and maturing securities.

As of September 30, 2013, the Bank's total borrowing capacity was \$36.0 million with the FHLB of Seattle, with unused borrowing capacity of \$22.4 million at that date. The FHLB borrowing limit is based on certain categories of loans, primarily real estate loans that qualify as collateral for FHLB advances. As of September 30, 2013, the Bank held approximately \$48.8 million in loans that qualify as collateral for FHLB advances. In addition to the availability of liquidity from the FHLB of Seattle, the Bank maintained a short-term borrowing line with the Federal Reserve Bank of San Francisco ("Federal Reserve Bank"), with a current limit of \$78.8 million at September 30, 2013, and a \$6.0 million unsecured, variable rate, overnight short-term borrowing line with Pacific Coast Bankers' Bank. The Federal Reserve Bank borrowing limit is based on certain categories of loans, primarily consumer loans that qualify as collateral for Federal Reserve Bank line of credit. As of September 30, 2013, the Bank held approximately \$120.3 million in loans that qualify as collateral for the Federal Reserve Bank line of credit.

As of September 30, 2013, \$13.7 million in FHLB advances were outstanding and no advances were outstanding against the Federal Reserve Bank line of credit or Pacific Coast Bankers' Bank line of credit. The Bank's Asset Liability Management Policy permits management to utilize brokered deposits up to 20% of deposits or \$65.7 million as of September 30, 2013. Total brokered deposits as of September 30, 2013 were \$16.9 million.



Liquidity management is both a daily and long-term function of Company management. Excess liquidity is generally invested in short-term investments, such as overnight deposits and federal funds. On a longer-term basis, a strategy is maintained of investing in various lending products and investment securities, including U.S. Government obligations and federal agency securities. The Company uses sources of funds primarily to meet ongoing commitments, pay maturing deposits and fund withdrawals, and to fund loan commitments. At September 30, 2013, the approved outstanding loan commitments, including unused lines of credit, amounted to \$130.1 million. Certificates of deposit scheduled to mature in three months or less at September 30, 2013, totaled \$15.6 million. It is management's policy

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to offer deposit rates that are competitive with other local financial institutions. Based on this management strategy, the Company believes that a majority of maturing deposits will remain with the Bank. For additional information see the Consolidated Statements of Cash Flows in Part I. Item 1 of this report.

### Commitments and Off-Balance Sheet Arrangements

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the financing needs of our customers. For information regarding our commitments and off-balance sheet arrangements, see Note 9 of the Notes to Consolidated Financial Statements included in Part I. Item 1 of this report.

### Capital Resources

The Bank is subject to minimum capital requirements imposed by the FDIC. Based on its capital levels at September 30, 2013, the Bank exceeded these requirements as of that date. Consistent with our goals to operate a sound and profitable organization, our policy is for the Bank to maintain a "well capitalized" status under the capital categories of the FDIC. Based on capital levels at September 30, 2013, the Bank was considered to be "well capitalized". At September 30, 2013, the Bank exceeded all regulatory capital requirements with Tier 1 Leverage-Based Capital, Tier 1 Risk-Based Capital and Total Risk-Based Capital ratios of 12.7%, 15.6%, and 16.9%, respectively. For additional information regarding the Bank's regulatory capital compliance, see the discussion included in Note 11 to the Notes to Consolidated Financial Statements included in Part I. Item 1 of this report.

The Company exceeded all regulatory capital requirements as of September 30, 2013. The estimated regulatory capital ratios calculated for the Company as of September 30, 2013 were 15.9% for Tier 1 Leverage-Based Capital, 19.3% for Tier 1 Risk- Based Capital and 20.6% for Total Risk-Based Capital.

### Item 3. Quantitative and Qualitative Disclosure About Market Risk

Not required for smaller reporting companies.

### Item 4. Controls and Procedures

#### (a) Evaluation of Disclosure Controls and Procedures.

An evaluation of the disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the "Act")) as of September 30, 2013, was carried out under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and several other members of the Company's senior management. The Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures in effect as of September 30, 2013, were effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Act is: (i) accumulated and communicated to the Company's management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

#### (b) Changes in Internal Controls.

There have been no changes in the Company's internal control over financial reporting (as defined in Rule 13a-15(f) of the Act) that occurred during the three months ended September 30, 2013, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

The Company does not expect that its disclosure controls and procedures and internal control over financial reporting will prevent all error and all fraud. A control procedure, no matter how well conceived and operated, can provide only

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reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls may be circumvented by the individual acts of some persons, by collusion of two or more people, or by override of the control. The design of any control procedure also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In the normal course of business, the Company occasionally becomes involved in various legal proceedings. In the opinion of management, any liability from such proceedings would not have a material adverse effect on the business or financial condition of the Company.

Item 1A. Risk Factors

There have been no material changes to the risk factors set forth in Part I. Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Not applicable.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

3.1 Articles of Incorporation of FS Bancorp, Inc. (1)

3.2 Bylaws of FS Bancorp, Inc. (1)

4.0 Form of Common Stock Certificate of FS Bancorp, Inc. (1)

10.1 Severance Agreement between 1st Security Bank of Washington and Joseph C. Adams (1)

10.2 Form of Change of Control Agreement between 1st Security Bank of Washington and each of Matthew D. Mullet and Drew B. Ness (1)

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31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

The following materials from the Company's Annual Report on Form 10-Q for the quarter ended September 30, 2013, formatted in Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) 101 Consolidated Statements of Income; (3) Consolidated Statements of Comprehensive Income; (4) Consolidated Statements of Stockholders' Equity; (5) Consolidated Statements of Cash Flows; and (6) Notes to Consolidated Financial Statements. \*

(1) Filed as an exhibit to the Registrant's Registration Statement on Form S-1 (333-35817) and incorporated by reference.

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

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SIGNATURES

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

FS BANCORP, INC.

Date: November 12, 2013

By: /s/Joseph C. Adams  
Joseph C. Adams,  
Chief Executive Officer  
(Duly Authorized Officer)

Date: November 12, 2013

By: /s/Matthew D. Mullet  
Matthew D. Mullet  
Secretary, Treasurer and  
Chief Financial Officer  
(Principal Financial and Accounting Officer)