

FS Bancorp, Inc.  
Form 10-Q  
November 10, 2014  
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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, 2014 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 7, 2014, there were 3,235,625 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, 2014	December 31, 2013
<b>ASSETS</b>		
Cash and due from banks	\$1,995	\$1,425
Interest-bearing deposits at other financial institutions	7,696	39,660
Securities available-for-sale, at fair value	49,443	56,239
Federal Home Loan Bank ("FHLB") stock, at cost	1,853	1,702
Loans held for sale, at fair value	20,254	11,185
Consumer loans held for sale	10,231	—
Loans receivable, net	354,574	281,081
Accrued interest receivable	1,525	1,261
Premises and equipment, net	13,747	13,818
Other real estate owned ("OREO")	—	2,075
Deferred tax asset	—	816
Bank owned life insurance ("BOLI")	6,508	6,369
Other assets	3,776	3,556
<b>TOTAL ASSETS</b>	<b>\$471,602</b>	<b>\$419,187</b>
<b>LIABILITIES</b>		
Deposits		
Noninterest-bearing accounts	\$49,543	\$45,783
Interest-bearing accounts	330,746	291,093
Total deposits	380,289	336,876
Borrowings	22,552	16,664
Other liabilities	4,755	3,334
Total liabilities	407,596	356,874
<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; 3,235,625 and 3,240,125 shares issued and outstanding at September 30, 2014 and December 31, 2013, respectively	32	32
Additional paid-in capital	29,200	30,097
Retained earnings	36,772	35,215
Accumulated other comprehensive loss	(63	(898
Unearned shares - Employee Stock Ownership Plan ("ESOP")	(1,935	(2,133
Total stockholders' equity	64,006	62,313
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$471,602</b>	<b>\$419,187</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 September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
<b>INTEREST INCOME</b>				
Loans receivable	\$6,339	\$5,365	\$17,013	\$15,536
Interest and dividends on investment securities, cash and cash equivalents, and interest-bearing deposits at other financial institutions	264	232	950	672
Total interest and dividend income	6,603	5,597	17,963	16,208
<b>INTEREST EXPENSE</b>				
Deposits	675	502	1,818	1,438
Borrowings	76	56	197	142
Total interest expense	751	558	2,015	1,580
<b>NET INTEREST INCOME</b>	<b>5,852</b>	<b>5,039</b>	<b>15,948</b>	<b>14,628</b>
<b>PROVISION FOR LOAN LOSSES</b>	<b>450</b>	<b>520</b>	<b>1,350</b>	<b>1,720</b>
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>5,402</b>	<b>4,519</b>	<b>14,598</b>	<b>12,908</b>
<b>NONINTEREST INCOME</b>				
Service charges and fee income	458	473	1,301	1,420
Gain on sale of loans	1,789	1,537	5,092	5,316
Gain (loss) on sale of investment securities	(51)	) —	(41)	) 264
Other noninterest income	188	153	540	357
Total noninterest income	2,384	2,163	6,892	7,357
<b>NONINTEREST EXPENSE</b>				
Salaries and benefits	3,557	2,578	9,920	8,190
Operations	932	752	2,403	2,268
Occupancy	420	372	1,221	1,074
Data processing	331	285	918	817
OREO fair value impairments, net of loss on sales	11	151	42	347
OREO expenses	10	41	13	79
Loan costs	316	362	1,012	1,007
Professional and board fees	317	331	919	894
FDIC insurance	62	62	188	186
Marketing and advertising	138	107	371	350
Recovery on servicing rights	(18)	) (2)	) (19)	) (102)
Total noninterest expense	6,076	5,039	16,988	15,110
<b>INCOME BEFORE PROVISION FOR INCOME TAX</b>	<b>1,710</b>	<b>1,643</b>	<b>4,502</b>	<b>5,155</b>
<b>PROVISION FOR INCOME TAX</b>	<b>564</b>	<b>581</b>	<b>1,495</b>	<b>1,772</b>
<b>NET INCOME</b>	<b>\$1,146</b>	<b>\$1,062</b>	<b>\$3,007</b>	<b>\$3,383</b>
Basic earnings per share	\$0.39	\$0.35	\$1.00	\$1.12
Diluted earnings per share	\$0.39	\$0.35	\$1.00	\$1.12

See accompanying notes to these consolidated financial statements.





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FS BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(In thousands) (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net Income	\$ 1,146	\$ 1,062	\$ 3,007	\$ 3,383
Other comprehensive income (loss), net of tax:				
Unrealized gain (loss) on securities available-for-sale:				
Unrealized holding gain (loss) arising during period	(119	) 193	1,225	(1,370 )
Income tax (provision) benefit related to unrealized gains	40	(65	) (417	) 466
Reclassification adjustment for realized (gains) loss included in net income	51	—	41	(264 )
Income tax (provision) benefit related to reclassification for realized gains	(17	) —	(14	) 90
Other comprehensive income (loss), net of tax	(45	) 128	835	(1,078 )
COMPREHENSIVE INCOME	\$ 1,101	\$ 1,190	\$ 3,842	\$ 2,305

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 Paid-in Capital	Retained Earnings	Accumulated		Unearned ESOP Shares	Total Stockholders' Equity
	Shares	Amount			Other Comprehensive Income (Loss)			
BALANCE, January 1, 2013	3,240,125	\$32	\$29,894	\$31,746	\$ 597		\$(2,372 )	\$ 59,897
Net income	—	—	—	3,383	—		—	3,383
Other comprehensive loss, net of tax	—	—	—	—	(1,078 )		—	(1,078 )
Dividends paid (\$0.10 per share)	—	—	—	(301 )	—		—	(301 )
ESOP shares allocated	—	—	135	—	—		198	333
BALANCE, September 30, 2013	3,240,125	\$32	\$30,029	\$34,828	\$ (481 )		\$(2,174 )	\$ 62,234
BALANCE, January 1, 2014	3,240,125	\$32	\$30,097	\$35,215	\$ (898 )		\$(2,133 )	\$ 62,313
Net income	—	—	—	3,007	—		—	3,007
Dividends paid (\$0.16 per share)	—	—	—	(523 )	—		—	(523 )
Share-based compensation	—	—	297	—	—		—	297
Restricted stock awards	125,105	—	(1 )	—	—		—	(1 )
Common stock repurchased	(129,605 )	—	(1,295 )	(927 )	—		—	(2,222 )
Other comprehensive income, net of tax	—	—	—	—	835		—	835
ESOP cash distribution	—	—	(35 )	—	—		—	(35 )
ESOP shares allocated	—	—	137	—	—		198	335
BALANCE, September 30, 2014	3,235,625	\$32	\$29,200	\$36,772	\$ (63 )		\$(1,935 )	\$ 64,006

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 September	
	30,	
	2014	2013
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$3,007	\$3,383
Adjustments to reconcile net income to net cash from operating activities		
Provision for loan losses	1,350	1,720
Depreciation, amortization and accretion	2,555	1,286
Compensation expense related to stock options and restricted stock awards	297	—
ESOP compensation expense for allocated shares	335	333
Provision for deferred income taxes	816	1,512
Increase in cash surrender value of BOLI	(139	) (38
Gain on sale of loans held for sale	(4,528	) (4,933
Gain on sale of portfolio loans	(564	) (383
Origination of loans held for sale	(182,264	) (193,123
Proceeds from sale of loans held for sale	176,878	197,396
(Gain) loss on sale of investment securities	41	(264
Recovery of servicing rights	(19	) (102
Impairment loss on other real estate owned	42	347
Changes in operating assets and liabilities		
Accrued interest receivable	(264	) (110
Other assets	(244	) 165
Other liabilities	1,421	34
Net cash from (used by) operating activities	(1,280	) 7,223
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Activity in securities available-for-sale:		
Proceeds from sale of investment securities	21,074	8,786
Maturities, prepayments, and calls	10,809	3,971
Purchases	(22,943	) (18,223
Loan originations and principal collections, net	(98,854	) (18,964
Proceeds from sale of portfolio loans	12,849	8,195
Proceeds from sale of OREO	2,478	163
Purchase BOLI	—	(6,000
Purchase of premises and equipment, net	(692	) (1,714
FHLB stock purchased	(225	) —
FHLB stock redeemed	74	48
Net cash used by investing activities	(75,430	) (23,738
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in deposits	43,413	27,919
Proceeds from borrowings	123,358	101,454
Repayments of borrowings	(117,470	) (94,630
Dividends paid	(523	) (301
Common stock repurchased	(2,222	) —
Net cash from financing activities	46,556	34,442

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NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(30,154	)	17,927
CASH AND CASH EQUIVALENTS, beginning of period	38,459		6,787
CASH AND CASH EQUIVALENTS, end of period	\$8,305		\$24,714
SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION			
Cash paid during the period for:			
Interest	\$2,007		\$1,574
Income taxes	\$377		\$260
SUPPLEMENTARY DISCLOSURES OF NONCASH OPERATING, INVESTING AND FINANCING ACTIVITIES			
Change in unrealized gain (loss) on investment securities	\$1,267		\$(1,634)
Property received in settlement of loans	\$445		\$642
Transfer portfolio loans to loans held for sale	\$10,231		\$—
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, 2013 filed with the Securities and Exchange Commission (“SEC”) on March 29, 2014. 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, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014 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 2014 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 benefit 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.

Subsequent Events – The Company has evaluated events and transactions subsequent to September 30, 2014 for potential recognition or disclosure.

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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)

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, 2014 and December 31, 2013, 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 \$7.7 million and \$39.7 million as of September 30, 2014 and December 31, 2013, respectively. Certificates of deposits in the amount of \$1.4 million and \$2.6 million with original maturity dates greater than 90 days were excluded from cash and cash equivalents as of September 30, 2014 and December 31, 2013, respectively.

RECENT ACCOUNTING PRONOUNCEMENTS

In January 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014 - 01, Accounting for Investments in Qualified Affordable Housing Projects. ASU 2014 - 01 permits an entity to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments are effective for annual and interim reporting periods beginning on or after December 15, 2014 and should be applied prospectively. The adoption of this ASU is not expected to have a material impact on the Company's consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014 - 09, Revenue from Contracts with Customers, which creates Topic 606 and supersedes Topic 605, Revenue Recognition. The core principle of Topic 606 is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In general, the ASU requires companies to use more judgment and make more estimates than under current accounting guidance, including identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. The standard is effective for public entities for interim and annual periods beginning after December 15, 2016; early adoption is not permitted. For financial reporting purposes, the standard allows for either full retrospective adoption, meaning the standard is applied to all of the periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements with the cumulative effect of initially applying the standard recognized at the date of initial application. The Company is currently evaluating the provisions of ASU No. 2014-09 to determine the potential impact the new standard will have on the Company's consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014 - 11, Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures, which changes the accounting for repurchase-to-maturity transactions and repurchase financing arrangements. It also requires additional disclosures about repurchase agreements and other similar transactions. The ASU aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. Going forward, these transactions would all be accounted for as secured borrowings. The ASU also requires new and expanded disclosures. This ASU is effective for the first interim or annual period beginning after December 15, 2014. The adoption of this ASU is not expected to have a material impact on the Company's 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  
(Continued)

In June 2014, the FASB issued ASU No. 2014 - 12, Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period. The ASU requires that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. A reporting entity should apply existing accounting guidance in Topic 718, Compensation - Stock Compensation, as it relates to awards with performance conditions that affect vesting to account for such awards. The performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. The amendments in this ASU can be applied prospectively or retrospectively and are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015 with early adoption permitted. The adoption of this ASU is not expected to have a material impact on the Company's consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014 - 14, Receivables -Troubled Debt Restructuring by Creditors. Under certain government-sponsored loan guarantee programs, such as those offered by the Federal Housing Administration ("FHA") and the Department of Veterans Affairs ("VA"), qualifying creditors can extend mortgage loans to borrowers with a guarantee that entitles the creditor to recover all or a portion of the unpaid principal balance from the government if the borrower defaults. The objective of this ASU is to reduce diversity in practice by addressing the classification of foreclosed mortgage loans that are fully or partially guaranteed under government programs. Currently, some creditors reclassify those loans to real estate as with other foreclosed loans that do not have guarantees; others reclassify the loans to other receivables. The amendments affect creditors that hold government-guaranteed mortgage loans, including those guaranteed by the FHA and the VA. This ASU is effective for annual periods and interim periods within those annual periods beginning after December 15, 2014 with early adoption permitted. The adoption of this ASU is not expected to have a material impact on the Company's consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014 - 15, Presentation of Financial Statements —Going Concern (Subtopic 205-40). The ASU provides U.S. GAAP guidance on management's responsibility in evaluating whether there is substantial doubt about a company's ability to continue as a going concern and about related footnote disclosures. For each reporting period, management will be required to evaluate whether there are conditions or events that raise substantial doubt about a company's ability to continue as a going concern within one year from the date the financial statements are issued. The adoption of this ASU 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 following tables present the amortized costs, unrealized gains, unrealized losses and approximate fair values of securities available-for-sale at September 30, 2014 and December 31, 2013:

	September 30, 2014			Estimated
	Amortized	Unrealized	Unrealized	Fair
	Cost	Gains	Losses	Values
<b>SECURITIES AVAILABLE-FOR-SALE</b>				
Federal agency securities	\$5,999	\$4	\$(237)	) \$5,766
Municipal bonds	15,974	314	(50)	) 16,238
Corporate securities	4,496	2	(35)	) 4,463
Mortgage-backed securities	21,049	66	(161)	) 20,954
Asset-backed and other amortizing securities	2,020	2	—	) 2,022
Total securities available-for-sale	\$49,538	\$388	\$(483)	) \$49,443
	December 31, 2013			Estimated
	Amortized	Unrealized	Unrealized	Fair
	Cost	Gains	Losses	Values
<b>SECURITIES AVAILABLE-FOR-SALE</b>				
Federal agency securities	\$12,297	\$21	\$(651)	) \$11,667
Municipal bonds	13,347	111	(278)	) 13,180
Corporate securities	4,005	2	(69)	) 3,938
Mortgage-backed securities	27,952	66	(564)	) 27,454
Total securities available-for-sale	\$57,601	\$200	\$(1,562)	) \$56,239



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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Investment securities that were in an unrealized loss position as of September 30, 2014 and December 31, 2013 are presented in the following tables, based on the length of time individual securities have been in an unrealized loss position. In the opinion of management, these securities are considered only temporarily impaired due to changes in market interest rates or the widening of market spreads subsequent to the initial purchase of the securities, and not due to concerns regarding the underlying credit of the issuers or the underlying collateral.

	September 30, 2014		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>SECURITIES AVAILABLE-FOR-SALE</b>						
Federal agency securities	\$500	\$(1)	\$4,759	\$(236)	\$5,259	\$(237)
Municipal bonds	1,171	(3)	3,228	(47)	4,399	(50)
Corporate securities	—	—	1,465	(35)	1,465	(35)
Mortgage-backed securities	8,251	(36)	4,825	(125)	13,076	(161)
Total securities available-for-sale	\$9,922	\$(40)	\$14,277	\$(443)	\$24,199	\$(483)

	December 31, 2013		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<b>SECURITIES AVAILABLE-FOR-SALE</b>						
Federal agency securities	\$4,772	\$(244)	\$3,591	\$(407)	\$8,363	\$(651)
Municipal bonds	5,915	(206)	1,210	(72)	7,125	(278)
Corporate securities	2,443	(59)	490	(10)	2,933	(69)
Mortgage-backed securities	23,696	(564)	—	—	23,696	(564)
Total securities available-for-sale	\$36,826	\$(1,073)	\$5,291	\$(489)	\$42,117	\$(1,562)

There were nine investments with unrealized losses of less than one year as of September 30, 2014, and 16 investments with unrealized losses of more than one year. There were 31 investments with unrealized losses of less than one year as of December 31, 2013, and seven investments with unrealized losses of more than one year. 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 does not intend to sell the securities, and it is not likely to be required to sell these securities. No other-than-temporary impairment was recorded for the nine months ended September 30, 2014 or the year ended December 31, 2013.



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

The contractual maturities of securities available-for-sale at September 30, 2014 were as follows:

	September 30, 2014	
	Amortized Cost	Fair Value
Due in one year or less	\$1,505	\$1,509
Due after one year through five years	3,757	3,775
Due after five years through ten years	18,960	18,746
Due after ten years	25,316	25,413
Total	\$49,538	\$49,443

The proceeds and resulting gains, computed using specific identification, from sales of securities available-for-sale for the three and nine months ended September 30, 2014 and 2013 were as follows:

	Three Months Ended September 30, 2014			Nine Months Ended September 30, 2014		
	Proceeds	Gross Gains	Gross (Losses)	Proceeds	Gross Gains	Gross (Losses)
Securities available-for-sale	\$8,610	\$14	\$(65 )	\$20,330	\$78	\$(119 )

	Three Months Ended September 30, 2013			Nine Months Ended September 30, 2013		
	Proceeds	Gross Gains	Gross (Losses)	Proceeds	Gross Gains	Gross (Losses)
Securities available-for-sale	\$—	\$—	\$—	\$8,786	\$264	\$—

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

The composition of the loan portfolio at September 30, 2014 and December 31, 2013 was as follows:

	September 30, 2014	December 31, 2013
<b>REAL ESTATE LOANS</b>		
Commercial	\$44,190	\$32,970
Construction and development	51,413	41,633
Home equity	16,270	15,172
One-to-four-family (excludes held for sale loans)	41,757	20,809
Multi-family	15,023	4,682
Total real estate loans	168,653	115,266
<b>CONSUMER LOANS</b>		
Indirect home improvement	96,949	91,167
Solar (excludes held for sale loans)	13,402	16,838
Marine	16,523	11,203
Automobile	764	1,230
Recreational	463	553
Home improvement	367	463
Other	1,222	1,252
Total consumer loans	129,690	122,706
<b>COMMERCIAL BUSINESS LOANS</b>		
Total loans	361,947	287,216
Allowance for loan losses	(5,812	) (5,092
Deferred costs, fees, and discounts, net	(1,561	) (1,043
Total loans receivable, net	\$354,574	\$281,081

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 the Puget Sound market area.

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

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

Multi-family Lending. Apartment term lending (more than four units) to current banking customers and community reinvestment loans for housing for low to moderate income individuals primarily located in the 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. These indirect home improvement loans include replacement windows, siding, roofing, solar panels, and other home fixture installations in Washington, Oregon and California.

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

	At or For the Three Months Ended September 30, 2013				
ALLOWANCE FOR LOAN LOSSES	Real Estate	Consumer	Commercial 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
LOANS RECEIVABLE					
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 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
LOANS RECEIVABLE					
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)

Information pertaining to the aging analysis of past due loans at September 30, 2014 and December 31, 2013 is summarized as follows:

	September 30, 2014			Total Past Due	Non-Accrual	Current	Total Loans Receivable
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due and Accruing				
<b>REAL ESTATE LOANS</b>							
Commercial	\$—	\$—	\$—	\$—	\$ —	\$44,190	\$44,190
Construction and development	—	—	—	—	—	51,413	51,413
Home equity	51	185	—	236	65	15,969	16,270
One-to-four-family	—	—	—	—	94	41,663	41,757
Multi-family	—	—	—	—	—	15,023	15,023
Total real estate loans	51	185	—	236	159	168,258	168,653
<b>CONSUMER</b>							
Indirect home improvement	460	218	—	678	221	96,050	96,949
Solar	—	—	—	—	29	13,373	13,402
Marine	—	—	—	—	—	16,523	16,523
Automobile	5	7	—	12	—	752	764
Recreational	—	—	—	—	—	463	463
Home improvement	—	—	—	—	—	367	367
Other	2	—	—	2	—	1,220	1,222
Total consumer loans	467	225	—	692	250	128,748	129,690
<b>COMMERCIAL BUSINESS LOANS</b>							
	—	—	—	—	—	63,604	63,604
Total	\$518	\$410	\$—	\$928	\$ 409	\$360,610	\$361,947





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

	December 31, 2013				Non-Accrual	Current	Total Loans Receivable
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due and Accruing	Total Past Due			
<b>REAL ESTATE LOANS</b>							
Commercial	\$—	\$—	\$—	\$—	\$ 567	\$ 32,403	\$ 32,970
Construction and development	—	—	—	—	—	41,633	41,633
Home equity	63	146	—	209	172	14,791	15,172
One-to-four-family	—	—	—	—	104	20,705	20,809
Multi-family	—	—	—	—	—	4,682	4,682
Total real estate loans	63	146	—	209	843	114,214	115,266
<b>CONSUMER</b>							
Indirect home improvement	533	218	—	751	258	90,158	91,167
Solar	—	—	—	—	—	16,838	16,838
Marine	33	—	—	33	—	11,170	11,203
Automobile	34	13	—	47	—	1,183	1,230
Recreational	39	—	—	39	—	514	553
Home improvement	7	—	—	7	—	456	463
Other	15	6	—	21	—	1,231	1,252
Total consumer loans	661	237	—	898	258	121,550	122,706
<b>COMMERCIAL BUSINESS LOANS</b>							
Total	\$ 778	\$ 383	\$—	\$ 1,161	\$ 1,101	\$ 284,954	\$ 287,216

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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, 2014 and at or for the year ended December 31, 2013:

At or For the Nine Months Ended September 30, 2014

	Unpaid Principal Balance	Write- downs	Recorded Investment	Specific Reserve	Adjusted Recorded Investment	YTD Average Recorded Investment	YTD Interest Income Recognized
WITH NO RELATED ALLOWANCE RECORDED							
Commercial	\$—	\$—	\$—	\$—	\$—	\$—	\$—
Construction and development	—	—	—	—	—	—	—
Home equity	37	—	37	—	37	37	2
One-to-four-family	910	(67 )	843	—	843	852	29
Multi-family	—	—	—	—	—	—	—
Indirect home improvement	—	—	—	—	—	—	—
Marine	—	—	—	—	—	—	—
Automobile	—	—	—	—	—	—	—
Recreational	—	—	—	—	—	—	—
Home improvement	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—
Commercial business loans	—	—	—	—	—	—	—
Subtotal loans	947	(67 )	880	—	880	889	31
WITH AN ALLOWANCE RECORDED							
Commercial	—	—	—	—	—	—	—
Construction and development	—	—	—	—	—	—	—
Home equity	—	—	—	—	—	—	—
One-to-four-family	—	—	—	—	—	—	—
Multi-family	—	—	—	—	—	—	—
Indirect home improvement	—	—	—	—	—	—	—
Marine	—	—	—	—	—	—	—
Automobile	—	—	—	—	—	—	—
Recreational	—	—	—	—	—	—	—
Home improvement	—	—	—	—	—	—	—

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Other	—	—	—	—	—	—	—	
Commercial business loans	44	(2	) 42	(4	) 45	38	47	3
Subtotal loans	44	(2	) 42	(4	) 38		47	3
Total	\$991	\$(69	) \$922	\$(4	) \$918		\$936	\$34

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

	At or For the Year Ended December 31, 2013							
	Unpaid Principal Balance	Write- downs	Recorded Investment	Specific Reserve	Adjusted Recorded Investment	YTD Average Recorded Investment	YTD Interest Income Recognized	
<b>WITH NO RELATED ALLOWANCE RECORDED</b>								
Commercial	\$—	\$—	\$—	\$—	\$—	\$—	\$—	
Construction and development	—	—	—	—	—	—	—	
Home equity	39	—	39	—	39	39	59	
One-to-four-family	1,212	(169 )	1,043	—	1,043	1,041	—	
Multi-family	—	—	—	—	—	—	—	
Indirect home improvement	—	—	—	—	—	—	—	
Marine	—	—	—	—	—	—	—	
Automobile	—	—	—	—	—	—	—	
Recreational	—	—	—	—	—	—	—	
Home improvement	—	—	—	—	—	—	—	
Other	—	—	—	—	—	—	—	
Commercial business loans	—	—	—	—	—	—	—	
Subtotal loans	1,251	(169 )	1,082	—	1,082	1,080	59	
<b>WITH AN ALLOWANCE RECORDED</b>								
Commercial	731	(164 )	567	(85 )	482	622	15	
Construction and development	—	—	—	—	—	—	—	
Home equity	—	—	—	—	—	—	—	
One-to-four-family	—	—	—	—	—	—	—	
Multi-family	—	—	—	—	—	—	—	
Indirect home improvement	—	—	—	—	—	—	—	
Marine	—	—	—	—	—	—	—	
Automobile	—	—	—	—	—	—	—	
Recreational	—	—	—	—	—	—	—	
Home improvement	—	—	—	—	—	—	—	
Other	—	—	—	—	—	—	—	

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Commercial business loans	56	(2	) 54	(6	) 48	59	—
Subtotal loans	787	(166	) 621	(91	) 530	681	15
Total	\$2,038	\$(335	) \$1,703	\$(91	) \$1,612	\$1,761	\$74

The average recorded investment in impaired loans was \$924,000 and \$3.5 million for the three months ended September 30, 2014 and 2013, respectively, and \$936,000 and \$3.5 million for the nine months ended September 30, 2014 and 2013, respectively. For the three and nine months ended September 30, 2014, the Company recognized interest income on impaired loans of \$10,000 and \$34,000, respectively, compared to \$28,000 and \$108,000, respectively, for same periods a year ago.

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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 and are typically secured by cash and/or marketable securities.

• 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. Closed-end loans that are 120 days past due and open-end loans that are 180 days past due are charged off based on the value of the collateral less cost to sell.





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

The following tables summarize risk rated loan balances by category at September 30, 2014 and December 31, 2013:

	September 30, 2014						
	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful(9)	Loss (10)	Total
<b>REAL ESTATE LOANS</b>							
Commercial	\$42,770	\$548	\$872	\$—	\$ —	\$—	\$44,190
Construction and development	51,413	—	—	—	—	—	51,413
Home equity	16,205	—	—	65	—	—	16,270
One-to-four-family	41,132	—	—	625	—	—	41,757
Multi-family	15,023	—	—	—	—	—	15,023
Total real estate loans	166,543	548	872	690	—	—	168,653
<b>CONSUMER</b>							
Indirect home improvement	96,728	—	—	221	—	—	96,949
Solar	13,373	—	—	29	—	—	13,402
Marine	16,523	—	—	—	—	—	16,523
Automobile	764	—	—	—	—	—	764
Recreational	463	—	—	—	—	—	463
Home improvement	367	—	—	—	—	—	367
Other	1,222	—	—	—	—	—	1,222
Total consumer loans	129,440	—	—	250	—	—	129,690
COMMERCIAL BUSINESS LOANS	54,293	5,638	3,290	383	—	—	63,604
Total	\$350,276	\$6,186	\$4,162	\$1,323	\$ —	\$—	\$361,947
	December 31, 2013						
	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful(9)	Loss (10)	Total
<b>REAL ESTATE LOANS</b>							
Commercial	\$31,500	\$903	\$—	\$567	\$ —	\$—	\$32,970
Construction and development	41,633	—	—	—	—	—	41,633
Home equity	15,000	—	—	172	—	—	15,172
One-to-four-family	19,766	—	—	1,043	—	—	20,809
Multi-family	4,682	—	—	—	—	—	4,682
Total real estate loans	112,581	903	—	1,782	—	—	115,266
<b>CONSUMER</b>							
Indirect home improvement	90,909	—	—	258	—	—	91,167
Solar	16,838	—	—	—	—	—	16,838
Marine	11,203	—	—	—	—	—	11,203
Automobile	1,230	—	—	—	—	—	1,230
Recreational	553	—	—	—	—	—	553
Home improvement	463	—	—	—	—	—	463

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Other	1,252	—	—	—	—	—	1,252
Total consumer loans	122,448	—	—	258	—	—	122,706
COMMERCIAL BUSINESS LOANS	38,492	10,698	—	54	—	—	49,244
Total	\$273,521	\$11,601	\$—	\$2,094	\$—	\$—	\$287,216

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

## Troubled Debt Restructured Loans

Troubled debt restructured (“TDR”) loans are loans for which the Company, for economic or legal reasons related to the borrower’s financial condition, has granted a significant concession to the borrower that it would otherwise not consider. The loan terms which have been modified or restructured due to a borrower’s financial difficulty include but are not limited to: a reduction in the stated interest rate; an extension of the maturity at an interest rate below current market; a reduction in the face amount of the debt; a reduction in the accrued interest; or re-aging, extensions, deferrals and renewals. TDR loans are considered impaired loans and are individually evaluated for impairment. TDR loans can be classified as either accrual or non-accrual. TDR loans are classified as non-performing loans unless they have been performing in accordance with their modified terms for a period of at least six months in which case they are placed on accrual status. The Company had four TDR loans on accrual and included in impaired loans at September 30, 2014, and December 31, 2013, respectively. In addition, the Company had no TDR loans on non-accrual, and had no commitments to lend additional funds on these restructured loans at September 30, 2014, and December 31, 2013.

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

	September 30, 2014	December 31, 2013
TDR loans still on accrual	\$791	\$815
TDR loans on non-accrual	—	—
Total TDR loans	\$791	\$815

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

	At or For the Three Months Ended September 30, 2014				2013			
	Number of Contracts	Recorded Investment	Increase in Allowance	Charge-offs to the Allowance	Number of Contracts	Recorded Investment	Increase in Allowance	Charge-offs to the Allowance
Loans	—	\$ —	\$ —	\$ —	—	\$ —	\$ —	\$ —
Total	—	\$ —	\$ —	\$ —	—	\$ —	\$ —	\$ —

  

	At or For the Nine Months Ended September 30, 2014				2013			
	Number of Contracts	Recorded Investment	Increase in Allowance	Charge-offs to the Allowance	Number of Contracts	Recorded Investment	Increase in Allowance	Charge-offs to the Allowance
Commercial business	—	\$ —	\$ —	\$ —	1	\$ 35	\$ —	\$ 35
Total	—	\$ —	\$ —	\$ —	1	\$ 35	\$ —	\$ 35



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

There were no TDRs recorded in the twelve months prior to September 30, 2014 and 2013, that subsequently defaulted in the nine months ended September 30, 2014 and 2013.

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.

The TDR in the table above was the result of interest rate modifications and extended payment terms. The Company has not forgiven any principal on the above loan.

## NOTE 4 – 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 \$297.5 million and \$243.0 million at September 30, 2014 and December 31, 2013, respectively. The fair market value of the servicing rights' asset was \$3.5 million and \$3.0 million at September 30, 2014 and December 31, 2013, respectively.

The following tables summarize servicing rights activity for the three and nine months ended September 30, 2014 and 2013:

	At or For the Three Months Ended September 30,	
	2014	2013
Beginning balance	\$2,336	\$1,785
Additions	356	350
Mortgage, commercial, and consumer servicing rights amortized	(141)	(110)
Recovery on servicing rights	18	2
Ending balance	\$2,569	\$2,027
	At or For the Nine Months Ended September 30,	
	2014	2013
Beginning balance	\$2,093	\$1,064
Additions	845	1,141
Mortgage, commercial, and consumer servicing rights amortized	(388)	(280)
Recovery on servicing rights	19	102
Ending balance	\$2,569	\$2,027



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## NOTE 4 – SERVICING RIGHTS (Continued)

Fair value adjustments to mortgage, commercial and consumer servicing rights were mainly due to market based assumptions associated with discounted cash flows, loan prepayment speeds, and changes in interest rates. Valuation assumptions used in determining the fair value of servicing rights at the dates indicated are as follows:

	At September 30,			
	2014	2013		
Key assumptions				
Weighted average discount rate	8.5	% 7.5		%
Weighted average life in years	7.5	5.9		
Prepayment speed (Public Securities Association "PSA" model)	155	225		

The Company recorded \$187,000 and \$135,000 of contractually specified servicing fees, late fees, and other ancillary fees resulting from servicing of mortgage, commercial and consumer loans for the three months ended September 30, 2014 and 2013, respectively, and \$521,000 and \$355,000 for the nine months ended September 30, 2014 and 2013, respectively, which is reported in noninterest income.

## 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.

The following tables summarize the Company's derivative instruments as of the dates indicated:

	September 30, 2014		
	Notional	Fair Value	
		Asset	Liability
Fallout adjusted interest rate lock commitments with customers	\$22,117	\$517	\$—
Mandatory and best effort forward commitments with investors	13,816	18	—
Forward TBA mortgage-backed securities	26,500	—	21
TBA mortgage-backed securities forward sales paired off with investors	16,500	—	64
		December 31, 2013	
		Fair Value	

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	Notional	Asset	Liability
Fallout adjusted interest rate lock commitments with customers	\$8,467	\$166	\$—
Mandatory and best effort forward commitments with investors	4,527	45	—
Forward TBA mortgage-backed securities	13,750	106	—
TBA mortgage-backed securities forward sales paired off with investors	4,000	44	—

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## NOTE 5 - DERIVATIVES (Continued)

The income on derivatives from fair value changes recognized in other noninterest income on the consolidated statements of income, included in gain on sale of loans was \$143,000 and \$42,000 for the three months ended September 30, 2014 and 2013, respectively, and \$464,000 and \$1.4 million for the nine months ended September 30, 2014 and 2013, respectively.

## NOTE 6 – OTHER REAL ESTATE OWNED

The following table presents the activity related to OREO for the three and nine months ended September 30, 2014 and 2013:

	At or For the Three Months Ended		At or For the Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Beginning balance	\$36	\$1,805	\$2,075	\$2,127
Additions	—	605	445	642
Fair value impairments	—	(151 )	(40 )	(347 )
Disposition of assets	(36 )	—	(2,480 )	(163 )
Ending balance	\$—	\$2,259	\$—	\$2,259

At September 30, 2014, there were no OREO properties. For the three months ended September 30, 2014 and 2013, the Company recorded an \$11,000 net loss, and no gain or loss on disposals of OREO, respectively. For the nine months ended September 30, 2014 and 2013, the Company recorded a \$2,000 net loss and no net gain or loss, respectively, on disposals of OREO. Holding costs associated with OREO were \$10,000 and \$41,000, for the three months ended September 30, 2014 and 2013, respectively, and \$13,000 and \$79,000, for the nine months ended September 30, 2014 and 2013, respectively.

## NOTE 7 – DEPOSITS

Deposits are summarized as follows as of September 30, 2014 and December 31, 2013:

	September 30, 2014	December 31, 2013
Noninterest-bearing checking <sup>(1)</sup>	\$49,543	\$45,783
Interest-bearing checking	26,179	26,725
Savings	19,388	15,345
Money market	124,026	119,162
Certificates of deposits of less than \$100,000 <sup>(2)</sup>	51,539	46,237
Certificates of deposits of \$100,000 through \$250,000	70,691	52,264

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Certificates of deposits of more than \$250,000	38,923	31,360
Total	\$380,289	\$336,876

(1) Includes \$3.4 million and \$1.5 million in escrow balances at September 30, 2014 and December 31, 2013, respectively.

(2) Includes \$19.6 million and \$16.9 million of brokered deposits at September 30, 2014 and December 31, 2013, respectively.

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## NOTE 7 – DEPOSITS (Continued)

Scheduled maturities of time deposits as of September 30, 2014 for future periods ending were as follows:

	As of September 30, 2014
2014	\$27,944
2015	51,311
2016	55,639
2017	16,403
2018	5,590
Thereafter	4,266
Total	\$161,153

The Bank pledged two securities held at the FHLB of Seattle with a fair value of \$1.2 million to secure Washington State public deposits of \$1.7 million with no collateral requirement by the Washington Public Deposit Protection Commission as of September 30, 2014.

FRB regulations require that the Bank maintain reserves in the form of cash on hand and deposit balances with the Federal Reserve Bank, based on a percentage of deposits. The amounts of such balances at September 30, 2014 and December 31, 2013 were \$1.8 million and \$1.6 million, respectively, and were in compliance with FRB regulations.

Interest expense by deposit category for the three and nine months ended September 30, 2014 and 2013 was as follows:

	For Three Months Ended September 30,		For Nine Months Ended September 30,	
	2014	2013	2014	2013
Interest-bearing checking	\$7	\$9	\$22	\$25
Savings and money market	137	138	385	396
Certificates of deposit	531	355	1,411	1,017
Total	\$675	\$502	\$1,818	\$1,438

## NOTE 8 – INCOME TAXES

The Company recorded a provision for income taxes of \$1.5 million and \$1.8 million during the nine months ended September 30, 2014 and September 30, 2013, respectively.

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, 2014, the Company had no uncertain tax positions. The Company recognizes interest and penalties in tax expense and at September 30, 2014, the Company had recognized no interest and penalties.

## 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.

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## NOTE 9 – COMMITMENTS AND CONTINGENCIES (Continued)

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, 2014 and December 31, 2013 were as follows:

	September 30, 2014	December 31, 2013
COMMITMENTS TO EXTEND CREDIT		
REAL ESTATE LOANS		
Construction and development	\$46,719	\$25,164
One-to-four-family	43,088	18,277
Home equity	12,741	12,452
Commercial/Multi-family	549	518
Total real estate loans	103,097	56,411
CONSUMER LOANS		
Other	5,959	6,162
Total consumer loans	5,959	6,162
COMMERCIAL BUSINESS LOANS		
Total commitments to extend credit	\$163,705	\$114,917

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 accounts receivable, inventory, property and equipment, residential real estate, and commercial, multi-family, and residential real estate.

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 \$124,000 and \$58,000 as of September 30, 2014 and December 31, 2013, 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.

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NOTE 9 – COMMITMENTS AND CONTINGENCIES (Continued)

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 \$295,000 and \$217,000 reserve to cover loss exposure related to these guarantees for one-to-four-family loans sold into the secondary market at September 30, 2014 and December 31, 2013, respectively.

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.

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 Bank must meet specific capital adequacy guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital 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, 2014 and December 31, 2013, the Bank was categorized as "well capitalized" under the regulatory framework for prompt corrective action. The Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table below to be categorized as well capitalized. There are no conditions or events since that notification that management believes have changed the Bank's category.





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## NOTE 11 – REGULATORY CAPITAL (Continued)

The Bank's capital amounts and ratios at September 30, 2014 and December 31, 2013 are also presented in the table.

Bank Only	Actual		For Capital Adequacy Purposes		To be Well Capitalized Under Prompt Corrective Action Provisions			
	Amount	Ratio	Amount	Ratio	Amount	Ratio		
As of September 30, 2014								
Total risk-based capital (to risk-weighted assets)	\$59,228	14.88	% \$31,835	8.00	% \$39,793	10.00	%	
Tier 1 risk-based capital (to risk-weighted assets)	\$54,238	13.63	% \$15,917	4.00	% \$23,876	6.00	%	
Tier 1 leverage capital (to average assets)	\$54,238	11.79	% \$18,405	4.00	% \$23,007	5.00	%	
As of December 31, 2013								
Total risk-based capital (to risk-weighted assets)	\$55,141	16.64	% \$26,512	8.00	% \$33,140	10.00	%	
Tier 1 risk-based capital (to risk-weighted assets)	\$50,985	15.38	% \$13,256	4.00	% \$19,884	6.00	%	
Tier 1 leverage capital (to average assets)	\$50,985	12.61	% \$16,177	4.00	% \$20,221	5.00	%	

Regulatory capital levels reported above differ from the Company's total equity, computed in accordance with U.S. GAAP with \$9.8 million of additional capital held at the holding company.

	Company		Bank	
	September 30, 2014	December 31, 2013	September 30, 2014	December 31, 2013
Equity	\$64,006	\$62,313	\$54,175	\$50,297
Unrealized loss on securities available-for-sale	63	898	63	898
Disallowed deferred tax assets	—	—	—	—
Disallowed servicing assets	—	(210)	—	(210)
Total Tier 1 capital	64,069	63,001	54,238	50,985
Allowance for loan and lease losses for regulatory capital purposes	4,990	4,156	4,990	4,156
Total risk-based capital	\$69,059	\$67,157	\$59,228	\$55,141

For a bank holding company with less than \$500 million in assets, the capital guidelines apply on a bank only basis and the Federal Reserve expects the holding company's subsidiary banks to be well capitalized under the prompt corrective action regulations. If the Company were subject to regulatory guidelines for bank holding companies with

\$500 million or more in assets, at September 30, 2014, the Company would have exceeded all regulatory capital

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NOTE 11 – REGULATORY CAPITAL (Continued)

requirements. The regulatory capital ratios calculated for the Company as of September 30, 2014 were 13.9% for Tier 1 leverage-based capital, 16.1% for Tier 1 risk-based capital and 17.4% 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. Transfers between the fair value hierarchy are determined through the third-party service provider which, from time to time will transfer between levels based on market conditions per the related security. All models and processes used, take into account market convention (Levels 1 and 2).

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

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 similar contracts in the market and changes in the market interest rates (Levels 2 and 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).

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

The following tables present securities available-for-sale measured at fair value on a recurring basis at September 30, 2014 and December 31, 2013:

	Securities Available-for-Sale			Total
	Level 1	Level 2	Level 3	
As of September 30, 2014				
Federal agency securities	\$—	\$5,766	\$—	\$5,766
Municipal bonds	—	16,238	—	16,238
Corporate securities	—	4,463	—	4,463
Mortgage-backed securities	—	20,954	—	20,954
Asset-backed and other amortized securities	—	2,022	—	2,022
Total	\$—	\$49,443	\$—	\$49,443

	Securities Available-for-Sale			Total
	Level 1	Level 2	Level 3	
As of December 31, 2013				
Federal agency securities	\$—	\$11,667	\$—	\$11,667
Municipal bonds	—	13,180	—	13,180
Corporate securities	997	2,941	—	3,938
Mortgage-backed securities	—	27,454	—	27,454
Total	\$997	\$55,242	\$—	\$56,239

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, 2014 and December 31, 2013.

	Interest Rate Lock Commitments with Customers			Total
	Level 1	Level 2	Level 3	
September 30, 2014	\$—	\$—	\$517	\$517
December 31, 2013	\$—	\$—	\$166	\$166

	Forward Sale Commitments with Investors			Total
	Level 1	Level 2	Level 3	
September 30, 2014	\$—	\$(21	) \$18	\$(3
December 31, 2013	\$—	\$106	\$45	\$151



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

	Paired Off Commitments with Investors			Total
	Level 1	Level 2	Level 3	
September 30, 2014	\$—	\$(64	) \$—	\$(64
December 31, 2013	\$—	\$44	\$—	\$44

The following table presents the impaired loans measured at fair value on a nonrecurring basis at September 30, 2014 and December 31, 2013:

	Impaired Loans			Total
	Level 1	Level 2	Level 3	
September 30, 2014	\$—	\$—	\$922	\$922
December 31, 2013	\$—	\$—	\$1,703	\$1,703

The following table presents OREO measured at fair value on a nonrecurring basis at September 30, 2014 and December 31, 2013:

	OREO			Total
	Level 1	Level 2	Level 3	
September 30, 2014	\$—	\$—	\$—	\$—
December 31, 2013	\$—	\$—	\$2,075	\$2,075

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, 2014 is shown in the following table.

Level 3 Fair Value Instrument	Valuation Technique	Significant Unobservable Inputs	Range (Weighted Average)	Weighted Average Rate
<b>RECURRING</b>				
Interest rate lock commitments with customers	Quoted market prices	Pull-through expectations	80% - 99.99%	91.81%
Forward sale commitments with investors	Quoted market prices	Pull-through expectations	80% - 99.99%	91.81%
<b>NONRECURRING</b>				
Impaired loans	Fair value of underlying collateral	Discount applied to the obtained appraisal	0.00% - 28.0%	0.45%





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NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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 approximates their fair value (Level 1).

Consumer Loans Held for Sale - The carrying amounts of consumer loans approximates its fair value (Level 1).

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

Accrued Interest – The carrying amounts of accrued interest approximates its 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).

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).

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).

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 at September 30, 2014 and December 31, 2013 were as follows:

	September 30, 2014		December 31, 2013	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets				
Level 1 inputs:				
Cash, due from banks, and interest-bearing deposits at other financial institutions	\$9,691	\$9,691	\$41,085	\$41,085
Securities available-for-sale	—	—	997	997
Level 2 inputs:				
Securities available-for-sale, at fair value	49,443	49,443	55,242	55,242
Loans held for sale, at fair value	20,254	20,254	11,185	11,185
Consumer loans held for sale	10,231	10,231	—	—
FHLB stock	1,853	1,853	1,702	1,702
Accrued interest receivable	1,525	1,525	1,261	1,261
Forward sale commitments with investors	—	—	106	106
Paired off commitments with investors	—	—	44	44
Level 3 inputs:				
Loans receivable, net	354,574	400,757	281,081	310,641
Servicing rights	2,569	3,457	2,092	2,961
Fair value interest rate locks with customers	517	517	166	166
Forward sale commitments with investors	18	18	45	45
Financial Liabilities				
Level 2 inputs:				
Deposits	380,289	393,508	336,876	351,408
Borrowings	22,552	22,526	16,664	16,553
Accrued interest payable	30	30	22	22
Forward sale commitments with investors	21	21	—	—
Paired off commitments with investors	64	64	—	—

## 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.

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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 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%.

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## NOTE 13 - EMPLOYEE BENEFITS (Continued)

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, 2013, the ESOP paid the second annual installment of principal in the amount of \$240,000, plus accrued interest of \$55,000 pursuant to the ESOP loan. No payment of principal or interest was made during the nine months ended September 30, 2014.

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, 2014 and September 30, 2013 was \$335,000 and \$333,000, respectively.

Shares held by the ESOP as of September 30, 2014 were as follows:

	Balances
Allocated shares	51,842
Committed to be released shares	19,441
Unallocated shares	187,927
Total ESOP shares	259,210
Fair value of unallocated shares (in thousands)	\$3,236

## 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.



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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 14 - EARNINGS PER SHARE (Continued)

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, 2014 and 2013.

	At or For the Three Months Ended September 30, 2014		At or For the Nine Months Ended September 30, 2013	
Numerator:				
Net Income (in thousands)	\$1,146	\$1,062	\$3,007	\$3,383
Denominator:				
Basic weighted average common shares outstanding	2,922,593	3,026,277	2,994,596	3,026,277
Dilutive restricted stock grants	9,658	—	4,013	—
Diluted weighted average common shares outstanding	2,932,251	3,026,277	2,998,609	3,026,277
Basic earnings per share	\$0.39	\$0.35	\$1.00	\$1.12
Diluted earnings per share	\$0.39	\$0.35	\$1.00	\$1.12
Potentially dilutive weighted average share options that were not included in the computation of diluted EPS because to do so would be anti-dilutive	36,954	—	20,296	—

Potential dilutive shares are excluded from the computation of earnings per share if their effect is anti-dilutive. Options to purchase 322,000 common stock shares at \$16.89 per share were outstanding at September 30, 2014, and were not included in the computation of diluted earnings per share because their exercise price resulted in them being anti-dilutive.

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 are included as outstanding shares for both basic and diluted earnings per share. There were 187,927 shares in the ESOP that were not committed to be released as of September 30, 2014.

## NOTE 15 - STOCK-BASED COMPENSATION

## Stock Options and Restricted Stock

In September 2013, the shareholders of FS Bancorp, Inc. approved the FS Bancorp 2013 Equity Incentive Plan ("Plan"). The Plan provides for the grant of stock options and restricted stock awards.

Total share-based compensation expense for the Plan was \$186,000 and \$297,000 for the three and nine months ended September 30, 2014, and there were no restricted stock or stock option grants in 2013.

## Stock Options

The Plan authorizes the grant of stock options totaling 324,013 shares to Company directors and employees. Option awards are granted with an exercise price equal to the market price of FS Bancorp's common stock at the grant date,





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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 15 - STOCK-BASED COMPENSATION (Continued)

May 8, 2014, of \$16.89 per share. These option awards have a vesting period of five years, with 20% vesting on the anniversary date of each grant date, and a contractual life of 10 years. Options were granted as non-qualified stock options ("NQSO"). Any unexercised stock options will expire 10 years after the grant date or sooner in the event of the award recipient's termination of service with the Company or the Bank.

The fair value of each option award is estimated on the grant date using a Black-Scholes Option pricing model that uses the following assumptions. The dividend yield is based on the current quarterly dividend in effect at the time of the grant. Historical employment data is used to estimate the forfeiture rate. The Company became a publicly held company in July 2012, therefore historical data was not available to calculate the volatility for FS Bancorp stock. Given this limitation, management utilized a proxy to determine the expected volatility of FS Bancorp's stock. The proxy chosen was the NASDAQ Bank Index, or NASDAQ Bank (NASDAQ symbol: BANK). This index provides the volatility of the banking sector for NASDAQ traded banks. The majority of smaller banks are traded on the NASDAQ given the costs and daily interaction required with trading on the New York Stock Exchange. The Company utilized the comparable Treasury rate for the discount rate associated with the stock options granted. The Company elected to use Staff Accounting Bulletin 107, simplified expected term calculation for the "Share-Based Payments" method permitted by the Securities and Exchange Commission to calculate the expected term. This method uses the vesting term of an option along with the contractual term, setting the expected life at 6.5 years.

A summary of the Company's stock option plan awards during the nine months ended September 30, 2014 is as follows:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term In Years	Aggregate Intrinsic Value
Outstanding at January 1, 2014	—	\$ —		\$—
Granted	322,000	16.89		9,660
Exercised	—	—		—
Forfeited or expired	—	—		—
Outstanding at September 30, 2014	322,000	\$ 16.89	9.61	\$9,660
Expected to vest, assuming a 0.31% annual forfeiture rate	319,407	\$ 16.89	9.61	\$9,582
Exercisable at September 30, 2014	—	\$ —	—	\$—

For the nine months ended September 30, 2014, there was \$1.1 million of total unrecognized compensation cost related to nonvested stock options granted under the Plan. The cost is expected to be recognized over the remaining weighted-average vesting period of 4.61 years.

**Restricted Stock Awards**

The Plan authorizes the grant of restricted stock awards totaling 129,605 shares to Company directors and employees, and all but 4,500 shares were granted on May 8, 2014. Compensation expense is recognized over the vesting period of

the awards based on the fair value of the stock at the grant date of \$16.89 per share. The restricted stock awards' fair value is equal to the value on the grant date. Shares awarded as restricted stock vest ratably over a three-year period for directors and a five-year period for employees, beginning at the grant date. Any unexercised restricted stock awards will expire after vesting or sooner in the event of the award recipient's termination of service with the Company or the Bank.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 15 - STOCK-BASED COMPENSATION (Continued)

A summary of the Company's nonvested awards during the nine months ended September 30, 2014 is as follows:

Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value Per Share	Aggregate Intrinsic Value
Nonvested at January 1, 2014	—	\$—	\$—
Granted	125,105	16.89	—
Vested	—	—	—
Forfeited or expired	—	—	—
Nonvested at September 30, 2014	125,105	\$16.89	\$—

For the nine months ended September 30, 2014, there was \$1.9 million of total unrecognized compensation costs related to nonvested shares granted as restricted stock awards. The cost is expected to be recognized over the remaining weighted-average vesting period of 3.98 years.

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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;
- secondary market conditions and our ability to sell loans in the secondary market;
- 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, 2013.

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 focuses on diversifying revenues, expanding lending channels, and growing the banking franchise. Management remains focused on building diversified revenue streams based upon credit, interest rate, and concentration risks. Our business plan remains as follows:

Growing and diversifying our loan portfolio;

Maintaining and improving asset quality;

Emphasizing lower cost core deposits to reduce the costs of funding our loan growth;

Capturing our customers' full relationship by offering a wide range of products and services; and

Expanding our reach by leveraging our well-established involvement in our communities and by selectively emphasizing products and services designed to meet our customers' banking needs.

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, solar panels, 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, 2014, consumer loans represented 35.8% of the Company's total portfolio, down from 42.7% at December 31, 2013, as real estate loan originations have increased at a faster pace than consumer loan originations during the nine months ended September 30, 2014.

Indirect home improvement lending is dependent on the Bank's relationships with home improvement contractors and dealers. The Company funded \$19.1 million, or 1,225 loans during the quarter ended September 30, 2014 using its indirect home improvement contractor/dealer network located throughout Washington, Oregon and California with

four contractors/dealers responsible for 59.1% of the funded loans dollar volume. The Company began originating consumer indirect loans during the fourth quarter of 2012 in the State of California and since inception has originated \$46.7 million. During the three months ended September 30, 2014, the Company originated \$7.6 million of consumer

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loans in California, and as of September 30, 2014, the Company had \$13.4 million of consumer indirect solar 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, 2014, the limit was \$25.9 million.

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.

The Company's earnings are primarily dependent upon 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.

### 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 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 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.

**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



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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.

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.

#### Comparison of Financial Condition at September 30, 2014 and December 31, 2013

Assets. Total assets increased \$52.4 million, or 12.5%, to \$471.6 million at September 30, 2014, from \$419.2 million at December 31, 2013, primarily as a result of a \$73.5 million, or 26.1% increase in net loans receivable, a \$10.2 million, or 100.0% increase in consumer loans held for sale, and a \$9.1 million, or 81.1% increase in loans held for sale, partially offset by a \$31.4 million, or 76.4% decrease in cash and cash equivalents, and a \$6.8 million, or 12.1% decrease in securities available-for-sale. In addition, both OREO and the deferred tax asset decreased to none at September 30, 2014, from \$2.1 million and \$816,000, respectively, at December 31, 2013.

Loans receivable, net increased \$73.5 million, or 26.1% to \$354.6 million at September 30, 2014, from \$281.1 million at December 31, 2013. Total real estate secured loans increased \$53.4 million, or 46.3% to \$168.7 million at September 30, 2014, from \$115.3 million at December 31, 2013, primarily as a result of a \$20.9 million, or 100.7% increase in one-to-four-family loans, an \$11.2 million, or 34.0% increase in commercial real estate loans, and a \$10.3 million, or 220.9% increase in multi-family loans, and a \$9.8 million or 8.5% increase in construction and development loans. Consumer loans increased \$7.0 million, or 5.7%, to \$129.7 million at September 30, 2014, from \$122.7 million at December 31, 2013, primarily as a result of a \$5.8 million, or 6.3% increase in indirect home improvement loans, and a \$5.3 million, or 47.5% increase in marine loans, partially offset by a \$3.4 million, or 20.4% decrease in solar loans, and a \$466,000, or 37.9% decrease in automobile loans. During the nine months ended September 30, 2014, the Company sold \$12.8 million of consumer solar loans at a pre-tax gain of \$507,000. The sale enabled the Company to continue to originate these loans while complying with its business plan limits on California lending to be no more than 20% of the total consumer loan portfolio. Commercial business loans increased \$14.4 million, or 29.2%, to \$63.6 million at September 30, 2014, from \$49.2 million at December 31, 2013.

Loans held for sale, consisting of one-to-four-family loans, increased by \$9.1 million to \$20.3 million at September 30, 2014, from \$11.2 million at December 31, 2013. In addition, during the three months ended September 30, 2014, \$10.2 million of California solar loans were reclassified to consumer loans held for sale from total consumer loans. 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 from time to time, California solar loans to maintain compliance with internal limits and to generate noninterest income. During the quarter ended September 30, 2014, the Company did not purchase any loans and sold \$74.4 million of one-to-four-family mortgage loans compared to \$65.2 million for the preceding quarter and \$62.5 million for the same quarter one year ago.

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The allowance for loan losses at September 30, 2014 was \$5.8 million, or 1.6% of gross loans receivable, compared to \$5.1 million, or 1.8% of gross loans receivable, at December 31, 2013. Substandard loans decreased to \$1.3 million at September 30, 2014, compared to \$2.1 million at December 31, 2013. Non-performing loans, consisting of non-accruing loans, decreased to \$409,000 at September 30, 2014, from \$1.1 million at December 31, 2013. At September 30, 2014, non-performing loans consisted of \$94,000 of one-to-four-family loans, \$65,000 of home equity loans, and \$250,000 of consumer loans. Non-performing loans to total gross loans decreased to 0.1% at September 30, 2014,

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from 0.4% at December 31, 2013. The Company had no OREO at September 30, 2014, compared to \$2.1 million at December 31, 2013. During the nine months ended September 30, 2014, there was one property foreclosed upon of \$445,000, \$40,000 in OREO impairments, and sales totaling \$2.5 million, representing proceeds from all properties held as OREO. The Company also had \$791,000 in TDRs at September 30, 2014, all of which were performing in accordance with their modified payment terms.

A summary of non-performing assets as of September 30, 2014 and December 31, 2013:

	September 30, 2014	December 31, 2013
Non-performing assets:		
Non-accrual loans	\$ 409	\$ 1,101
OREO	—	2,075
Other assets	—	32
Total non-performing assets	\$ 409	\$ 3,208

**Liabilities.** Total liabilities increased \$50.7 million, or 14.2%, to \$407.6 million at September 30, 2014, from \$356.9 million at December 31, 2013. Deposits increased \$43.4 million, or 12.9%, to \$380.3 million at September 30, 2014, from \$336.9 million at December 31, 2013. Transaction accounts (noninterest, interest-bearing checking, and escrow accounts) increased \$3.2 million, or 4.4% to \$75.7 million as of September 30, 2014, from \$72.5 million at December 31, 2013. Money market and savings accounts increased \$8.9 million, or 6.6%, to \$143.4 million at September 30, 2014, from \$134.5 million at December 31, 2013. Time deposits increased \$31.3 million, or 24.1% to \$161.2 million at September 30, 2014, from \$129.9 million at December 31, 2013. Non-retail deposits which include \$19.6 million of brokered certificates of deposit, \$19.3 million of online certificates of deposit, and \$1.7 million of public funds, increased to \$40.5 million as of September 30, 2014, compared to \$24.1 million at December 31, 2013. The Company continues its focus on relationship deposit growth with new and existing customers as the primary source of funds for loan growth.

Total borrowings, which consisted of FHLB advances, increased \$5.9 million, or 35.3%, to \$22.6 million at September 30, 2014, from \$16.7 million at December 31, 2013. The increase in borrowings was primarily due to funding loan growth through similar duration borrowings to manage interest rate risk.

**Stockholders' Equity.** Total stockholders' equity increased \$1.7 million, or 2.7%, to \$64.0 million at September 30, 2014, from \$62.3 million at December 31, 2013. The increase in stockholders' equity was primarily a result of net income of \$3.0 million during the nine months ended September 30, 2014. The increase during this period also included an improvement of \$835,000 in accumulated other comprehensive income representing a decline in the unrealized loss on securities available-for-sale due to a decrease in treasury rates and the sale of some of the Company's longer term bonds to reduce the exposure to longer term rates, partially offset by \$2.2 million of common stock share repurchases, and \$523,000 of dividends paid. Book value per common share was \$21.90 at September 30, 2014, compared to \$20.55 at December 31, 2013.

#### Comparison of Results of Operations for the Three and Nine Months Ended September 30, 2014 and 2013

**General.** Net income for the three months ended September 30, 2014 was unchanged at \$1.1 million for both three month periods ended September 30, 2014 and 2013. Although unchanged in total, the components of net income changed as a result of a \$1.0 million, or 18.0% increase in interest income, a \$221,000, or 10.2% increase in noninterest income, offset by a \$1.0 million increase in noninterest expense, and a \$193,000, or 34.6% increase in

interest expense.

Net income for the nine months ended September 30, 2014 was \$3.0 million compared to the net income of \$3.4 million for the nine months ended September 30, 2013. The \$376,000 decrease in net income was primarily attributable to a

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\$1.9 million, or 12.4% increase in noninterest expense, and a \$465,000 or 6.3% decrease in noninterest income, partially offset by a \$1.3 million, or 9.0% increase in net interest income, a \$370,000, or 21.5% decrease in the provision for loan losses, and a \$277,000 or 15.6% decrease in the provision for income tax.

The following table sets forth the average balances of all major categories of interest-earning assets and interest-bearing liabilities to calculate the comparison of results of operations for the three and nine months ended September 30, 2014 and 2013:

Average Balances	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2014	2013	2014	2013
<b>Assets</b>				
Loans receivable <sup>(1)</sup>	\$378,293	\$304,036	\$334,904	\$295,575
Securities available-for-sale, at fair value	53,791	49,549	62,396	46,500
Interest-bearing deposits at other financial institutions	7,425	19,919	19,677	18,614
Total interest-earning assets	439,509	373,504	416,977	360,689
Noninterest-earning assets	20,684	21,138	21,433	19,251
Total assets	\$460,193	\$394,642	\$438,410	\$379,940
<b>Liabilities and Stockholders' Equity</b>				
Interest-bearing deposits	\$312,125	\$267,463	\$300,878	\$260,568
Borrowings	30,804	21,272	22,843	16,939
Total interest-bearing liabilities	342,929	288,735	323,721	277,507
Noninterest-bearing deposits	50,558	41,703	48,244	38,532
Other noninterest-bearing liabilities	3,920	3,620	3,678	3,304
Stockholders' equity	62,786	60,584	62,767	60,597
Total liabilities and stockholders' equity	\$460,193	\$394,642	\$438,410	\$379,940

(1) Includes loans held for sale

Net Interest Income. Net interest income increased \$813,000, or 16.1%, to \$5.8 million for the three months ended September 30, 2014, from \$5.0 million for the three months ended September 30, 2013. The increase in net interest income was attributable to a \$974,000, or 18.2% increase in loans receivable interest income primarily due to an increase in the average loans receivable balance, partially offset by a \$193,000 or 34.5% increase in interest expense, primarily due to increases in the average balances of interest-bearing deposits and borrowings as compared to the same period last year.

The net interest income increased \$1.3 million, or 9.0%, to \$15.9 million for the nine months ended September 30, 2014, from \$14.6 million for the nine months ended September 30, 2013. The increase in net interest income was attributable to a \$1.5 million, or 9.5% increase in loan receivable interest income, and a \$278,000 or 41.4% increase in interest and dividends on investment securities, and cash and cash equivalents interest income, reflecting primarily increased average balances, partially offset by a \$435,000 or 27.5% increase in interest expense as a result of increases in the average balances of interest-bearing deposits and borrowings, as compared to the same period last year.

The net interest margin ("NIM") decreased seven basis points to 5.28% for the three months ended September 30, 2014, from 5.35% for the three months ended September 30, 2013, and decreased 31 basis points to 5.11% for the nine months ended September 30, 2014, from 5.42% for the same period of the prior year. The reduced NIM reflects growth in lower yielding loan types as part of the loan diversification strategy instituted with the three year business

plan. The loan diversification strategy will continue to pressure the NIM as real estate and business loans have a lower yield than

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consumer loan products. As a percentage, consumer loans to total loans were 35.8% as of September 30, 2014, compared to 42.9% as of September 30, 2013. The average cost of funds decreased one basis point to 0.76% for the three months ended September 30, 2014, from 0.77% for the three months ended September 30, 2013, and decreased four basis points to 0.72% for the nine months ended September 30, 2014, from 0.76% for the same period in the prior year as a result of increased loan activity. Management is focused on matching deposit duration with the duration of earning assets as appropriate.

**Interest Income.** Interest income for the three months ended September 30, 2014 increased \$1.0 million, or 18.0%, to \$6.6 million from \$5.6 million for the three months ended September 30, 2013. The increase during the period was primarily attributable to the increase in the average balance of the loan portfolio to \$378.3 million for the three months ended September 30, 2014, compared to \$304.0 million for the three months ended September 30, 2013, as well as a shift of funds during the period to lower yielding investment securities and loans during the three months ended September 30, 2014, compared to the same period last year. The average yield on interest-earning assets increased one basis point to 5.96% for the three months ended September 30, 2014, compared to 5.95% for the three months ended September 30, 2013.

Interest income for the nine months ended September 30, 2014 increased \$1.8 million, or 10.8%, to \$18.0 million, from \$16.2 million for the nine months ended September 30, 2013. The increase during the period was primarily attributable to the increase in the average balance of the loan portfolio to \$334.9 million for the nine months ended September 30, 2014, compared to \$295.6 million for the nine months ended September 30, 2013, and a \$15.9 million increase in the average balance of securities available-for-sale to \$62.4 million for the nine months ended September 30, 2014, compared to \$46.5 million for the same period last year, partially offset by a 25 basis point decline in the average yield on interest-earning assets to 5.76% during the nine months ended September 30, 2014 from 6.01% for the same period last year.

**Interest Expense.** Interest expense increased \$193,000 or 34.6%, to \$751,000 for the three months ended September 30, 2014, from \$558,000 for the same period of the prior year. The increase during the period was primarily attributable to the \$54.2 million, or 18.8% increase in the average balance of total interest-bearing liabilities to \$342.9 million for the quarter ended September 30, 2014, from \$288.7 million for the quarter ended September 30, 2013. The average cost of funds decreased one basis point to 0.76% for the three months ended September 30, 2014, compared to 0.77% for the three months ended September 30, 2013. The decrease was primarily due to growth in noninterest-bearing deposits and extending maturities on deposit products to manage interest rate risk.

Interest expense increased \$435,000, or 27.5%, to \$2.0 million for the nine months ended September 30, 2014, from \$1.6 million for the same period of the prior year. The increase during the period was primarily attributable to the \$46.2 million, or 16.7% increase in the average balance of total interest-bearing liabilities to \$323.7 million for the nine months ended September 30, 2014, from \$277.5 million for the nine months ended September 30, 2013. As a result of the general decline in market rates, the average cost of funds for total interest-bearing liabilities decreased four basis points to 0.72% for the nine months ended September 30, 2014, compared to 0.76% for the nine months ended September 30, 2013.

**Provision for Loan Losses.** The provision for loan losses was \$450,000 for the three months ended September 30, 2014, compared to \$520,000 for the three months ended September 30, 2013. The \$70,000 decrease in the provision during the current quarter over the comparable quarter last year, primarily relates to improved asset quality performance as both non-accrual and substandard loans continued to decline and loan charge-offs decreased. The provision for loan losses was also impacted by the change in loan mix with lower reserves required for the increase in real estate and commercial business loans as compared to consumer loans. During the three months ended September 30, 2014, net charge-offs totaled \$186,000 compared to \$486,000 during the same period last year.

The provision for loan losses was \$1.4 million for the nine months ended September 30, 2014, compared to \$1.7 million for the nine months ended September 30, 2013. The \$370,000 decrease in the provision primarily relates to improved asset quality performance due to the decline in both the non-accrual and substandard loans. Non-performing loans were \$409,000, or 0.1% of total loans at September 30, 2014, compared to \$1.5 million, or 0.5% of total loans at



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September 30, 2013. During the nine months ended September 30, 2014, net charge-offs totaled \$630,000 compared to \$1.1 million during the nine months ended September 30, 2013.

**Noninterest Income.** Noninterest income increased \$221,000, or 10.2%, to \$2.4 million for the three months ended September 30, 2014, from \$2.2 million for the three months ended September 30, 2013. The increase during the period was primarily due to an increase of \$252,000 in gain on sale of loans. One-to-four-family originations of loans held for sale, including loans brokered to other institutions, increased 35.1% to \$81.2 million during the quarter ended September 30, 2014, compared to \$60.1 million for the same quarter one year ago. The increase in originations directly correlated to increased purchase activity by borrowers because of seasonality in home purchases in the Northwest. Purchase production increased with \$73.6 million in closed purchase loans for the three months ended September 30, 2014, up from \$46.7 million for the three months ended September 30, 2013. Refinances increased by \$1.2 million, or 7.2% to \$18.3 million for the three months ended September 30, 2014, from \$17.1 million for the same period last year.

Noninterest income decreased \$465,000, or 6.3%, to \$6.9 million for the nine months ended September 30, 2014, from \$7.4 million for the nine months ended September 30, 2013. The decrease during the period was due to a \$305,000 reduction in gain on sale of investments, a \$224,000 decrease in gain on sale of loans, a \$119,000 decrease in service charges and fee income, offset by a \$183,000 increase in other noninterest income. The decrease in gain on sale of loans was primarily attributable to a decrease in the home lending gain on sales of \$405,000 to \$4.5 million for the nine months ended September 30, 2014, from \$4.9 million for the nine months ended September 30, 2013, partially offset by the consumer loan gain on sales of \$564,000 for the nine month period ended September 30, 2014, as compared to \$200,000 gains on consumer loan sales during the same period last year.

**Noninterest Expense.** Noninterest expense increased \$1.1 million, or 20.6%, to \$6.1 million for the three months ended September 30, 2014, from \$5.0 million for the three months ended September 30, 2013. Changes in noninterest expense included a \$979,000, or 38.0% increase in salaries and benefits, a \$180,000, or 23.9% increase in operation costs and a \$48,000 increase in occupancy expense associated with the continued investment in growing the lending and deposit franchise, primarily as a result of the hiring of additional employees in mortgage-related lending, and loan servicing and operations areas. These increases were partially offset by a decrease of \$140,000, or 92.7% of OREO fair value impairments.

Noninterest expense increased \$1.9 million, or 12.4%, to \$17.0 million for the nine months ended September 30, 2014, from \$15.1 million for the nine months ended September 30, 2013. Changes in noninterest expense included a \$1.7 million, or 21.1% increase in salaries and benefit costs reflecting the hiring of additional employees and the implementation of the Company's equity incentive plan, a \$147,000, or 13.7% increase in occupancy costs primarily due to renting additional home lending office space, and a \$101,000, or 12.4% increase in data processing costs reflecting operational growth, partially offset by a \$66,000 or 83.5% decrease in OREO expenses.

The efficiency ratio, which is noninterest expense as a percentage of net interest income and noninterest income, increased to 73.8% for the three months ended September 30, 2014, compared to 70.0% for the three months ended September 30, 2013, and was 74.4% for the nine months ended September 30, 2014, compared to 68.7% for the nine months ended September 30, 2013, primarily as a result of an increase in noninterest expense, and the decrease in noninterest income partially offset by the increase in net interest income.

**Provision for Income Tax.** For the nine months ended September 30, 2014, the Company recorded a provision for income tax expense of \$1.5 million on pre-tax income as compared to \$1.8 million for the nine months ended September 30, 2013. The effective tax rate for the nine month periods ended September 30, 2014 and 2013, were 33.0% and 34.4%, respectively.

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

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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, 2014, the Bank's total borrowing capacity was \$53.5 million with the FHLB of Seattle, with unused borrowing capacity of \$19.0 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, 2014, the Bank held approximately \$68.7 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 \$69.3 million, and a combined credit limit of \$25.0 million in written Fed Funds lines of credit through correspondent banking relationships as of September 30, 2014. 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, 2014, the Bank held approximately \$133.9 million in loans that qualify as collateral for the Federal Reserve Bank line of credit.

As of September 30, 2014, \$22.6 million in FHLB advances were outstanding and no advances were outstanding against the Federal Reserve Bank line of credit or Fed Funds lines of credit. The Bank's Asset Liability Management Policy permits management to utilize brokered deposits up to 20% of deposits or \$77.9 million as of September 30, 2014. Total brokered deposits as of September 30, 2014 were \$19.6 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, 2014, the approved outstanding loan commitments, including unused lines of credit, amounted to \$163.7 million. Certificates of deposit scheduled to mature in three months or less at September 30, 2014, totaled \$27.9 million. It is management's policy 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, 2014, 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, 2014, the Bank was considered to be "well capitalized". At September 30, 2014, 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 11.8%, 13.6%, and 14.9%, 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.

For a bank holding company with less than \$500 million in assets, the capital guidelines apply on a bank only basis and the Federal Reserve expects the holding company's subsidiary banks to be well capitalized under the prompt corrective action regulations. If the Company were subject to regulatory guidelines for bank holding companies with \$500 million or more in assets, at September 30, 2014 the Company would have exceeded all regulatory capital requirements. The estimated regulatory capital ratios calculated for the Company as of September 30, 2014 were 13.9% for Tier 1 leverage-based capital, 16.1% for Tier 1 risk-based capital and 17.4% for total risk-based capital.

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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, 2014, 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, 2014, 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, 2014, 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 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, 2013.

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

(a) Not applicable

(b) Not applicable

The following table summarizes common stock repurchases during the nine months ended September 30, 2014:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Repurchased as Part of Publicly Announced Plan	Maximum Number of Shares that May Yet Be Repurchased Under the Plan
January 1, 2014 - January 31, 2014	—	\$—	—	—
February 1, 2014 - February 28, 2014	—	—	—	—
March 1, 2014 - March 31, 2014	—	—	—	—
April 1, 2014 - April 30, 2014	—	—	—	—
May 1, 2014 - May 31, 2014	129,605	17.15	129,605	—
June 1, 2014 - June 30, 2014	—	—	—	—
July 1, 2014 - July 31, 2014	—	—	—	—
August 1, 2014 - August 31, 2014	—	—	—	—
September 1, 2014 - September 30, 2014	—	—	—	—
Total	129,605	\$17.15	129,605	—

On May 9, 2014, the Company announced that its Board of Directors authorized the repurchase of up to 129,605 shares of the Company's common stock, or 4% of the Company's outstanding shares, which is being used to fund grants of restricted stock under the Company's 2013 Equity Incentive Plan. The repurchase program permits shares to be repurchased in open market or private transactions, through block trades, and pursuant to any trading plan that may be adopted in accordance with Rule 10b5-1 of the Securities and Exchange Commission.

## Item 3. Defaults Upon Senior Securities

Not applicable.

## Item 4. Mine Safety Disclosures

Not applicable.

## Item 5. Other Information

Not applicable.

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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)

10.3 FS Bancorp, Inc. 2013 Equity Incentive Plan (the "2013 Plan") (2)

10.4 Form of Incentive Stock Option Agreement under the 2013 Plan (2)

10.5 Form of Non-Qualified Stock Option Agreement under the 2013 Plan (2)

10.6 Form of Restricted Stock Agreement under the 2013 Plan (2)

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 Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, 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 (333-177125) filed on October 3, 2011 and incorporated by reference.

(2) Filed as an exhibit to the Registrant's Registration Statement on Form S-8 (333-192990) filed on December 20, 2013 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 10, 2014

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

Date: November 10, 2014

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

Exhibit Index

Exhibit No.	Description
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
101	The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, formatted in Extensible Business Reporting Language (XBRL): (1) Consolidated Balance Sheets; (2) 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. *

\*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.