FS Bancorp, Inc.
Form 10-Q
August 08, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 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	45-4585178
(State or other jurisdiction of incorporation or organization)	(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 [X] 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 [X] 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 [ ]

Non-accelerated filer [ ] (Do not check if a smaller reporting company)	Smaller reporting company [X]

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

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 August 8, 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)

	June 30, 2014	December 31, 2013
ASSETS		
Cash and due from banks	$2,049	$1,425
Interest-bearing deposits at other financial institutions	7,106	39,660
Securities available-for-sale, at fair value	58,363	56,239
Federal Home Loan Bank stock, at cost	1,670	1,702
Loans held for sale, at fair value	15,975	11,185
Loans receivable, net	325,495	281,081
Accrued interest receivable	1,366	1,261
Premises and equipment, net	13,763	13,818
Other real estate owned ("OREO")	36	2,075
Deferred tax asset	—	816
Bank owned life insurance ("BOLI")	6,460	6,369
Other assets	3,738	3,556
TOTAL ASSETS	$436,021	$419,187
LIABILITIES		
Deposits		
Noninterest-bearing accounts	$47,685	$45,783
Interest-bearing accounts	303,959	291,093
Total deposits	351,644	336,876
Borrowings	17,552	16,664
Other liabilities	4,041	3,334
Total liabilities	373,237	356,874
COMMITMENTS AND CONTINGENCIES (NOTE 9)		
STOCKHOLDERS' EQUITY		
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 June 30, 2014 and December 31, 2013, respectively	32	32
Additional paid-in capital	28,963	30,097
Retained earnings	35,808	35,215
Accumulated other comprehensive loss	(18)	(898)
Unearned shares - Employee Stock Ownership Plan ("ESOP")	(2,001)	(2,133)
Total stockholders' equity	62,784	62,313
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$436,021	$419,187

See accompanying notes to these consolidated financial statements.

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FS BANCORP, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
(Dollars in thousands, except earnings per share data) (Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
INTEREST INCOME				
Loans receivable	$5,493	$5,233	$10,674	$10,171
Interest and dividends on investment securities, cash and cash equivalents, and interest-bearing deposits at other financial institutions	356	203	686	440
Total interest and dividend income	5,849	5,436	11,360	10,611
INTEREST EXPENSE				
Deposits	594	464	1,144	936
Borrowings	63	48	121	87
Total interest expense	657	512	1,265	1,023
NET INTEREST INCOME	5,192	4,924	10,095	9,588
PROVISION FOR LOAN LOSSES	450	600	900	1,200
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	4,742	4,324	9,195	8,388
NONINTEREST INCOME				
Service charges and fee income	446	494	844	948
Gain on sale of loans	1,794	2,228	3,302	3,779
Gain on sale of investment securities	10	96	10	264
Other noninterest income	206	113	352	203
Total noninterest income	2,456	2,931	4,508	5,194
NONINTEREST EXPENSE				
Salaries and benefits	3,240	3,135	6,363	5,612
Operations	926	759	1,472	1,517
Occupancy	403	385	801	702
Data processing	300	266	588	532
OREO fair value impairments, net of (gain) loss on sales	(1)	117	30	195
OREO expenses (income)	(29)	16	3	38
Loan costs	391	345	696	645
Professional and board fees	298	333	602	563
FDIC insurance	62	67	125	123
Marketing and advertising	125	158	232	243
Impairment (recovery) on mortgage servicing rights	(1)	22	(1)	(100)
Total noninterest expense	5,714	5,603	10,911	10,070
INCOME BEFORE PROVISION FOR INCOME TAX	1,484	1,652	2,792	3,512
PROVISION FOR INCOME TAX	498	566	931	1,191
NET INCOME	$986	$1,086	$1,861	$2,321
Basic earnings per share	$0.33	$0.36	$0.62	$0.77
Diluted earnings per share	$0.33	$0.36	$0.62	$0.77

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 June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Net Income	$ 986	$ 1,086	$ 1,861	$ 2,321
Other comprehensive gain (loss), net of tax:				
Unrealized gain (loss) on securities available-for-sale:				
Unrealized holding gain (loss) arising during period	802	(1,299)	1,344	(1,564)
Income tax (provision) benefit related to unrealized gains	(272)	442	(457)	532
Reclassification adjustment for realized gains included in net income	(10)	(96)	(10)	(264)
Income tax benefit related to reclassification for realized gains	3	33	3	90
Other comprehensive gain (loss), net of tax	523	(920)	880	(1,206)
COMPREHENSIVE INCOME	$ 1,509	$ 166	$ 2,741	$ 1,115

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				Accumulated		
	Shares	Amount	Additional Paid-in Capital	Retained Earnings	Other Comprehensive Income (Loss)	Unearned ESOP Shares	Total Stockholders' Equity
BALANCE, January 1, 2013	3,240,125	$32	$29,894	$31,746	$ 597	$(2,372)	$ 59,897
Net income	—	—	—	2,321	—	—	2,321
Other comprehensive loss, net of tax	—	—	—	—	(1,206)	—	(1,206)
Dividends paid ($0.05 per share)	—	—	—	(150)	—	—	(150)
ESOP shares allocated	—	—	85	—	—	132	217
BALANCE, June 30, 2013	3,240,125	$32	$29,979	$33,917	$ (609)	$(2,240)	$ 61,079
BALANCE, January 1, 2014	3,240,125	$32	$30,097	$35,215	$ (898)	$(2,133)	$ 62,313
Net income	—	—	—	1,861	—	—	1,861
Dividends paid ($0.11 per share)	—	—	—	(341)	—	—	(341)
Share-based compensation	—	—	110	—	—	—	110
Restricted stock awards	125,105	—	(1)	—	—	—	(1)
Common stock repurchased	(129,605)	—	(1,295)	(927)	—	—	(2,222)
Other comprehensive income, net of tax					880		880
ESOP cash distribution	—	—	(35)	—	—	—	(35)
ESOP shares allocated	—	—	87	—	—	132	219
BALANCE, June 30, 2014	3,235,625	$32	$28,963	$35,808	$ (18)	$(2,001)	$ 62,784

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)

	Six Months Ended June 30,	
	2014	2013
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$1,861	$2,321
Adjustments to reconcile net income to net cash from operating activities		
Provision for loan losses	900	1,200
Depreciation, amortization and accretion	1,677	513
Compensation expense related to stock options and restricted stock awards	110	—
ESOP compensation expense for allocated shares	219	217
Provision for deferred income taxes	816	981
Increase in cash surrender value of BOLI	(91)	—
Gain on sale of loans held for sale	(2,741)	(3,779)
Gain on sale of portfolio loans	(561)	—
Origination of loans held for sale	(103,425)	(132,168)
Proceeds from sale of loans held for sale	100,887	133,978
Gain on sale of investment securities	(10)	(264)
Gain on sale of OREO	(10)	—
Recovery of servicing rights	(1)	(100)
Impairment loss on other real estate owned	40	195
Changes in operating assets and liabilities		
Accrued interest receivable	(105)	(69)
Other assets	(429)	(1,368)
Other liabilities	707	(52)
Net cash from (used by) operating activities	(156)	1,605
CASH FLOWS FROM INVESTING ACTIVITIES		
Activity in securities available-for-sale:		
Proceeds from sale of investment securities	11,720	8,786
Maturities, prepayments, and calls	7,964	1,676
Purchases	(20,923)	(13,083)
Loan originations and principal collections, net	(58,734)	(9,496)
Proceeds from sale of portfolio loans	12,849	—
Proceeds from sale of OREO	2,454	163
Purchase of premises and equipment, net	(447)	(1,289)
Net cash used by investing activities	(45,117)	(13,243)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	14,768	11,964
Proceeds from borrowings	30,207	76,454
Repayments of borrowings	(29,319)	(69,630)
Dividends paid	(341)	(150)
Common stock repurchased	(2,222)	—
Net cash from financing activities	13,093	18,638
NET DECREASE IN CASH AND CASH EQUIVALENTS	(32,180)	7,000
CASH AND CASH EQUIVALENTS, beginning of period	38,459	6,787
CASH AND CASH EQUIVALENTS, end of period	$6,279	$13,787

SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid during the period for:		
Interest	$1,262	$1,017
Income taxes	$175	$210
SUPPLEMENTARY DISCLOSURES OF NONCASH OPERATING, INVESTING AND FINANCING ACTIVITIES		
Change in unrealized gain (loss) on investment securities	$880	$(1,206)
Property received in settlement of loans	$445	$(36)
Transfer portfolio loans to loans held for sale	$—	$3,251

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 six months ended June 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 benefits of eligible savings account holders as of June 30, 2007 and supplemental eligible account holders as of March 31, 2012 who maintain deposit accounts at the Bank after the conversion. The conversion was accounted for as a change in corporate form with the historic basis of the Company's assets, liabilities, and equity unchanged as a result.

Use of Estimates – The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements. Actual results could differ

from these estimates. Material estimates that are particularly susceptible to change in the near term are allowances for loan losses, fair value of measurements, and the estimated realizability related to the deferred tax asset.

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

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

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

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

Cash and Cash Equivalents – Cash and cash equivalents include cash and due from banks, and interest-bearing balances due from other banks and the Federal Reserve Bank of San Francisco. Cash and cash equivalents have a maturity of 90 days or less at the time of purchase. As of June 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 $7.1 million and $39.7 million as of June 30, 2014 and December 31, 2013, respectively. Certificates of deposits in the amount of $2.9 million and $2.6 million with original maturity dates greater than 90 days were excluded from cash and cash equivalents as of June 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 - 04, Receivables - Trouble Debt Restructurings by Creditors (Subtopic 310-40) - Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. This ASU is intended to clarify when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan should be derecognized and the real estate recognized. This ASU clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either: (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure, or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. This ASU is effective for fiscal years, and interim reporting periods within those annual periods 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.

In April 2014, the FASB issued ASU No. 2014-08, “Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity." ASU 2014-08 raises the threshold for a disposal to qualify as a discontinued operation and requires new disclosures of both discontinued operations and certain other disposals that do not meet the definition of a discontinued operation. This ASU is effective for annual periods beginning on or after December 15, 2014. Early adoption is permitted but only for disposals that have not been reported in financial statements previously 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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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2 – SECURITIES AVAILABLE-FOR-SALE

The following table presents the amortized costs, unrealized gains, unrealized losses and approximate fair values of securities available-for-sale at June 30, 2014 and December 31, 2013:

	June 30, 2014			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Values
SECURITIES AVAILABLE-FOR-SALE				
Federal agency securities	$6,754	$9	$(216)	$6,547
Municipal bonds	16,027	288	(82)	16,233
Corporate securities	4,997	2	(40)	4,959
Mortgage-backed securities	30,613	171	(160)	30,624
Total securities available-for-sale	$58,391	$470	$(498)	$58,363

	December 31, 2013			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Estimated Fair Values
SECURITIES AVAILABLE-FOR-SALE				
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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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Investment securities that were in an unrealized loss position as of June 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.

	June 30, 2014					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
SECURITIES AVAILABLE-FOR-SALE						
Federal agency securities	$—	$—	$4,779	$(216)	$4,779	$(216)
Municipal bonds	2,149	(3)	3,534	(79)	5,683	(82)
Corporate securities	2,471	(31)	491	(9)	2,962	(40)
Mortgage-backed securities	—	—	11,061	(160)	11,061	(160)
Total securities available-for-sale	$4,620	$(34)	$19,865	$(464)	$24,485	$(498)

	December 31, 2013					
	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
SECURITIES AVAILABLE-FOR-SALE						
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 five investments with unrealized losses of less than one year as of June 30, 2014, and 19 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 has the intent and ability to hold these securities until recovery, and is not likely to be required to sell these securities. No other-than-temporary impairment was recorded for the six months ended June 30, 2014 or the year ended December 31, 2013.

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

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

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

	June 30, 2014	
	Amortized Cost	Fair Value
Due in one year or less	$1,760	$1,765
Due after one year through five years	4,769	4,788
Due after five years through ten years	17,105	16,903
Due after ten years	34,757	34,907
Total	$58,391	$58,363

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

	Three Months Ended June 30, 2014			Six Months Ended June 30, 2014		
	Proceeds	Gross Gains	Gross (Losses)	Proceeds	Gross Gains	Gross (Losses)
Securities available-for-sale	$11,721	$64	$(54)	$11,721	$64	$(54)

	Three Months Ended June 30, 2013			Six Months Ended June 30, 2013		
	Proceeds	Gross Gains	Gross (Losses)	Proceeds	Gross Gains	Gross (Losses)
Securities available-for-sale	$4,718	$96	$—	$8,786	$264	$—

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

NOTE 3 – LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

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

	June 30, 2014	December 31, 2013
REAL ESTATE LOANS		
Commercial	$39,832	$32,970
Construction and development	40,736	41,633
Home equity	15,113	15,172
One-to-four-family (excludes held for sale loans)	32,039	20,809
Multi-family	11,448	4,682
Total real estate loans	139,168	115,266
CONSUMER LOANS		
Indirect home improvement	93,905	91,167
Solar	17,026	16,838
Marine	14,518	11,203
Automobile	929	1,230
Recreational	490	553
Home improvement	410	463
Other	1,214	1,252
Total consumer loans	128,492	122,706
COMMERCIAL BUSINESS LOANS	64,584	49,244
Total loans	332,244	287,216
Allowance for loan losses	(5,548)	(5,092)
Deferred costs, fees, and discounts, net	(1,201)	(1,043)
Total loans receivable, net	$325,495	$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 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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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

	At or For the Three Months Ended June 30, 2014				
ALLOWANCE FOR LOAN LOSSES	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance	$1,465	$1,462	$1,036	$1,280	$5,243
Provision for loan losses	(76)	503	662	(639)	450
Charge-offs	(3)	(386)	—	—	(389)
Recoveries	61	183	—	—	244
Net charge-offs	58	(203)	—	—	(145)
Ending balance	$1,447	$1,762	$1,698	$641	$5,548
Period end amount allocated to:					
Loans individually evaluated for impairment	$—	$—	$4	$—	$4
Loans collectively evaluated for impairment	1,447	1,762	1,694	641	5,544
Ending balance	$1,447	$1,762	$1,698	$641	$5,548
LOANS RECEIVABLE					
Loans individually evaluated for impairment	$627	$—	$45	$—	$672
Loans collectively evaluated for impairment	138,541	128,492	64,539	—	331,572
Ending balance	$139,168	$128,492	$64,584	$—	$332,244

	At or For the Six Months Ended June 30, 2014				
ALLOWANCE FOR LOAN LOSSES	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance	$1,963	$1,512	$800	$817	$5,092
Provision for loan losses	(449)	552	973	(176)	900
Charge-offs	(147)	(637)	(75)	—	(859)
Recoveries	80	335	—	—	415
Net charge-offs	(67)	(302)	(75)	—	(444)
Ending balance	$1,447	$1,762	$1,698	$641	$5,548
Period end amount allocated to:					
Loans individually evaluated for impairment	$—	$—	$4	$—	$4
Loans collectively evaluated for impairment	1,447	1,762	1,694	641	5,544
Ending balance	$1,447	$1,762	$1,698	$641	$5,548
LOANS RECEIVABLE					
Loans individually evaluated for impairment	$627	$—	$45	$—	$672
Loans collectively evaluated for impairment	138,541	128,492	64,539	—	331,572
Ending balance	$139,168	$128,492	$64,584	$—	$332,244

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

	At or For the Three Months Ended June 30, 2013				
ALLOWANCE FOR LOAN LOSSES	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance	$2,264	$1,831	$679	$270	$5,044
Provision for loan losses	317	143	(55)	195	600
Charge-offs	(86)	(460)	(44)	—	(590)
Recoveries	—	222	—	—	222
Net charge-offs	(86)	(238)	(44)	—	(368)
Ending balance	$2,495	$1,736	$580	$465	$5,276
Period end amount allocated to:					
Loans individually evaluated for impairment	$233	$—	$6	$—	$239
Loans collectively evaluated for impairment	2,262	1,736	574	465	5,037
Ending balance	$2,495	$1,736	$580	$465	$5,276
LOANS RECEIVABLE					
Loans individually evaluated for impairment	$4,198	$—	$152	$—	$4,350
Loans collectively evaluated for impairment	109,608	117,930	53,814	—	281,352
Ending balance	$113,806	$117,930	$53,966	$—	$285,702

	At or For the Six Months Ended June 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	971	(7)	(194)	430	1,200
Charge-offs	(201)	(859)	(44)	—	(1,104)
Recoveries	35	444	3	—	482
Net charge-offs	(166)	(415)	(41)	—	(622)
Ending balance	$2,495	$1,736	$580	$465	$5,276
Period end amount allocated to:					
Loans individually evaluated for impairment	$233	$—	$6	$—	$239
Loans collectively evaluated for impairment	2,262	1,736	574	465	5,037
Ending balance	$2,495	$1,736	$580	$465	$5,276
LOANS RECEIVABLE					
Loans individually evaluated for impairment	$4,198	$—	$152	$—	$4,350
Loans collectively evaluated for impairment	109,608	117,930	53,814	—	281,352
Ending balance	$113,806	$117,930	$53,966	$—	$285,702

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

	June 30, 2014						
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due and Accruing	Total Past Due	Non-Accrual	Current	Total Loans Receivable
REAL ESTATE LOANS							
Commercial	$—	$—	$—	$—	$ —	$39,832	$39,832
Construction and development	—	—	—	—	—	40,736	40,736
Home equity	125	231	—	356	—	14,757	15,113
One-to-four-family	—	—	—	—	94	31,945	32,039
Multi-family	—	—	—	—	—	11,448	11,448
Total real estate loans	125	231	—	356	94	138,718	139,168
CONSUMER							
Indirect home improvement	521	288	—	809	212	92,884	93,905
Solar	—	—	—	—	29	16,997	17,026
Marine	—	—	—	—	—	14,518	14,518
Automobile	5	—	—	5	6	918	929
Recreational	38	—	—	38	—	452	490
Home improvement	—	7	—	7	—	403	410
Other	—	7	—	7	4	1,203	1,214
Total consumer loans	564	302	—	866	251	127,375	128,492
COMMERCIAL BUSINESS LOANS	—	—	—	—	—	64,584	64,584
Total	$689	$533	$—	$1,222	$ 345	$330,677	$332,244

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

	December 31, 2013						
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due and Accruing	Total Past Due	Non-Accrual	Current	Total Loans Receivable
REAL ESTATE LOANS							
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
CONSUMER							
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
COMMERCIAL BUSINESS LOANS	54	—	—	54	—	49,190	49,244
Total	$778	$383	$—	$1,161	$ 1,101	$284,954	$287,216

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FS BANCORP, INC. AND SUBSIDIARY
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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 Six Months Ended June 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	—	—	—	—	—	—	—
One-to-four-family	634	(7)	627	—	627	634	17
Multi-family	—	—	—	—	—	—	—
Indirect home improvement	—	—	—	—	—	—	—
Marine	—	—	—	—	—	—	—
Automobile	—	—	—	—	—	—	—
Recreational	—	—	—	—	—	—	—
Home improvement	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—
Commercial business loans	—	—	—	—	—	—	—
Subtotal loans	634	(7)	627	—	627	634	17
WITH AN ALLOWANCE RECORDED							
Commercial	—	—	—	—	—	—	—
Construction and development	—	—	—	—	—	—	—
Home equity	—	—	—	—	—	—	—
One-to-four-family			—	—	—		
Multi-family	—	—	—	—	—	—	—
Indirect home improvement	—	—	—	—	—	—	—
Marine	—	—	—	—	—	—	—
Automobile	—	—	—	—	—	—	—
Recreational	—	—	—	—	—	—	—
Home improvement	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—

Commercial business loans	47	(2)	45	(4)	45	41	48	2
Subtotal loans	47	(2)	45	(4)		41	48	2
Total	$681	$(9)	$672	$(4)		$668	$682	$19

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

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
WITH NO RELATED ALLOWANCE RECORDED							
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
WITH AN ALLOWANCE RECORDED							
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	—	—	—	—	—	—	—

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 $677,000 and $528,000 for the three months ended June 30, 2014 and 2013, respectively, and $682,000 and $4.3 million for the six months ended June 30, 2014 and 2013, respectively. For the three and six months ended June 30, 2014, the Company recognized interest income on impaired loans of $9,000 and $19,000, respectively, compared to $54,000 and $80,000, respectively, for same periods a year ago.

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

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

Credit Quality Indicators

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

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

A description of the 10 risk grades is as follows:

- Grades 1 and 2 – These grades include loans to very high quality borrowers with excellent or desirable business credit 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. At 120 days past due, homogeneous loans are charged off based on the value of the collateral less cost to sell.

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

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

The following tables summarize risk rated loan balances by category:

	June 30, 2014						
	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful(9)	Loss (10)	Total
REAL ESTATE LOANS							
Commercial	$38,400	$549	$883	$—	$ —	$—	$39,832
Construction and development	40,736	—	—	—	—	—	40,736
Home equity	15,113	—	—	—	—	—	15,113
One-to-four-family	31,412	—	—	627	—	—	32,039
Multi-family	11,448	—	—	—	—	—	11,448
Total real estate loans	137,109	549	883	627	—	—	139,168
CONSUMER							
Indirect home improvement	93,664	—	—	241	—	—	93,905
Solar	17,026	—	—	—	—	—	17,026
Marine	14,518	—	—	—	—	—	14,518
Automobile	923	—	—	6	—	—	929
Recreational	490	—	—	—	—	—	490
Home improvement	410	—	—	—	—	—	410
Other	1,210	—	—	4	—	—	1,214
Total consumer loans	128,241	—	—	251	—	—	128,492
COMMERCIAL BUSINESS LOANS	43,843	9,701	10,995	45	—	—	64,584
Total	$309,193	$10,250	$11,878	$923	$ —	$—	$332,244

	December 31, 2013						
	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful(9)	Loss (10)	Total
REAL ESTATE LOANS							
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
CONSUMER							
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

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

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. At June 30, 2014, the Company had four TDR loans still on accrual. The Company had two TDR's included in impaired loans at June 30, 2014, and four TDR's at December 31, 2013. In addition, at June 30, 2014 and December 31, 2013, the Company had no TDR loans on non-accrual. The Company had no commitments to lend additional funds on these restructured loans.

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

	June 30, 2014	December 31, 2013
TDR loans still on accrual	$799	$815
TDR loans on non-accrual	—	—
Total TDR loans	$799	$815

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

	At or For the Three Months Ended June 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	—	$ —	$ —	$ —	—	$ —	$ —	$ —
Total	—	$ —	$ —	$ —	—	$ —	$ —	$ —

	At or For the Six Months Ended June 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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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

There were no TDRs recorded in the twelve months prior to June 30, 2014 and 2013, that subsequently defaulted in the six months ended June 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 $276.5 million and $243.0 million at June 30, 2014 and December 31, 2013, respectively. The fair market value of the servicing rights' asset was $3.1 million and $3.0 million at June 30, 2014 and December 31, 2013, respectively.

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

	At or For the Three Months Ended June 30,			
	2014		2013	
Beginning balance	$2,134		$1,404	
Additions	313		494	
Mortgage, commercial, and consumer servicing rights amortized	(112	)	(91	)
(Impairment) recovery on servicing rights	1		(22	)
Ending balance	$2,336		$1,785	

	At or For the Six Months Ended June 30,			
	2014		2013	
Beginning balance	$2,093		$1,064	
Additions	489		790	
Mortgage, commercial, and consumer servicing rights amortized	(247	)	(169	)
Recovery of loss on servicing rights	1		100	
Ending balance	$2,336		$1,785	

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

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 June 30,			
	2014		2013	
Key assumptions				
Weighted average discount rate	8.5	%	7.5	%
Weighted average life in years	7.3		5.9	
Projected prepayment speed in months	163		226	

The Company recorded $172,000 and $127,000 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 June 30, 2014 and 2013, respectively, and $334,000 and $220,000 for the six months ended June 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:

	June 30, 2014		
		Fair Value	
	Notional	Asset	Liability
Fallout adjusted interest rate lock commitments with customers	$21,510	$651	$—
Mandatory and best effort forward commitments with investors	10,437	—	61
Forward TBA mortgage-backed securities	26,500	—	182
TBA mortgage-backed securities forward sales paired off with investors	19,250	—	241

	December 31, 2013		
		Fair Value	
	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	—

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

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 $110,000 and $772,000 for the three months ended June 30, 2014 and 2013, respectively, and $322,000 and $1.1 million for the six months ended June 30, 2014 and 2013, respectively.

NOTE 6 – OTHER REAL ESTATE OWNED

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

	At or For the Three Months Ended June 30,		At or For the Six Months Ended June 30,	
	2014	2013	2014	2013
Beginning balance	$535	$1,956	$2,075	$2,127
Additions	—	36	445	36
Fair value impairments	—	(117)	(40)	(195)
Disposition of assets	(499)	(70)	(2,444)	(163)
Ending balance	$36	$1,805	$36	$1,805

At June 30, 2014, OREO consisted of one property located in Washington with a balance of $36,000. For the three months ended June 30, 2014 and 2013, the Company recorded a $1,000 net gain, and no gain or loss on disposals of OREO, respectively. For the six months ended June 30, 2014 and 2013, the Company recorded a $10,000 net gain and no net gain or (loss), respectively, on disposals of OREO. Holding costs or (recovery) associated with OREO were $(29,000) and $16,000, for the three months ended June 30, 2014 and 2013, respectively, and $3,000 and $38,000, for the six months ended June 30, 2014 and 2013, respectively.

NOTE 7 – DEPOSITS

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

	June 30, 2014	December 31, 2013
Noninterest-bearing checking[(1)]	$47,685	$45,783
Interest-bearing checking	27,654	26,725
Savings	17,289	15,345
Money market	116,600	119,162
Certificates of deposits of less than $100,000[(2)]	48,220	46,237
Certificates of deposits of $100,000 through $250,000	60,749	52,264
Certificates of deposits of more than $250,000	33,447	31,360
Total	$351,644	$336,876

(1) Includes $1.9 million and $1.5 million in escrow balances at June 30, 2014 and December 31, 2013, respectively.

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

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

NOTE 7 – DEPOSITS (Continued)

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

	As of June 30, 2014
2014	$ 33,237
2015	48,184
2016	41,002
2017	10,453
2018	5,580
Thereafter	3,960
Total	$ 142,416

The Bank pledged two securities held at the Federal Home Loan Bank ("FHLB") of Seattle with a fair value of $1.3 million to secure Washington State public deposits of $250,000 with a collateral requirement of $29,000, at June 30, 2014.
Federal Reserve regulations require that the Bank maintain reserves in the form of cash on hand and deposit balances with the FRB, based on a percentage of deposits. The amounts of such balances at June 30, 2014 and December 31, 2013 were $1.7 million and $1.6 million, respectively, and were in compliance with FRB regulations.
Interest expense by deposit category for the three and six months ended June 30, 2014 and 2013 was as follows:

	For Three Months Ended June 30,		For Six Months Ended June 30,	
	2014	2013	2014	2013
Interest-bearing checking	$7	$8	$16	$16
Savings and money market	130	124	248	258
Certificates of deposit	457	332	880	662
Total	$594	$464	$1,144	$936

NOTE 8 – INCOME TAXES

The Company recorded a provision for income taxes of $931,000 and $1.2 million during the six months ended June 30, 2014 and June 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 June 30, 2014, the Company had no uncertain tax positions. The Company recognizes interest and penalties in tax expense and at June 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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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 June 30, 2014 and December 31, 2013 were as follows:

	June 30, 2014	December 31, 2013
COMMITMENTS TO EXTEND CREDIT		
REAL ESTATE LOANS		
Construction and development	$26,632	$25,164
One-to-four-family	39,912	18,277
Home equity	13,984	12,452
Commercial/Multi-family	504	518
Total real estate loans	81,032	56,411
CONSUMER LOANS		
Indirect home improvement	—	—
Other	6,024	6,162
Total consumer loans	6,024	6,162
COMMERCIAL BUSINESS LOANS	49,479	52,344
Total commitments to extend credit	$136,535	$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 $115,000 and $58,000 as of June 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

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

NOTE 9 – COMMITMENTS AND CONTINGENCIES (Continued)

each be entitled to receive a cash payment in an amount equal to 12 months of their then current salary, subject to certain requirements in the Agreements.

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

In the ordinary course of business, the Company sells loans without recourse that may have to subsequently be repurchased due to defects that occurred during the origination of the loan. The defects are categorized as documentation errors, underwriting errors, early payment defaults, breach of representation or warranty, and fraud. When a loan sold to an investor without recourse fails to perform according to its contractual terms, the investor will typically review the loan file to determine whether defects in the origination process occurred. If a defect is identified, the Company may be required to either repurchase the loan or indemnify the investor for losses sustained. If there are no such defects, the Company has no commitment to repurchase the loan. The Company has recorded a $258,000 and $217,000 reserve to cover loss exposure related to these guarantees for one-to-four-family loans sold into the secondary market at June 30, 2014 and December 31, 2013, respectively.

In December 2013, the Company sold a portion of the consumer loan portfolio with an unpaid principal balance of approximately $9.3 million and recognized a gain of $166,000. Under the terms of this sale, the Company had recourse for loans that defaulted before June 14, 2014 and had recorded a reserve of $35,000 for potential defaults. As of June 30, 2014, the Company had satisfied its obligation under the purchase agreement without utilizing any of the recourse reserve and accordingly, the full reserve was reversed in the second quarter of 2014 and included in operations within noninterest expense.

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

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

As of June 30, 2014 and December 31, 2013, the Bank was categorized as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total

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

NOTE 11 – REGULATORY CAPITAL (Continued)

risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table below. There are no conditions or events since that notification that management believes have changed the Bank's category.

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

	Actual			For Capital Adequacy Purposes			To be Well Capitalized Under Prompt Corrective Action Provisions		
	Amount	Ratio		Amount	Ratio		Amount	Ratio	
As of June 30, 2014									
Total risk-based capital (to risk-weighted assets)	$57,604	15.97	%	$28,849	8.00	%	$36,062	10.00	%
Tier 1 risk-based capital (to risk-weighted assets)	$53,079	14.72	%	$14,425	4.00	%	$21,637	6.00	%
Tier 1 leverage capital (to average assets)	$53,079	12.31	%	$17,248	4.00	%	$21,560	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.

	Company June 30, 2014	December 31, 2013		Bank June 30, 2014	December 31, 2013	
Equity	$62,784	$62,313		$53,061	$50,297	
Unrealized loss on securities available-for-sale	18	898		18	898	
Disallowed deferred tax assets	—	—		—	—	
Disallowed servicing assets	—	(210	)	—	(210	)
Total Tier 1 capital	62,802	63,001		53,079	50,985	
Allowance for loan and lease losses for regulatory capital purposes	4,525	4,156		4,525	4,156	
Total risk-based capital	$67,327	$67,157		$57,604	$55,141	

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

NOTE 11 – REGULATORY CAPITAL (Continued)

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 June 30, 2014, the Company would have exceeded all regulatory capital requirements. The regulatory capital ratios calculated for the Company as of June 30, 2014 were 14.6% for Tier 1 leverage-based capital, 17.4% for Tier 1 risk-based capital and 18.7% for total risk-based capital.

NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS

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

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

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

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

Determination of Fair Market Values:

Securities - Securities available-for-sale are recorded at fair value on a recurring basis. The fair value of investments and mortgage-backed securities are provided by a third-party pricing service. These valuations are based on market data using pricing models that vary by asset class and incorporate available current trade, bid and other market information, and for structured securities, cash flow and loan performance data. The pricing processes utilize benchmark curves, benchmarking of similar securities, sector groupings, and matrix pricing. Option adjusted spread models are
also used to assess the impact of changes in interest rates and to develop prepayment scenarios. All models and processes used take into account market convention (Level 1 and 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 (Level 3).

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

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

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

NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

	Securities Available-for-Sale			
	Level 1	Level 2	Level 3	Total
As of June 30, 2014				
Federal agency securities	$—	$6,547	$—	$6,547
Municipal bonds	—	16,233	—	16,233
Corporate securities	—	4,959	—	4,959
Mortgage-backed securities	—	30,624	—	30,624
Total	$—	$58,363	$—	$58,363

	Securities Available-for-Sale			
	Level 1	Level 2	Level 3	Total
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 June 30, 2014 and December 31, 2013.

	Interest Rate Lock Commitments with Customers			
	Level 1	Level 2	Level 3	Total
June 30, 2014	$—	$—	$651	$651
December 31, 2013	$—	$—	$166	$166

	Forward Sale Commitments with Investors			
	Level 1	Level 2	Level 3	Total
June 30, 2014	$—	$(182)	$(61)	$(243)
December 31, 2013	$—	$106	$45	$151

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

NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

	Paired Off Commitments with Investors			
	Level 1	Level 2	Level 3	Total
June 30, 2014	$—	$(241)	$—	$(241)
December 31, 2013	$—	$44	$—	$44

The following table presents the impaired loans measured at fair value on a nonrecurring basis:

	Impaired Loans			
	Level 1	Level 2	Level 3	Total
June 30, 2014	$—	$—	$672	$672
December 31, 2013	$—	$—	$1,703	$1,703

The following table presents OREO measured at fair value on a nonrecurring basis:

	OREO			
	Level 1	Level 2	Level 3	Total
June 30, 2014	$—	$—	$36	$36
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 June 30, 2014 is shown in the following table.

Level 3 Fair Value Instrument	Valuation Technique	Significant Unobservable Inputs	Range (Weighted Average)	Weighted Average Rate
RECURRING				
Interest rate lock commitments with customers	Quoted market prices	Pull-through expectations	80% - 99.99%	88.90%
Forward sale commitments with investors	Quoted market prices	Pull-through expectations	80% - 99.99%	88.90%
NONRECURRING				
Impaired loans	Fair value of underlying collateral	Discount applied to the obtained appraisal	0.00% - 10.00%	0.70%
OREO	Fair value of collateral	Discount applied to the obtained appraisal	—	41.50%

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

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 approximate their fair value (Level 1).

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

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

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

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

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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FS BANCORP, INC. AND SUBSIDIARY
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NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

	June 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	$9,155	$9,155	$41,085	$41,085
Securities available-for-sale	—	—	997	997
Level 2 inputs:				
Securities available-for-sale	58,363	58,363	55,242	55,242
Loans held for sale	15,975	15,975	11,185	11,185
FHLB stock	1,670	1,670	1,702	1,702
Accrued interest receivable	1,366	1,366	1,261	1,261
Forward sale commitments with investors	—	—	106	106
Paired off commitments with investors	—	—	44	44
Level 3 inputs:				
Loans receivable, net	325,495	358,737	281,081	310,641
Servicing rights	2,336	3,116	2,093	2,961
Fair value interest rate locks with customers	651	651	166	166
Forward sale commitments with investors	—	—	45	45
Financial Liabilities				
Level 2 inputs:				
Deposits	351,644	364,240	336,876	351,408
Borrowings	17,552	17,549	16,664	16,553
Accrued interest payable	25	25	22	22
Forward sale commitments with investors	182	182	—	—
Paired off commitments with investors	241	241	—	—
Level 3 inputs:				
Forward sale commitments with investors	61	61	—	—

NOTE 13 - EMPLOYEE BENEFITS

Employee Stock Ownership Plan

On January 1, 2012, the Company established an ESOP for eligible employees of the Company and the Bank. Employees of the Company and the Bank who have been credited with at least 1,000 hours of service during a 12-month period are eligible to participate in the ESOP.

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

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 six months ended June 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 six months ended June 30, 2014 and June 30, 2013 was $219,000 and $217,000, respectively.

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

	Balances
Allocated shares	51,842
Committed to be released shares	12,960
Unallocated shares	194,408
Total ESOP shares	259,210
Fair value of unallocated shares (in thousands)	$3,284

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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FS BANCORP, INC. AND SUBSIDIARY
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 six months ended June 30, 2014 and 2013.

	At or For the Three Months Ended June 30,		At or For the Six Months Ended June 30,	
	2014	2013	2014	2013
Numerator:				
Net Income (in thousands)	$986	$1,086	$1,861	$2,321
Denominator:				
Basic weighted average common shares outstanding	3,002,515	3,019,797	3,024,116	3,019,797
Dilutive restricted stock grants	2,233	—	1,123	—
Diluted weighted average common shares outstanding	3,004,748	3,019,797	3,025,239	3,019,797
Basic earnings per share	$0.33	$0.36	$0.62	$0.77
Diluted earnings per share	$0.33	$0.36	$0.62	$0.77
Potentially dilutive weighted average share options that were not included in the computation of diluted EPS because to do so would be anti-dilutive	23,572	—	11,852	—

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 June 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 194,408 shares in the ESOP that were not committed to be released as of June 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 compensation expense for the Plan was $110,000 for the three and six months ended June 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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FS BANCORP, INC. AND SUBSIDIARY
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 (^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 six months ended June 30, 2014:

	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	6.5	164,220
Exercised	—	—	—	—
Forfeited or expired	—	—	—	—
Outstanding at June 30, 2014	322,000	$ 16.89	6.5	$164,220
Expected to vest, assuming a 0.31% annual forfeiture rate	320,992	$ 16.89	6.5	$163,706
Exercisable at June 30, 2014	—	$ —	—	$—

As of June 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 4.4 years.

Restricted Stock Awards

The Plan authorizes the grant of restricted stock awards totaling 129,505 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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FS BANCORP, INC. AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 15 - STOCK-BASED COMPENSATION (Continued)

A summary of the Company's nonvested awards during the period ended June 30, 2014:

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 June 30, 2014	125,105	$16.89	$—

As of June 30, 2014, there was $2.0 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 4.4 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 June 30, 2014, consumer loans represented 38.7% 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 six months ended June 30, 2014.

Indirect home improvement lending is dependent on the Bank’s relationships with home improvement contractors and dealers. The Company funded 1,157 loans during the quarter ended June 30, 2014 using its indirect home improvement contractor/dealer network located throughout Washington, Oregon and California with four

contractors/dealers responsible for 64.8% of this loan volume. The Company began originating consumer indirect loans during the fourth quarter of 2012 in the State of California and since inception has originated $39.1 million. During the three months ended June 30, 2014, the Company originated $8.0 million of consumer loans in California, and as of June 30, 2014,

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the Company had $17.0 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 June 30, 2014, the limit was $25.7 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 to include the following:

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

Other Real Estate Owned. Property acquired by foreclosure or deed in lieu of foreclosure is recorded at fair value, less cost to sell. Development and improvement costs relating to the property are capitalized. The carrying value of the property is periodically evaluated by management and, if necessary, allowances are established to reduce the carrying value to net realizable value. Gains or losses at the time the property is sold are charged or credited to operations in the period in which they are realized. The amounts that will be ultimately realized from the sale of other

real estate owned may differ substantially from the carrying value of the assets because of market factors beyond our control or because of changes in management's strategies for recovering the investment.

Income Taxes. Income taxes are reflected in the Company's consolidated financial statements to show the tax effects of the operations and transactions reported in the financial statements and consist of taxes currently payable plus deferred taxes. Accounting Standards Codification, ASC 740, “Accounting for Income Taxes,” requires the asset and liability

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

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 June 30, 2014 and December 31, 2013

Assets. Total assets increased $16.8 million, or 4.0%, to $436.0 million at June 30, 2014, from $419.2 million at December 31, 2013, primarily as a result of a $44.4 million, or 15.8% increase in net loans receivable, a $4.8 million, or 42.8% increase in loans held for sale, and a $2.1 million, or 3.8% increase in securities available-for-sale, primarily funded by a $31.9 million, or 77.7% decrease in cash and cash equivalents. In addition, OREO decreased $2.0 million, or 98.3% during the six months ended June 30, 2014.

Loans receivable, net increased $44.4 million, or 15.8% to $325.5 million at June 30, 2014, from $281.1 million at December 31, 2013. Total real estate secured loans increased $23.9 million, or 20.7% to $139.2 million at June 30, 2014, from $115.3 million at December 31, 2013, as a result of an $11.2 million, or 54.0% increase in one-to-four-family loans, a $6.9 million, or 20.8% increase in commercial real estate loans, and a $6.8 million, or 144.5% increase in multi-family loans, partially offset by an $897,000, or 2.2% decrease in construction and development loans. Consumer loans increased $5.8 million, or 4.7%, to $128.5 million at June 30, 2014, from $122.7 million at December 31, 2013, primarily as a result of a $3.3 million, or 29.6%, increase in marine loans, and a $2.7 million, or 3.0%, increase in indirect home improvement loans, partially offset by a $301,000, or 24.5% decrease in automobile loans. During the six months ended June 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 $15.3 million, or 31.2%, to $64.6 million at June 30, 2014, from $49.2 million at December 31, 2013.

Loans held for sale increased by $4.8 million to $16.0 million at June 30, 2014, from $11.2 million at December 31, 2013, as management continues to manage the holding period between the funding and sale date for loans held for sale during periods of volatile interest rates. The Company continues to expand its home lending operations by hiring additional lending staff and will continue selling one-to-four-family mortgage loans into the secondary market for asset/liability management purposes and to generate noninterest income. During the quarter ended June 30, 2014, the Company did not purchase any loans and sold $65.2 million of one-to-four-family mortgage loans compared to $33.4 million for the preceding quarter and $89.9 million for the same quarter one year ago.

The allowance for loan losses at June 30, 2014 was $5.5 million, or 1.7% of gross loans receivable, compared to $5.1 million, or 1.8% of gross loans receivable, at December 31, 2013. Substandard loans decreased to $923,000 at June 30, 2014, compared to $2.1 million at December 31, 2013. Non-performing loans, consisting of non-accruing loans,

decreased to $345,000 at June 30, 2014, from $1.1 million at December 31, 2013. At June 30, 2014, non-performing loans consisted of $94,000 of one-to-four-family loans, and $251,000 of consumer loans. Non-performing loans to total gross loans decreased to 0.1% at June 30, 2014, from 0.4% at December 31, 2013. OREO totaled $36,000 at June 30, 2014, compared to $2.1 million at December 31, 2013. The $2.0 million, or 98.3% decrease in OREO reflects sales of $2.4 million, $40,000 in impairments, and transfers of $445,000 during the six months ended June 30, 2014. The Company also had $799,000 in TDRs at June 30, 2014, all of which were performing in accordance with their modified payment terms.

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

	June 30, 2014	December 31, 2013
Non-performing assets:		
Non-accrual loans	$ 345	$ 1,101
Other real estate owned	36	2,075
Other assets	—	32
Total non-performing assets	$ 381	$ 3,208

Liabilities. Total liabilities increased $16.3 million, or 4.6%, to $373.2 million at June 30, 2014, from $356.9 million at December 31, 2013. Deposits increased $14.7 million, or 4.4%, to $351.6 million at June 30, 2014, from $336.9 million at December 31, 2013. Transaction accounts (noninterest, interest-bearing checking, and escrow accounts) increased $2.8 million, or 3.9% to $75.3 million as of June 30, 2014, from $72.5 million at December 31, 2013. Money market and savings accounts decreased $618,000, or 0.5%, to $133.9 million at June 30, 2014, from $134.5 million at December 31, 2013. Time deposits increased $12.5 million, or 9.7% to $142.4 million at June 30, 2014, from $129.9 million at December 31, 2013. Non-retail deposits which include $19.6 million of brokered certificates of deposit, $16.6 million of online certificates of deposit, and $250,000 of public funds, increased to $36.2 million as of June 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 $888,000, or 5.3%, to $17.6 million at June 30, 2014, from $16.7 million at December 31, 2013.

Stockholders' Equity. Total stockholders' equity increased $471,000, or 0.8%, to $62.8 million at June 30, 2014, from $62.3 million at December 31, 2013. The increase in stockholders' equity was primarily a result of net income of $1.9 million, and an improvement of $880,000 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 repurchase, and $341,000 of dividends paid. Book value per common share was $21.53 at June 30, 2014, compared to $20.55 at December 31, 2013.

Comparison of Results of Operations for the Three and Six Months Ended June 30, 2014 and 2013

General. Net income for the three months ended June 30, 2014 was $986,000 compared to net income of $1.1 million for the three months ended June 30, 2013. The $100,000 decrease in net income was primarily attributable to a $475,000, or 16.2% decrease in noninterest income, and a $111,000, or 2.0% increase in noninterest expense, partially offset by a $268,000, or 5.4% increase in net interest income, a $150,000, or 25.0% decrease in provision for loan losses, and a $68,000, or 12.0% decrease in provision for income tax.

Net income for the six months ended June 30, 2014 was $1.9 million compared to the net income of $2.3 million for the six months ended June 30, 2013. The $460,000 decrease in net income was primarily attributable to an $841,000, or 8.4% increase in noninterest expense, and a $686,000, or 13.2% decrease in noninterest income, partially offset by a $507,000, or 5.3% increase in net interest income, a $300,000, or 25.0% decrease in the provision for loan losses, and a $260,000, or 21.8% 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.

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	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2014	2013	2014	2013
Assets				
Loans receivable	$325,777	$301,524	$312,850	$291,274
Securities available-for-sale, at fair value	68,359	43,957	66,771	44,952
Interest-bearing deposits at other financial institutions	15,810	15,475	25,903	17,950
Total interest-earning assets	409,946	360,956	405,524	354,176
Noninterest-earning assets	21,546	17,259	21,814	18,291
Total assets	$431,492	$378,215	$427,338	$372,467
Liabilities and Stockholders' Equity				
Interest-bearing deposits	$296,856	$258,193	$295,162	$257,063
Borrowings	21,021	17,025	18,796	14,737
Total interest-bearing liabilities	317,877	275,218	313,958	271,800
Noninterest-bearing deposits	47,380	38,813	47,067	36,921
Other noninterest-bearing liabilities	3,307	3,399	3,556	3,143
Stockholders' equity	62,928	60,785	62,757	60,603
Total liabilities and stockholders' equity	$431,492	$378,215	$427,338	$372,467

Net Interest Income. Net interest income increased $268,000, or 5.4%, to $5.2 million for the three months ended June 30, 2014, from $4.9 million for the three months ended June 30, 2013. The increase in net interest income was attributable to a $260,000, or 5.0% increase in loans receivable interest income, as well as a $153,000, or 75.4% increase in interest and dividends on investment securities, and cash and cash equivalents, reflecting primarily increased average balances as compared to the same period last year, partially offset by a $145,000, or 28.3% increase in interest expense, primarily due to increases in the average balances of interest-bearing deposits and borrowings.

The net interest income increased $507,000, or 5.3%, to $10.1 million for the six months ended June 30, 2014, from $9.6 million for the six months ended June 30, 2013. The increase in net interest income was attributable to a $503,000, or 4.9% increase in loan receivable interest income, and a $246,000, or 55.9% increase in interest and dividends on investment securities, and cash and cash equivalents interest income, reflecting primarily increased average balances as compared to the same period last year, partially offset by a $242,000, or 23.7% increase in interest expense as a result of increases in the average balances of interest-bearing deposits and borrowings.

The net interest margin ("NIM") decreased 39 basis points to 5.08% for the three months ended June 30, 2014, from 5.47% for the three months ended June 30, 2013, and decreased 44 basis points to 5.02% for the six months ended June 30, 2014, from 5.46% for the same period of the prior year. The decreases reflect the change in our asset mix, including increased investment securities, commercial business loans, one-to-four-family loans, and reductions in the percentage of higher yielding consumer loans held in the loan portfolio. Diversified loan growth continues to pressure the NIM as real estate and business loans have a lower yield than consumer loan products. Reducing the impact of lower loan yields was a three basis point decrease in the cost of funds to 0.72% for the three months ended June 30, 2014, from 0.75% for the three months ended June 30, 2013, and five basis point decrease in the cost of funds to 0.71% for the six months ended June 30, 2014, from 0.76% for the same period in the prior year as a result of growth in noninterest-bearing deposits. Management remains focused on matching the average duration on time deposits with the duration of earning assets where appropriate.

Interest Income. Interest income for the three months ended June 30, 2014 increased $413,000, or 7.6%, to $5.8 million from $5.4 million for the three months ended June 30, 2013. The increase during the period was primarily attributable to the increase in the average balance of the loan portfolio to $325.8 million for the three months ended June 30, 2014,

compared to $301.5 million for the three months ended June 30, 2013, as well as a shift of funds during the period to lower yielding investment securities and loans during the three months ended June 30, 2014, compared to the same period last year.

Interest income for the six months ended June 30, 2014 increased $749,000, or 7.1%, to $11.4 million, from $10.6 million for the six months ended June 30, 2013. The increase during the period was primarily attributable to the increase in the average balance of the loan portfolio to $312.9 million for the six months ended June 30, 2014, compared to $291.3 million for the six months ended June 30, 2013, and a $21.8 million increase in the average balance of securities available-for-sale to $66.8 million for the six months ended June 30, 2014, compared to $45.0 million for the same period last year.

Interest Expense. Interest expense increased $145,000 or 28.3%, to $657,000 for the three months ended June 30, 2014, from $512,000 for the same period of the prior year. The average cost of funds decreased three basis points to 0.72% for the three months ended June 30, 2014, compared to 0.75% for the three months ended June 30, 2013. The decrease was primarily due to growth in noninterest-bearing deposits and extending maturities on deposit products to manage interest rate risk. The average balance of total interest-bearing liabilities increased $42.7 million, or 15.5%, to $317.9 million for the quarter ended June 30, 2014, from $275.2 million for the quarter ended June 30, 2013.

Interest expense increased $242,000, or 23.7%, to $1.3 million for the six months ended June 30, 2014, from $1.0 million for the same period of the prior year. As a result of the general decline in market rates, the average cost of funds for total interest-bearing liabilities decreased five basis points to 0.71% for the six months ended June 30, 2014, compared to 0.76% for the six months ended June 30, 2013.

Provision for Loan Losses. The provision for loan losses was $450,000 for the three months ended June 30, 2014, compared to $600,000 for the three months ended June 30, 2013. The $150,000 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 declined throughout the last year, 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 June 30, 2014, net charge-offs totaled $145,000 compared to $368,000 during the same period last year.

The provision for loan losses was $900,000 for the six months ended June 30, 2014, compared to $1.2 million for the six months ended June 30, 2013. The $300,000 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 $345,000, or 0.1% of total loans at June 30, 2014, compared to $2.3 million, or 0.8% of total loans at June 30, 2013. During the six months ended June 30, 2014, net charge-offs totaled $444,000 compared to $622,000 during the six months ended June 30, 2013.

Noninterest Income. Noninterest income decreased $475,000, or 16.2%, to $2.4 million for the three months ended June 30, 2014, from $2.9 million for the three months ended June 30, 2013. The decrease during the period was primarily attributable to a $434,000 reduction in gains on sale of loans due to lower refinance transactions, and an $86,000 reduction in gains on sale of investment securities. One-to-four-family originations of loans held for sale, including loans brokered to other institutions, increased 92.0% to $72.2 million during the quarter ended June 30, 2014, compared to $37.6 million for the same quarter one year ago. The increase in originations was directly correlated to increased purchase activity associated with the seasonality in home purchases in the Northwest. Purchase production increased with $65.6 million in closed purchase loans for the three months ended June 30, 2014, up from $46.3 million for the three months ended June 30, 2013, partially offset by a $21.6 million decrease in refinances due to an increase in rates.

Noninterest income decreased $686,000, or 13.2%, to $4.5 million for the six months ended June 30, 2014, from $5.2 million for the six months ended June 30, 2013. The decrease during the period was primarily due to a $477,000 decrease in the gain on sale of loans, and a $254,000 decrease in the gain on sale of investment securities. The decrease in gains on sale of loans was primarily attributable to a decrease in the home lending gain on sales of $883,000 to $2.7 million for the six months ended June 30, 2014, from $3.6 million for the six months ended June 30, 2013, partially

offset by the consumer loan gain on sales of $561,000 for the current six month period as compared to no gains on consumer loan sales during the same period last year.

Noninterest Expense. Noninterest expense increased $111,000, or 2.0%, to $5.7 million for the three months ended June 30, 2014, from $5.6 million for the three months ended June 30, 2013. Changes in noninterest expense included a $167,000, or 22.0% increase in operations costs, and a $105,000, or 3.3% increase in salaries and benefits, primarily as a result of the hiring of additional employees in mortgage-related lending, and loan servicing and operations areas, as well as expenses associated with issued equity awards, partially offset by a decrease of $118,000, or 100.9% of OREO fair value impairments, and a $45,000, or 281.3% decrease in OREO expenses this quarter.

Noninterest expense increased $841,000, or 8.4%, to $10.9 million for the six months ended June 30, 2014, from $10.1 million for the six months ended June 30, 2013. Changes in noninterest expense included a $751,000, or 13.4% increase in salaries and benefit costs primarily as a result of hiring additional personnel, in addition to expenses associated with issued equity awards, a $99,000 or 99.0% reduction in the recovery on servicing rights, a $99,000, or 14.1% increase in occupancy costs primarily due to renting additional home lending office space, and a $56,000, or 10.5% increase in data processing costs, partially offset by a $165,000, or 84.6% decrease in OREO fair value impairments.

The efficiency ratio, which is noninterest expense as a percentage of net interest income and noninterest income, increased to 74.7% for the three months ended June 30, 2014, compared to 71.3% for the three months ended June 30, 2013, and was 74.7% for the six months ended June 30, 2014, compared to 68.1% for the six months ended June 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 six months ended June 30, 2014, the Company recorded a provision for income tax expense of $931,000 on pre-tax income as compared to $1.2 million for the six months ended June 30, 2013. The effective tax rate for the periods ended June 30, 2014 and 2013 were 33.2% and 33.6%, 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 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 June 30, 2014, the Bank's total borrowing capacity was $49.3 million with the FHLB of Seattle, with unused borrowing capacity of $19.9 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 June 30, 2014, the Bank held approximately $63.0 million in loans that qualify as collateral for FHLB advances. In addition to the availability of liquidity from the FHLB of Seattle, the Bank maintained a short-term borrowing line with the Federal Reserve Bank of San Francisco ("Federal Reserve Bank"), with a current limit of $78.6 million at June 30, 2014, and a $12.0 million unsecured, variable rate, overnight short-term borrowing line with Pacific Coast Bankers' Bank. The Bank also had a $11.0 million unsecured Fed Funds line of credit with a large financial institution of which none was outstanding at June 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 June 30, 2014, the Bank held approximately $121.6 million in loans that qualify as collateral for the Federal Reserve Bank line of credit.

As of June 30, 2014, $17.6 million in FHLB advances were outstanding and no advances were outstanding against the Federal Reserve Bank line of credit or Pacific Coast Bankers' Bank line of credit. The Bank's Asset Liability Management Policy permits management to utilize brokered deposits up to 20% of deposits or $72.2 million as of June 30, 2014. Total brokered deposits as of June 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 June 30, 2014, the approved outstanding loan commitments, including unused lines of credit, amounted to $137.0 million. Certificates of deposit scheduled to mature in six months or less at June 30, 2014, totaled $33.2 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 June 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 June 30, 2014, the Bank was considered to be "well capitalized". At June 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 12.3%, 14.7%, and 16.0%, 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 June 30, 2014 the Company would have exceeded all regulatory capital requirements. The estimated regulatory capital ratios calculated for the Company as of June 30, 2014 were 14.6% for Tier 1 leverage-based capital, 17.4% for Tier 1 risk-based capital and 18.7% for total risk-based capital.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

Not required for smaller reporting companies.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures.

An evaluation of the disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the "Act")) as of June 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 June 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.

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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 June 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.

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

Not applicable.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits

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

3.2 Bylaws of FS Bancorp, Inc. (1)

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

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

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

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

101 The following materials from the Company’s Quarterly Report on Form 10-Q for the quarter ended June 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. *

(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: August 8, 2014	By:	/s/Joseph C. Adams Joseph C. Adams, Chief Executive Officer (Duly Authorized Officer)
Date: August 8, 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
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