ART TECHNOLOGY GROUP INC
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SCHEDULE 14A INFORMATION

Proxy Statement Pursuant to Section 14(a) of the

Securities Exchange Act of 1934

Filed by the Registrant þ

Filed by a Party other than the Registrant o

Check the appropriate box:

o Preliminary Proxy Statement
þ Definitive Proxy Statement
o Definitive Additional Materials Soliciting Material Pursuant to sec.240.14a-11(c) or sec.240.14a-12
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ART TECHNOLOGY GROUP, INC.

(Name of Registrant as Specified In Its Charter)

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(4) Date Filed:

ART TECHNOLOGY GROUP, INC.

25 First Street
Cambridge, Massachusetts 02141

Dear Stockholder:

I am pleased to invite you to attend the 2003 Annual Meeting of Stockholders of Art Technology Group, Inc. on May 21, 2003. We will hold the meeting at 10:00 a.m. at the offices of Hale and Dorr LLP, 60 State Street, Boston, Massachusetts. Annual meetings play an important role in maintaining communications and understanding among our management, board of directors and stockholders, and I hope that you will be able to join us.

On the pages following this letter you will find the Notice of Annual Meeting of Stockholders, which lists the matters to be considered at the meeting, and the proxy statement, which describes the matters listed in the Notice. We have also enclosed our 2002 Annual Report.

If you are a stockholder of record, we have enclosed your proxy card, which allows you to vote on the matters considered at the meeting. Simply mark, sign and date your proxy card, and then mail the completed proxy card to our transfer agent, EquiServe Trust Company, N.A., in the enclosed postage-paid envelope. You may also submit your proxy electronically via the Internet or by telephone as described on pages 2 and 3 of the enclosed proxy. You may attend the meeting and vote in person even if you have sent in a proxy card or submitted your proxy electronically.

If your shares are held in the name of a bank, broker or other holder of record, you will receive instructions from the holder of record that you must follow in order for your shares to be voted.

Sincerely yours,

Robert D. Burke
Chief Executive Officer and President

THE ABILITY TO HAVE YOUR VOTE COUNTED AT THE MEETING IS AN IMPORTANT STOCKHOLDER RIGHT, AND I HOPE YOU WILL CAST YOUR VOTE IN PERSON OR BY PROXY REGARDLESS OF THE NUMBER OF SHARES YOU HOLD.

ART TECHNOLOGY GROUP, INC.

25 First Street
Cambridge, Massachusetts 02141

Notice of 2003 Annual Meeting of Stockholders

Time and Date	10:00 a.m., Eastern standard time, on May 21, 2003
Place	Hale and Dorr LLP 60 State Street Boston, Massachusetts
Items of Business	At the meeting, we will ask you and our other stockholders to: (1) Elect three directors to three year terms. (2) Approve an amendment to our charter to decrease the number of shares of authorized common stock from 500,000,000 to 200,000,000 and the number of shares of authorized stock (including common stock) from 510,000,000 to 210,000,000. (3) Approve the Amended and Restated 1999 Outside Director Stock Option Plan, which will increase the number of shares of common stock issuable under the plan from 300,000 to 800,000. (4) Approve an increase in the number of shares of common stock issuable under our 1999 Employee Stock Purchase Plan from 3,000,000 to 5,000,000. (5) Transact any other business properly presented at the meeting.
Record Date	You may vote if you were a stockholder of record at the close of business on March 26, 2003.
Proxy Voting	It is important that your shares be represented and voted at the meeting. Whether or not you plan to attend the meeting, please mark, sign, date and promptly mail your proxy card to our transfer agent, EquiServe Trust Company, N.A., in the enclosed postage-paid envelope. Alternatively, you may submit your proxy via the Internet or by telephone by following the directions on pages 2 and 3. You may revoke your proxy at any time prior to its exercise at the meeting. You may revoke electronic votes by using the same method as your original vote and making any changes you deem necessary.

By Order of the Board of Directors

Paul G. Shorthose
Chairman of the Board of Directors

Cambridge, Massachusetts
April 7, 2003

PROXY STATEMENT

for the
ART TECHNOLOGY GROUP, INC.
2003 ANNUAL MEETING OF STOCKHOLDERS

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INFORMATION ABOUT THE MEETING

This Proxy Statement

We have sent you this proxy statement and the enclosed proxy card because our board of directors is soliciting your proxy to vote at our 2003 Annual Meeting of Stockholders or any adjournment or postponement of the meeting. The meeting will be held at 10 a.m., local time, on Wednesday, May 21, 2003, at the offices of Hale and Dorr LLP, 60 State Street, Boston, Massachusetts.

THIS PROXY STATEMENT summarizes information about the proposals to be considered at the meeting and other information you may find useful in determining how to vote.

THE PROXY CARD is the means by which you actually authorize another person to vote your shares in accordance with the instructions.

Our directors, officers and employees may solicit proxies in person or by telephone, mail, electronic mail, facsimile or telegram. We will pay the expenses of soliciting proxies, although we will not pay additional compensation to these individuals for soliciting proxies. We will request banks, brokers and other nominees holding shares for a beneficial owner to forward copies of the proxy materials to those beneficial owners and to request instructions for voting those shares. We will reimburse these banks, brokers and other nominees for their related reasonable expenses. We have not retained the services of any proxy solicitation firm to assist us in soliciting proxies.

We are mailing this proxy statement and the enclosed proxy card to stockholders for the first time on or about April 9, 2003. In this mailing, we are enclosing a copy of our 2002 Annual Report to Stockholders, which includes our annual report on Form 10-K for the year ended December 31, 2002.

Who May Vote

Holders of record of our common stock at the close of business on March 26, 2003 are entitled to one vote per share on each matter properly brought before the meeting. The proxy card states the number of shares you are entitled to vote.

A list of stockholders entitled to vote will be available at the meeting. In addition, you may contact Edward Terino, our Secretary, at our address as set forth in the notice appearing before this proxy statement, to make arrangements to review a copy of the stockholder list at our offices located at 25 First Street, Cambridge, Massachusetts, prior to the meeting, between the hours of 8:30 a.m. and 5:30 p.m., local time, on any business day from May 9, 2003 up to the time of the meeting.

How to Vote

You may vote your shares at the meeting in person or by proxy:

To Vote in Person, you must attend the meeting, and then complete and submit the ballot provided at the meeting.

To Vote by Proxy, you must either: (1) mark, sign and date the enclosed proxy card and then mail the proxy card to our transfer agent, EquiServe Trust Company, N.A., or (2) submit your proxy electronically by using the Internet or telephone. To submit your vote using the Internet, log on to ***www.eproxyvote.com/artg***. Use the registration number printed on your proxy card as your login name, and use the last 4 digits of your Social Security number as the PIN. If you represent an entity rather than an individual, use the last 4 digits of the entity s Taxpayer Identification Number as the PIN. If the entity does not have a Taxpayer Identification Number, you will not be able to vote electronically. You will see an electronic version of the proxy card on the screen and you may submit your votes by clicking on your choice for each question. To submit your vote by telephone, you may call 1-877-PRX-VOTE (1-877-779-8683) and follow the directions. Your proxy will be valid only if you complete and return the proxy card or vote electronically before the meeting. By completing and returning the proxy card, either by mail or electronically, you will direct the designated persons to vote your shares at the meeting in the manner you specify in the proxy card. If you complete the proxy card with the exception of the voting instructions, then the designated persons will vote your shares for the election of the nominated directors, the amendment to our charter, the amendment and restatement of our 1999 Outside Director Stock Option Plan and the increase in shares issuable under our 1999 Employee Stock Purchase Plan. If any other business properly comes before the meeting, the designated persons will have the discretion to vote your shares as they deem appropriate.

Even if you complete and return a proxy card or submit your proxy electronically, you may revoke it at any time before it is exercised by taking one of the following actions:

send written notice to Edward Terino, our Secretary, at our address as set forth in the Notice appearing before this proxy statement;

send us another signed proxy with a later date;

log on to the Internet the same way you did originally and change your votes;

call the telephone number listed above and change your votes; or

attend the meeting, notify our Secretary that you are present, and then vote by ballot.

If your shares are held in the name of a bank, broker or other nominee holder, you will receive instructions from the holder of record explaining how your shares may be voted. Please note that, in such an event, you must obtain a proxy, executed in your favor, from the holder of record to be able to vote at the meeting.

Quorum Required to Transact Business

At the close of business on March 26, 2003, 70,996,637 shares of our common stock were outstanding. Our by-laws require that a majority of the shares of our common stock outstanding on that date be represented, in person or by proxy, at the meeting in order to constitute the quorum we need to transact business. We will count abstentions and broker non-votes in determining whether a quorum exists. A broker non-vote occurs when a nominee holding shares for a beneficial owner does not vote on a particular proposal because the nominee does not have discretionary voting power for that particular item and has not received instructions from the beneficial owner.

DISCUSSION OF PROPOSALS

Proposal One: Election of Class I Directors

The first proposal on the agenda for the meeting is the election of three people to serve as Class I directors for three-year terms beginning at the meeting and ending at our 2006 Annual Meeting of Stockholders.

Under our by-laws, our board of directors has the authority to fix the number of directors and our board is divided into three classes serving for staggered three-year terms. The number of directors currently is fixed at eight. Scott A. Jones, one of our Class II directors, has advised us that he is resigning from the board due to time constraints. The board has determined that the number of directors will decrease from eight to seven immediately before the meeting, upon the resignation of Mr. Jones.

The board has nominated John R. Held, Paul G. Shorthose and Phyllis S. Swersky, the current Class I directors, for re-election. Brief biographies of Mr. Held, Mr. Shorthose and Ms. Swersky, as of March 15, 2003, follow. You will find information about their stock holdings on page 27.

John R. Held	Mr. Held has been a director since July 2002. Mr. Held formerly served as both the President and Chief Executive Officer of Chipcom, and served in a variety of management positions during his 14-year tenure at Genrad. Mr. Held is a director of BNS Co. Mr. Held is 64 years old.
Paul G. Shorthose	Mr. Shorthose has been a director since October 2001 and Chairman of the Board of Directors since July 2002. Mr. Shorthose served as our Chief Executive Officer from October 2001 to December 2002, as our President from February 2000 through December 2002 and as our Chief Operating Officer from June 1999 to October 2001. From July 1998 to June 1999, he was Vice President of Marketing and Business Development for Context Integration, Inc., a software-related consulting services company. From August 1997 to July 1998, Mr. Shorthose served as our Vice President, Worldwide Services. Mr. Shorthose is 45 years old.
Phyllis S. Swersky	Ms. Swersky has been a director since May 2000. Since 1995 she has been President of The Meltech Group, a consulting firm specializing in business advisory services for high-growth potential businesses. Ms. Swersky also serves as a director of Investor Financial Services. Ms. Swersky is 51 years old.

We expect that Mr. Held, Mr. Shorthose and Ms. Swersky will be able to serve if elected. If any of them is not able to serve, proxies may be voted for a substitute nominee.

The nominees receiving the greatest number of votes cast will be elected as directors. We will not count abstentions when we tabulate votes cast for the director election. Brokers have discretionary voting power with respect to director elections.

Proposal Two: Amend our Charter to Decrease the Number of Authorized Shares of Stock

The board of directors believes that it would be in the best interests of our stockholders to amend our charter to decrease the number of shares of authorized common stock from 500,000,000 to 200,000,000 and the total number of authorized shares of stock (including common stock) from 510,000,000 to 210,000,000.

By decreasing the number of shares of authorized stock, we will be able to decrease our annual Delaware franchise tax payments. At current rates, for example, we would save approximately $90,000 per year.

As of February 28, 2003, 70,982,399 shares of common stock outstanding and an additional 8,655,285 shares of common stock reserved for issuance under our various equity incentive plans. The board believes that 200,000,000 shares of authorized common stock will provide us sufficient flexibility with regard to future financing and acquisition transactions, employee benefit plans, and other general corporate purposes. If the board believes it to be in our best interest to issue new shares of common stock in the future, the board will retain the authority to determine the terms of the issuance and would not seek further authorization by vote of the stockholders unless except as required by applicable law.

The board believes that stockholder approval of the amendment to our charter is in the best interest of our company and our stockholders and therefore recommends that stockholders vote FOR this proposal.

The affirmative vote of the holders of a majority of the outstanding common stock entitled to vote at the meeting is required for the approval of the amendment to our charter to decrease the number of authorized shares of common stock from 500,000,000 to 200,000,000 and the total number of authorized shares of stock (including common stock) from 510,000,000 to 210,000,000. Broker non-votes will not be counted as votes in favor of such matter. Accordingly, abstentions and broker non-votes will have the same effect as a vote against the proposed amendment to the charter.

Proposal Three: Amend and Restate the 1999 Outside Director Stock Option Plan

The board of directors believes that it would be in the best interests of our stockholders to amend and restate our 1999 Outside Director Stock Option Plan to increase the number of shares of common stock reserved under the plan from 300,000 to 800,000 and to eliminate automatic grants of options pursuant to the plan.

Our board believes that the strength of our corporate governance depends, in large part, upon our ability to attract and retain independent, qualified and active members to our board. Stock options, which provide our independent directors with a financial stake in our success are an important part of the incentives that we can provide to these directors. In addition, qualified individuals continue to expect and require public companies to provide stock option grants in connection with serving as directors.

As of March 1, 2003, only 50,000 shares of our common stock were available for future grant under the plan. Accordingly, on March 24, 2003, the board adopted, subject to stockholder approval, an amendment and restatement of the plan that would increase the number of shares of common stock available for issuance under the plan from 300,000 to 800,000 (subject to a proportionate adjustment for certain changes in our capitalization, such as stock splits). In addition, the board eliminated automatic grant provisions set forth in the plan because those provisions are not necessary to enable option grants and exercises under the plan to qualify as exempted transactions for purposes of Section 16 of the Securities Exchange Act.

See Appendix B to this proxy statement for the text of the Amended and Restated 1999 Outside Director Stock Option Plan.

The board believes that stockholder approval of the Amended and Restated 1999 Outside Director Stock Option Plan is in the best interests of our company and our stockholders and therefore recommends that stockholders vote FOR this proposal.

An affirmative vote of a majority of the common stock voting on the matter, in person or by proxy, is necessary to approve the amendment and restatement of our 1999 Outside Director Stock Option Plan. Abstentions effectively count as votes against approval of the plan. Brokers have discretionary voting power with respect to this proposal.

Federal Income Tax Consequences

The following summarizes the United States federal income tax consequences that generally will arise with respect to awards granted under the plan. This summary is based on the tax laws in effect as of the date of this proxy statement. Changes to these laws could alter the tax consequences described below.

Nonstatutory Stock Options. A director will not have income upon the grant of a nonstatutory stock option. A director will have compensation income upon the exercise of a nonstatutory stock option equal to the value of the stock on the day the director exercised the option less the exercise price. Upon sale of the stock, the director will have capital gain or loss equal to the difference between the sales proceeds and the value of the stock on the day the option was exercised. This capital gain or loss will be long-term if the director has held the stock for more than one year and otherwise will be short-term.

Tax Consequences to Us. There will be no tax consequences to us except that we will be entitled to a deduction when a director has compensation income. Any such deduction will be subject to the limitations of Section 162(m) of the Code.

Proposal Four: Increase in Shares Issuable under the 1999 Employee Stock Purchase Plan

Our board of directors believes that our growth and profitability depend, in large part, upon our ability to maintain a competitive position in attracting and retaining key personnel. The board continues to believe that it is important for employees to invest in our company in order for them to have a financial stake in our success, and employees in the technology sector continue to expect and require the ability to participate in an employee stock purchase plan as part of their total compensation packages because the benefits are more certain.

As of March 13, 2003, only 1,077,402 shares of our common stock were available for future purchase under our 1999 Employee Stock Purchase Plan. Accordingly, on March 24, 2003, the board adopted, subject to stockholder approval, an amendment to the purchase plan that would increase the number of shares of common stock available for issuance under the purchase plan from 3,000,000 to 5,000,000 (subject to a proportionate adjustment for certain changes in our capitalization, such as a stock split).

The table below shows the details of employee participation in the purchase plan during each period since its inception. Due to the price of our common stock during the last six months and the high percentage of employee participation (37%) in the purchase plan, employees purchased over 900,000 shares of common stock during the six-month period ending on December 31, 2002.

Purchases of Shares under 1999 Employee Stock Purchase Plan

Purchase Date	Purchase Price	Shares Purchased	Number of Participants
January 20, 2000	$ 5.10	150,850	180
August 10, 2000	53.23	23,172	257
February 12, 2001	32.03	43,441	415
August 10, 2001	1.62	88,267	273
February 8, 2002	1.49	694,131	271
September 30, 2002	0.81	456,157	198
December 31, 2002	0.79	466,580	209
Total		1,922,598	

Any increase in the number of shares reserved under the purchase plan must be approved by our stockholders in order for our employees to benefit from the tax advantages that underlie the purchase plan. Therefore, in order for us to continue to use the purchase plan effectively as part of the compensation package we offer to our employees, we need to obtain stockholder approval for the amendment to the purchase plan.

The board believes that stockholder approval of the amendment to the purchase plan is in the best interests of our company and our stockholders and therefore recommends that stockholders vote FOR this proposal.

An affirmative vote of the holders of a majority of the common stock voting on the matter, in person or by proxy, is necessary to approve the amendment to the purchase plan. Abstentions effectively count as votes against approval of the amendment. Brokers have discretionary voting power with respect to this proposal.

Summary of Employee Stock Purchase Plan

The following summary is qualified in all respects by reference to the full text of our 1999 Employee Stock Purchase Plan. You can obtain a copy of the purchase plan by writing to Edward Terino, our Secretary, at our address as set forth in the Notice appearing before this proxy statement.

The purchase plan was adopted by our board of directors on May 10, 1999 and approved by our stockholders on June 18, 1999. On March 20, 2002 the board voted to amend the purchase plan in order to reduce each plan offering period from 6 months to 3 months and to increase the number of shares that may be issued under the purchase plan from 1,000,000 to 3,000,000 and on May 22, 2002 the stockholders approved this increase. On March 24, 2003 the board voted to amend the purchase plan to increase the number of shares that may be issued under the purchase plan from 3,000,000 to 5,000,000.

Only our employees are eligible to purchase shares of our common stock under the purchase plan. Employees receive the right to purchase a specified number of shares of common stock at 85% of the closing market price of our common stock on either (1) the first business day of the offering period or (2) the last business day of the offering period, whichever price is lower.

An employee may authorize us to make a payroll deduction of between 1% and 10% of the employee s compensation during any offering period. At the end of the offering period, the deducted money is used to buy shares of our common stock. During an offering period, an employee may purchase no more than the number of shares calculated by dividing the closing market price of our common stock on the first day of the offering period into $6,250. This number is derived from a limitation imposed by the Internal Revenue Code, which provides that no employee may be granted an option which permits the employee s rights to purchase stock under an employee stock purchase plan to accrue at a rate that exceeds $25,000 of the fair market value of the common stock for each calendar year in which the option is outstanding at any time.

The board administers the purchase plan and has the authority to adopt, amend and repeal the administrative rules, guidelines and practices relating to the purchase plan and to interpret the provisions of the purchase plan.

The board may amend the purchase plan at any time, except that if Section 423 of the Internal Revenue Code requires that the stockholders approve an amendment, the amendment will not be effective until stockholders approve it. Section 423 requires approval of the increase in the number of shares issuable under the purchase plan. It does not require approval of the shortening of the plan offering period from six months to three months, as described above.

U.S. Federal Income Tax Consequences

The following is a summary of the United States federal income tax consequences that generally will arise with respect to purchases made under the purchase plan and with respect to the sale of common stock acquired under the purchase plan.

Tax Consequences to Participants. In general, a participant will not recognize taxable income upon enrolling in the purchase plan or upon purchasing shares of common stock at the end of an offering period. Instead, if a participant sells common stock acquired under the purchase plan at a sale price that exceeds the price at which the participant purchased the common stock, then the participant will recognize taxable income in an amount equal to the excess of the sale price of the common stock over the price at which the participant purchased the common stock. A portion of that taxable income will be ordinary income, and a portion may be capital gain.

If the participant sells the common stock more than one year after acquiring it and more than two years after the date on which the offering commenced, called the Grant Date, then the participant will be taxed as follows. If the sale price of the common stock is higher than the price at which the participant purchased the common stock, the participant will recognize ordinary compensation income in an amount equal to the lesser of:

fifteen percent of the fair market value of the common stock on the Grant Date; and

the excess of the sale price of the common stock over the price at which the participant purchased the common stock.

Any further income will be long-term capital gain. If the sale price of the common stock is less than the price at which the participant purchased the common stock, then the participant will recognize long-term capital loss in an amount equal to the excess of the price at which the participant purchased the common stock over the sale price of the common stock.

If the participant sells the common stock within one year after acquiring it or within two years after the Grant Date, then the participant will recognize ordinary compensation income in an amount equal to the excess of the fair market value of the common stock on the date that it was purchased over the price at which the participant purchased the common stock. The participant will also recognize capital gain in an amount equal to the excess of the sale price of the common stock over the fair market value of the common stock on the date that it was purchased, or capital loss in an amount equal to the excess of the fair market value of the common stock on the date that it was purchased over the sale price of the common stock. This capital gain or loss will be a long-term capital gain or loss if the participant has held the common stock for more than one year prior to the date of the sale and will be a short-term capital gain or loss if the participant has held the common stock for a shorter period.

Tax Consequences to ATG. The offering of common stock under the purchase plan will have no tax consequences to us. Moreover, in general, neither the purchase nor the sale of common stock acquired under the purchase plan will have any tax consequences to us except that we will be entitled to a business-expense deduction with respect to any ordinary compensation income recognized by a participant who sells common stock within one year after acquiring it or within two years after the Grant Date. Any such deduction will be subject to the limitations of Section 162(m) of the Internal Revenue Code.

Other Matters

Our board of directors is not aware of any matters that are expected to come before the meeting other than those referred to in this proxy statement. If any other matter should properly come before the meeting, the persons named in the accompanying proxy card intend to vote the proxies in accordance with their best judgment.

The chairperson of the meeting may refuse to allow the transaction of any business not presented beforehand, or to acknowledge the nomination of any person not made, in compliance with the above procedures.

Submission of Future Stockholder Proposals

Under SEC rules, a stockholder who intends to present a proposal, including nomination of a director, at our 2004 Annual Meeting of Stockholders and who wishes the proposal to be included in the proxy statement for that meeting must submit the proposal in writing to our Secretary at 25 First Street, Cambridge, Massachusetts 02141, prior to December 17, 2003. SEC rules set standards for the types of stockholder proposals and the information that must be provided by the stockholder making the request.

A stockholder may also submit a proposal to be considered at our 2004 Annual Meeting of Stockholders pursuant to our by-laws, which provide that the proposal must be received by our Secretary not less than sixty days nor more than ninety days prior to that meeting. This notice must include the information required by the provisions of our by-laws, a copy of which may be obtained by writing to our Secretary at the address specified above. We have not yet set a date for our 2004 Annual Meeting. If the 2004 Annual Meeting were to be held on May 21, 2004, the anniversary of the 2003 Annual Meeting, the deadline for delivery of a stockholder proposal pursuant to our by-laws would be March 22, 2004. If a proposal is submitted pursuant to our by-laws but after December 17, 2003, the stockholder may not require that the proposal be included in the proxy statement for the 2004 Annual Meeting.

INFORMATION ABOUT

CONTINUING DIRECTORS AND EXECUTIVE OFFICERS

Background Information about Directors Continuing in Office

The following Class II and Class III directors will continue in office following the meeting. Scott A. Jones, one of our Class II directors, resigned effective immediately before the meeting. The terms of our Class II directors will expire upon our 2004 Annual Meeting of Stockholders, and the terms of our Class III directors will expire upon our 2005 Annual Meeting of Stockholders. Brief biographies of these directors, as of March 15, 2003, follow. You will find information about their holdings of common stock on page 27.

Class II Directors

Ilene H. Lang	Ms. Lang has served as a director since October 2001. Since May 2000, Ms. Lang has been a business and financial consultant to various boards of directors, boards of trustees, and CEOs. From May 1999 to May 2000, she served as President and CEO of Individual.com, Inc., an Internet media service. From August 1998 until March 1999, Ms. Lang served as CEO of Essential.com, Inc., an e-commerce company. Ms. Lang has also serves as a director of Adaptec, Inc., a data storage and connectivity company. Ms. Lang is 59 years old.
Thomas N. Matlack	Mr. Matlack has served as a director since November 1997. Since August 1998, he has been a Managing Partner at Megunticook Management LLC, a private investment fund. Mr. Matlack is 38 years old.

Class III Directors

Robert D. Burke	Mr. Burke has served as a director since December 2002 and is our Chief Executive Officer and President. From November 2000 through November 2002, Mr. Burke worked at Quidnunc, a customer solutions and services company, where he served as Chief Executive Officer. Mr. Burke served as President ePresence Solutions (formerly Banyan Systems), a online security and identity management company, where he worked from March 1997 through October 2000. Mr. Burke is 48 years old.
Mary E. Makela	Ms. Makela has served as a director since July 2002. Ms. Makela formerly served as President of Cognos Corporation and President and CEO of IMC Systems. Since 1994, Ms. Makela has provided management consulting services to CEOs, and various for profit and non-profit boards of directors. Ms. Makela is 59 years old.

Background Information about Executive Officers

Our executive officers are elected by our board of directors and hold office until the first meeting of the board following the annual meeting of stockholders. Brief biographies of our executive officers follow. The ages of the executive officers are given as of March 15, 2003. You will find information about their holdings of common stock on page 27.

Robert D. Burke	Chief Executive Officer and President. You will find background information about Mr. Burke on page 12.
Edward Terino	Mr. Terino has been Chief Financial Officer and Senior Vice President, Finance since October 2001. From April 1999 to September 2001 he was Chief Financial Officer of Applix, Inc., a provider of enterprise-wide software solutions. From November 1996 to March 1999 he was Chief Financial Officer of Celerity Solutions, Inc. Mr. Terino is 49 years old.
John Dragoon	Mr. Dragoon has been our Senior Vice President of Marketing and Product Management since July 2002. From April 2000 to February 2002 he was Vice President Operations of Internet Capital Group. From June 1984 to April 2002 he served in a variety of roles at IBM, most recently as Director of Marketing, Supply Chain Management. Mr. Dragoon is 42 years old.
R. Gregory Lazar	Mr. Lazar has been Senior Vice President of Worldwide Sales and Field Operations since January 2003. Mr. Lazar was our Vice President and General Manager of North America from July 2002 to December 2002, and our Vice President North American Sales from October 2001 to June 2002. From March 2000 to July 2001 Mr. Lazar was the Chief Executive Officer of Innovia.com, a provider of marketing services to deliver live conferences and seminars over the Web. From 1996 to March 2000, Mr. Lazar served in a variety of roles at PictureTel Corporation, a provider of videoconferencing solutions, most recently as Vice President America Sales. Mr. Lazar is 51 years old.
Fumiaki Matsumoto	Mr. Matsumoto has been Chief Technology Officer since October 2002. Mr. Matsumoto was our Vice President of Technology from February 2002 to October 2002. Mr. Matsumoto has been in varying strategy and product planning roles since joining the company in September 1993. Mr. Matsumoto is 35 years old.

INFORMATION ABOUT CORPORATE GOVERNANCE

General

We believe that good corporate governance is important to ensure that our company is managed for the long-term benefit of our stockholders. During the past year, we have been reviewing our corporate governance policies and practices and comparing them to those suggested by various authorities in corporate governance and the practices of other public companies. We have also been reviewing the provisions of the Sarbanes-Oxley Act of 2002, the new and proposed rules of the SEC and the proposed new listing standards of the Nasdaq National Market.

Based on our review, we have taken steps to implement voluntarily many of the proposed new rules and listing standards. In particular, we have:

- reconstituted our Nominating Committee as the Nominating and Governance Committee;
- adopted a new charter for our Audit Committee;
- nominated for election three new directors, two of whom we believe will qualify as independent directors under the new rules and listing standards; and
- established a disclosure committee.

Board and Committee Meetings

The board of directors has responsibility for establishing broad corporate policies and reviewing our overall performance rather than day-to-day operations. The board s primary responsibility is to oversee the management of the company and, in so doing, serve the best interests of the company and its stockholders. The board selects, evaluates and provides for the succession of executive officers and, subject to stockholder election, directors. It reviews and approves corporate objectives and strategies, and evaluates significant policies and proposed major commitments of corporate resources. Management keeps the directors informed of our activities through regular written reports and presentations at board and committee meetings.

Our board of directors met in person or via teleconference 14 times in 2002. Scott A. Jones, Ilene H. Lang, Thomas N. Matlack, Paul G. Shorthose and Phyllis S. Swersky attended at least 75% of those meetings. Robert D. Burke, John R. Held and Mary E. Makela joined the board of directors in December 2002, July 2002 and July 2002, respectively, and each of them attended all of the meetings of the board of directors since they joined. The board has three standing committees: an Audit Committee, a Compensation Committee, and a Nominating and Governance Committee.

Audit Committee

The Audit Committee reviews our financial reporting and internal controls and policies, recommends the selection of independent accountants, reviews the overall plan and scope of the independent audit, and provides the opportunity for direct contact between our independent accountants and the board. The Audit Committee acts under a written charter adopted and approved on December 18, 2002, which replaced a written charter first adopted and approved on June 12, 2001. A copy of the current Audit Committee Charter is attached to this proxy statement as Appendix A.

The Audit Committee met in person or via teleceonference 10 times during 2002. The current Audit Committee members are Ilene H. Lang, Mary E. Makela and Thomas N. Matlack. Each of the members of the Audit Committee are independent pursuant to Rule 4200(a)(15) of the National Association of Securities Dealers listing standards. Ms. Lang and Mr. Matlack attended all of the meetings of the Audit Committee in 2002. Ms. Makela attended all of the meetings of the Audit Committee held after she joined the Audit Committee in July 2002.

Compensation Committee

The Compensation Committee reviews, and recommends to the board of directors for approval, the compensation programs for the chief executive officer, other executive officers and key employees. The Compensation Committee also administers our bonus and incentive plans and programs, including stock option and stock purchase plans. The Compensation Committee met or acted by written consent 6 times during 2002. The current members of the Compensation Committee are Mr. Held, Mr. Jones and Ms. Swersky. Mr. Jones and Ms. Swersky attended all of the meetings of the Compensation Committee in 2002. Mr. Held attended all of the meetings of the Compensation Committee held after he joined the Compensation Committee in July 2002.

Nominating and Governance Committee

The Nominating and Governance Committee is responsible for identifying and recommending candidates for membership on the board of directors, for conducting the board s annual performance evaluation, and for developing and recommending to the board of directors a set of corporate governance principles. The Nominating and Governance Committee will consider for nomination to the board candidates suggested by the stockholders, provided that such recommendations are delivered to us, with an appropriate biographical summary, no later than the deadline for submission of stockholder proposals. See Submission of Future Stockholder Proposals . The Nominating Committee was established in January 2002, and reconstituted as the Nominating and Governance Committee in July 2002. Its current members are Ms. Lang and Mr. Shorthose.

Compensation of Directors

In 2002, pursuant to our previous compensation program for non-employee directors:

- we paid a cash retainer of $25,000 per year, paid in quarterly installments, to our non-employee directors and additional payments of $1,500 for each meeting of the board of directors attended by those directors;
- we paid an additional annual retainer of $10,000, paid in quarterly installments, to each non-employee committee chairperson and an additional $1,500 to each non-employee director for each committee meeting attended by that director; and
- we granted each of our continuing non-employee directors an option to purchase 10,000 shares of common stock as of May 22, 2002, and we granted new, non-employee directors an option to purchase 25,000 shares of common stock as of the date they were added to the board of directors. Each of these grants was fully vested upon grant.
- we reimbursed directors living outside of the greater Boston area for travel and living expenses for attending regular board meetings and committee meetings.

In order to more closely align the interests of the outside directors and our stockholders and to assist in the Company s drive for profitability, in December 2002 we adopted our 2003 Outside Director Compensation Plan. Pursuant to the plan,

- we pay a cash retainer of $2,500 per full fiscal quarter to our non-employee directors;
- we pay additional payments of $500 for each in-person meeting of the board of directors or a committee of the board of directors attended by non-employee directors and $250 for each teleconference meeting of the board of directors or a committee of the board of directors attended by non-employee directors;
- in order to compensate committee chairpersons for the additional work imposed by these roles, we provide an additional retainer of $1,250 per full fiscal quarter to each non-employee committee chairperson;
- we reimburse directors living outside of the greater Boston area for travel and living expenses for attending regular board meetings and committee meetings; and
- we granted each of our continuing non-employee directors, pursuant to our 1996 Stock Option Plan, an option to purchase 25,000 shares of common stock as of January 14, 2003 which was fully vested upon grant.

If our stockholders approve the amendment and restatement of our 1999 Outside Director Stock Option Plan, we expect that future grants to the outside directors will be made pursuant to that plan.

Equity Compensation Plan Information

The following table provides information as of March 15, 2003 about the securities authorized for issuance under our equity compensation plans, consisting of our 1996 Stock Option Plan, our 1999 Outside Director Stock Option Plan and our 1999 Employee Stock Purchase Plan.

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by stockholders	11,924,455	$6.43	7,967,852
Equity compensation plans not approved by stockholders			
Total	11,924,455	$6.43	7,967,852

Audit Committee Report

The Audit Committee reviewed the audited financial statements for the year ended, and as of, December 31, 2002 and discussed these financial statements with management. The Audit Committee also reviewed and discussed the audited financial statements and the matters required by Statement on Auditing Standards 61, *Communication with Audit Committees,* with Ernst & Young LLP, our independent auditors for 2002. SAS 61 requires Ernst & Young to discuss with our Audit Committee, among other things, the following:

- methods to account for significant unusual transactions;
- the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus;
- the process used by management in formulating particularly sensitive accounting estimates and the basis for the auditors conclusions regarding the reasonableness of those estimates; and
- disagreements, of which there were none, with management over the application of accounting principles, the basis for management s accounting estimates and the disclosures in the financial statements.

Ernst & Young also provided the Audit Committee with the written disclosures and the letter required by Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees*. This Standard requires auditors annually to disclose in writing all relationships that in the auditors professional opinion may reasonably be thought to bear on independence, confirm their perceived independence and engage in a discussion of independence. In addition, the Audit Committee discussed with Ernst & Young the independence of Ernst & Young from the company, and considered whether Ernst & Young s provision of other, non-audit related services, which are described below under Independent Auditors Fees and Other Matters, is compatible with maintaining such independence.

Based on its discussions with management and Ernst & Young, and its review of the representations and information provided by management and Ernst & Young, the Audit Committee recommended to the board that the audited financial statements be included in the annual report on Form 10-K for the year ended December 31, 2002.

AUDIT COMMITTEE

Ilene H. Lang
Mary E. Makela
Thomas N. Matlack

Independent Auditors

The board of directors, upon the recommendation of the Audit Committee, selected Ernst & Young LLP to serve as our independent auditors for the year ending December 31, 2003. Ernst & Young served as our independent auditors for the year ended December 31, 2002. Representatives of Ernst & Young will be present at the meeting to answer appropriate questions and they will have the opportunity to make a statement if they desire to do so.

On March 28, 2002, our board, upon the recommendation of our Audit Committee, decided to dismiss Arthur Andersen LLP as the Company s independent auditors and engaged Ernst & Young LLP to serve as the Company s independent auditors for the fiscal year 2002, effective April 1, 2002.

Neither Arthur Andersen s report on the Company s consolidated financial statements for the year ended December 31, 2001 nor Ernst & Young s report on the Company s consolidated financial statements for the year ended December 31, 2002 contain any adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope or accounting principles.

During the year ended December 31, 2001 and the interim period ending on March 28, 2002, there were no disagreements with Arthur Andersen on any matter of accounting principle or practice, financial statement disclosure, or auditing scope or procedure which, if not resolved to Arthur Andersen s satisfaction, would have caused them to make reference to the subject matter in conjunction with their report on the Company s consolidated financial statements for such years; and there were no reportable events as defined in Item 304(a)(1)(v) of Regulation S-K.

During the year ended December 31, 2001 and through March 28, 2002 neither the Company, nor anyone acting on its behalf, consulted Ernst & Young with respect to the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered on the Company s consolidated financial statements, or any other matters or reportable events as set forth in Items 304(a)(2)(i) and (ii) of Regulation S-K.

Independent Auditor Fees and Other Matters

Audit Fees

Ernst & Young LLP billed us an aggregate of $399,200 in fees for professional services rendered in connection with the audit of our consolidated financial statements for the year ended, and as of, December 31, 2002 and the reviews of the consolidated financial statements included in each of our quarterly reports on Form 10-Q during the year ended December 31, 2002.

Financial Information Systems Design and Implementation Fees

Ernst & Young LLP did not bill us for any professional services rendered to us and our affiliates for the year ended December 31, 2002 in connection with financial information systems design or implementation, the operation of our information system or the management of our local area network.

All Other Fees

Ernst & Young LLP billed us an aggregate of $148,100 in fees for other services rendered to us and our affiliates for the year ended December 31, 2002. These services consisted of $28,000 of audit-related services and $120,100 related to tax compliance and advisory services. Audit-related services consisted of services in connection with registration statements and various other audit-related accounting consultation services.

Leased Employees

In connection with its engagement to audit our consolidated financial statements for the year ended December 31, 2002, Ernst & Young LLP has informed us that no work was performed by persons other than its full-time, permanent employees.

Certain Relationships and Related Party Transactions

On November 20, 2001 we loaned Ed Terino, our Chief Financial Officer, a total of $150,000 pursuant to a note that bears interest at an annual rate of 5.0%. The principal and all interest accruing on the note are payable on November 20, 2005 or such earlier date on which Mr. Terino ceases working for us. The note may be paid by Mr. Terino at any time without penalty. The note is not subject to redemption to us prior to maturity. Mr. Terino s largest aggregate indebtedness to us during 2002 was $158,366 as of December 31, 2002. As of March 15, 2003, Mr. Terino s aggregate indebtedness to us was $159,940.

INFORMATION ABOUT EXECUTIVE COMPENSATION

Summary Compensation

The following table sets forth information with respect to the annual and long-term compensation that we paid for the past three years to the following persons, who are referred to as our named executive officers:

Robert D. Burke, our chief executive officer since December 2002;

Paul G. Shorthose, our chief executive officer from October 2001 to December 2002;

Edward Terino, John Dragoon, R. Gregory Lazar and Fumiaki Matsumoto, our four other most highly compensated executive officers who continued to serve as executive officers as of December 31, 2002; and

Bernard Bailey, who was our chief operating officer until August 2002, and Lauren Kelley who was our senior vice president, strategic development through October 2002, each of whom would have been one of the four most highly compensated executive officers had he or she remained in his or her respective positions until December 31, 2002.

Summary Compensation Table

	Annual Compensation			Long-Term Compensation Awards
Name and Principal Position	**Year**	**Salary ($)**	**Bonus ($)**	**Securities Underlying Options (#)**
Robert D. Burke	2002	$ 16,177	$	500,000
President and Chief Executive Officer				
Paul G. Shorthose	2002	$360,600	$	
Former President and Chief Executive Officer	2001	255,192	195,000	500,000
	2000	200,769		
Edward Terino	2002	$250,600	$ 45,000	
Chief Financial Officer	2001	60,577		325,000
John Dragoon	2002	$158,033	$	200,000
Senior Vice President Marketing and Product Management				
R. Gregory Lazar	2002	$219,061	$ 77,095	175,000
Senior Vice President of Worldwide Sales and Field Operations	2001	41,538		125,000

Name and Principal Position	Year	Annual Compensation Salary ($)	Annual Compensation Bonus ($)	Long-Term Compensation Awards Securities Underlying Options (#)
Fumiaki Matsumoto	2002	$140,796	$ 7,450	75,000
Chief Technology Officer	2001	114,957	56,250	18,600
	2000	113,650		10,000
Bernard Bailey	2002	$195,368	$ 79,860	
Former Chief Operating Officer	2001	245,621	122,400	402,000
Lauren Kelley	2002	$263,957	$ 9,450	
Former Senior Vice President,	2001	241,538	118,189	32,000
Strategic Development	2000	170,769	209,430	

We hired Robert D. Burke as our President and Chief Executive Officer in December 2003. Mr. Burke currently earns an annual base salary of $350,000.

Stock Options Granted During 2002

Name	Number of Securities Underlying Option Granted (#)	Percent of Total Options/ Granted to Employees in Fiscal Year	Exercise or Base Price ($)	Expiration Date	Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term 5%	10%
Robert D. Burke	500,000	11.91%	$1.44	12/05/12	$452,804	$1,147,495
Paul G. Shorthose						
Edward Terino						
John Dragoon	200,000	4.76	0.92	8/16/12	115,717	293,249
R. Gregory Lazar	50,000	4.17	3.48	1/02/12	109,428	277,311
	50,000		0.95	7/10/12	29,872	75,703
	75,000		1.16	12/18/12	54,714	138,656
Fumiaki Matsumoto	25,000	1.79	2.79	2/22/12	43,865	111,164
	50,000		0.95	10/08/12	29,872	75,703
Bernard Bailey						
Lauren Kelley						

Each option included in the preceding table has an exercise price per share equal to the fair market value per share of the common stock on the date of grant.

The potential realizable values reflected in the preceding table represent hypothetical gains that could be achieved for the options if exercised at the end of their option terms. These gains are based on assumed rates of stock price appreciation of 5% and 10% compounded annually from the date an option was granted to their expiration date. The grants shown are net of the option exercise price, but do not include deductions for taxes or other expenses associated with the exercise of the option or the sale of the underlying shares. The actual gains, if any, on the exercises of stock options will depend on the future performance of the common stock, the option holder s continued employment through the option period, and the date on which the options are exercised.

Total Option Exercises During 2002 and Year-End Values

Name	Shares Acquired on Exercise(#)	Value Realized($)	Number of Securities Underlying Unexercised Options at December 31, 2002		Value of Unexercised In-the-Money Options At December 31, 2002	
			Exercisable(#)	Unexercisable(#)	Exercisable($)	Unexercisable($)
Robert D. Burke		$		500,000	$	$
Paul G. Shorthose			1,250,000			
Edward Terino			101,562	223,438	31,484	69,266
John Dragoon				200,000		64,000
R. Gregory Lazar			43,750	256,250	14,344	53,907
Fumiaki Matsumoto			102,747	83,813	72,230	14,500
Bernard Bailey						
Lauren Kelley			273,587		33,413	

The per-share value of unexercised in-the-money options is calculated by subtracting the option exercise price from $1.24, the last reported sale price of the common stock on December 31, 2002.

Compensation Committee Report

The Compensation Committee consists entirely of directors who are not officers or employees of ATG or of any of its affiliates. The Compensation Committee establishes the salaries and other compensation for executive officers, including our Chief Executive Officer and the other named executive officers. The Compensation Committee also administers the stock option and stock purchase plans.

General Compensation Philosophy. The executive compensation program is designed to:

retain executive officers by paying them competitively, motivating them to contribute to ATG s success and rewarding them for their performance;

link a substantial part of each executive officer s compensation to ATG s performance; and

encourage ownership of common stock by executive officers, to further tie the interests of management to the interests of stockholders.

The Compensation Committee applies these principles in determining annual compensation opportunities and payments for the named executive officers and other executive officers.

Establishing Total Compensation Opportunities. In determining total annual compensation opportunities for the named executive officers, the Compensation Committee considers many factors, including:

the experience and compensation history of the executive officer;

ATG s performance as measured by revenues, earnings and total stockholder return compared to that of other companies in the Internet software industry; and

the total annual compensation paid by competitors in the Internet software industry to their senior management.

Balancing the Elements of Compensation. The Compensation Committee seeks to balance three elements: salaries, bonuses and stock options. The Compensation Committee also tries to align the compensation opportunities of executive officers closely with the interests of stockholders in allocating compensation opportunities among these elements. Therefore, bonuses are tied to ATG s performance, as measured by revenues and earnings. The Compensation Committee also has relied on recommendations made by executive compensation specialists at Clark/ Bardes Consulting.

Salaries for each of the named executive officers are based on the Compensation Committee s evaluation of:

the executive officer s job performance;

the executive officer s contribution to our growth and profitability;

any increase in the executive officer s responsibilities, whether as a result of our growth or a reassignment of responsibilities;

the success of the management team in achieving ATG s short-term and long-term goals;

the importance of the executive officer to the future growth and profitability;

the salaries and total compensation mix paid to executive officers holding equivalent positions by companies in ATG s peer group; and

the experience and compensation history of the executive officer.

To determine the size of option grants to executive officers, the Compensation Committee relies on recommendations made by executive compensation specialists at Clark/ Bardes Consulting. The exercise price for all stock options granted to executive officers equals the market value of the underlying shares on the date of grant. Therefore, ultimately, the stock options have value only if the value of the underlying shares increases.

As Chief Executive Officer until December 2002, Paul G. Shorthose received salary compensation of $360,600. Mr. Shorthose did not receive bonus compensation in 2002. Following Mr. Shorthose s resignation, Robert D. Burke became Chief Executive Officer in December 2002. Mr. Burke s annualized base salary for 2003 is $350,000. He received salary compensation of $16,177 for 2002. Mr. Burke s and Mr. Shorthose s annual salaries were determined based on an assessment of comparative industry salaries using established executive compensation surveys.

Section 162(m) of the Internal Revenue Code generally disallows a tax deduction to a publicly traded company for compensation in excess of $1,000,000 paid to a company s chief executive officer and its four other most highly compensated executive officers. Some types of compensation, including qualified performance-based compensation, are not subject to the deduction limit if specified requirements are met. In general, ATG structures and administers its stock option plans in a manner intended to comply with the performance-based exception to Section 162(m). Nevertheless, there can be no assurance that compensation attributable to awards granted under ATG s stock option plans will be treated as qualified performance-based compensation under Section 162(m). In addition, the Compensation Committee reserves the right to use its judgment to authorize compensation payments that may be subject to the limit when the Compensation Committee believes such payments are appropriate and in the best interests of ATG and its stockholders, after taking into consideration changing business conditions and the performance of its employees.

COMPENSATION COMMITTEE

John R. Held
Scott A. Jones
Phyllis S. Swersky

Employment Contracts, Termination of Employment and Change of Control Arrangements

On December 4, 2002, we entered into an agreement with Robert Burke that provides for severance benefits in the event his employment is terminated under specified circumstances. This agreement provides that if we terminate his employment without cause or if he resigns for good reason, then Mr. Burke will receive a continuation of base pay and all employee benefits for the 12-month period following his termination. Among other events that constitute good reason for Mr. Burke s resignation is a change in control that results in us no longer having a public traded class of securities or us no longer being subject to reporting requirements under the Securities Exchange Act of 1934. In addition, we have granted to Mr. Burke two separate option grants, one being an option to acquire 500,000 shares of stock as of December 5, 2002, the other an option to acquire 400,000 shares of stock as of January 2, 2003. Under their terms, these options will vest in full in the event Mr. Burke s employment with us ceases within 12 months of a change in control.

On December 1, 2002, we entered into an agreement that provides for severance benefits in the event Mr. Terino s employment is terminated under specified circumstances following a change in control. The agreement expires on December 31, 2002; *provided* that the agreement is subject to automatic one-year extensions unless prior notice of termination is given by us. Mr. Terino is entitled to the severance benefits provided therein if a change in control occurs during the term of the agreement and his employment is terminated under specified circumstances within 12 months after such change in control. Upon a change in control, all of Mr. Terino s outstanding stock options and restricted stock award, become exercisable in full irrespective of whether an employment termination occurs. Mr. Terino s agreement provides that if his employment is terminated by the Company without cause or by him for good reason within 12 months following the change in control date, then he will receive a continuation of base pay (including salary and target bonus) and all employee benefits during the 12-month period following employment termination.

The Internal Revenue Code imposes certain tax penalties on both us and an executive if the amount of severance payments to the executive following a change in control exceeds certain limits (generally three times the average of the executive s compensation over the previous five years). Mr. Terino s agreement requires us to make a gross up payment such that their net after-tax severance benefits are equal to what they would have received absent the penalty tax.

On December 31, 2002, we entered into an agreement with Paul Shorthose regarding his continuing employment with us. As part of the agreement, Mr. Shorthose received a bonus payment for fiscal 2002 of $225,000 to be paid in 26 bi-weekly payments during 2003, in recognition and appreciation of the effort he invested in identifying and recruiting his successor as well as ensuring that the transition to the new chief executive officer was as seamless as possible, including introductions to customers, partners, and investors. In addition, Mr. Shorthose will receive a salary of $125,000 for his services to the company in 2003, of which, at his request, $25,000 will be in 26 bi-weekly payments, and a lump sum payment of $100,000 will be paid on January 2, 2004.

John Dragoon, R. Gregory Lazar and Fumiaki Matsumoto are entitled to certain benefits under a company-wide retention program adopted by our board of directors in July 2002. Under this program, one-half of the then-unvested options of each of these executive officers will vest upon a change of control. In addition, in the event the employment of any of these executive officers is terminated under specified circumstances within twelve months after a change of control, the executive officer will be entitled to severance consisting of six months of base salary and health benefits.

Compensation Committee Interlocks and Insider Participation

John R. Held, Scott A. Jones, Thomas N. Matlack and Phyllis S. Swersky served on the Compensation Committee during 2002. None of these directors was, during or before 2002, an officer or employee of our company or of any of our affiliates. None of our executive officers serves as a member of the board of directors or compensation committee of any entity that has one or more executive officers serving as members of our board of directors or Compensation Committee.

OTHER MATTERS

Information About Stock Ownership

The following table sets forth information as of February 28, 2003 with respect to the beneficial ownership of our common stock by:

each person known by us to own beneficially more than five percent of the outstanding shares of common stock,

each of our directors,

each of our named executive officers, and

all directors and executive officers as a group.

Beneficial Owner	Shares Beneficially Owned(1)	Shares Acquirable Within 60 Days	Total Beneficial Ownership	Percent Ownership(2)
Apex Capital, LLC and Sanford J. Colen(3)	4,505,000		4,505,000	6.35%
Jeet Singh	4,459,000		4,459,000	6.28
Joseph T. Chung(4)	4,319,682		4,319,682	6.09
Mellon Financial Corporation(5)	4,039,128		4,039,128	5.69
Robert D. Burke	20,000		20,000	*
Scott A. Jones	968,183	75,000	1,043,183	1.47
Paul G. Shorthose	94,803	1,250,000	1,344,803	1.86
Edward Terino	60,000	121,875	181,875	*
John R. Held	25,000	50,000	75,000	*
Thomas N. Matlack	110,600	65,000	175,600	*
Mary E. Makela	5,000	50,000	55,000	*
Phyllis S. Swersky	27,200	70,000	97,200	*
Lauren Kelly	33,819		33,819	*
Bernard Bailey				*
Ilene H. Lang	25,000	35,000	60,000	*
R. Gregory Lazar	20,000	76,562	96,562	*
John Dragoon				*
Fumiaki Matsumoto	216,346	114,634	330,980	*
All directors and executive officers as a group (12 persons)	1,572,132	1,908,071	3,480,203	4.77

* Less than 1%.

(1) Each person or entity listed has sole voting power and/or investment power with respect to the shares listed unless otherwise noted.

(2) In calculating the percent of our common stock beneficially owned by each person or entity listed, the number of shares deemed outstanding consists of 70,982,399 shares outstanding as of February 28, 2003, plus, for that person or entity only, any shares subject to options that were exercisable within 60 days of February 28, 2003.

(3) Beneficial ownership as represented to the company in a letter dated March 4, 2003. The address for Apex Capital, LLC and Sanford J. Colen is 25 Orinda Way, Suite 300, Orinda, California 94563.

(4) Beneficial ownership as represented to the company from Joe Chung in a letter dated March 12, 2003. A total of 111,896 shares are held in an irrevocable trust with respect to which Mr. Chung does not have sole voting power.

(5) Beneficial ownership as represented to the company from Mellon Financial Corporation in a letter dated February 26, 2003. Mellon Financial Corporation is located at One Mellon Center, Pittsburgh, Pennsylvania 15258.

Stock Performance Graph

The following graph compares the cumulative total stockholder return on our common stock during the period from July 21, 1999 to December 31, 2002 with the cumulative total return of the Nasdaq National Market Index and a peer group index over the same period. This comparison assumes the investment of $100 on July 21, 1999 in our common stock, the Nasdaq National Market Index and the peer group index and assumes dividends, if any, are reinvested. The peer group index we used is Media General Index Group 852 (Internet Software and Services), which reflects the stock performance of 264 publicly traded companies in the Internet software and services marketplace.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Securities Exchange Act requires our directors and executive officers to file reports of holdings and transactions in our equity securities with the SEC. We are also required to identify any director or executive officer who fails to timely file with the SEC any required report relating to ownership or changes in ownership of our equity securities. Forms 4 were filed late or transactions were reported on a Form 5 by the following individuals for transactions effected in the specified months of 2002: Joseph Chung, February, March, November, December; John R. Held, August; Jeet Singh, February, March, November, December.

Householding

Some banks, brokers and other nominee record holders may be participating in the practice of householding proxy statements and annual reports. This means that only one copy of our proxy statement or annual report may have been sent to multiple stockholders in your household. We will promptly deliver separate copies of our proxy statement and annual report to you if you call us at (617) 386-1000 or write us at Art Technology Group, Inc., 25 First Street, Cambridge, Massachusetts 02141, Attention: Secretary. If you want to receive separate copies of the annual report and proxy statement in the future, or if you are receiving multiple copies and would like to receive only one copy for your household, you should contact your bank, broker, or other nominee record holder, or you may contact us at the above address and phone number.

APPENDIX A

ART TECHNOLOGY GROUP, INC.

AUDIT COMMITTEE CHARTER

A. Purpose

The purpose of the Audit Committee is to assist the Board of Directors oversight of:

the integrity of the Company s financial statements;

the independent auditor s qualifications and independence; and

the performance of the Company s internal audit function and independent auditors.

B. Structure and Membership

1. *Number.* The Audit Committee shall consist of at least three members of the Board of Directors.

2. *Independence.* Except as otherwise permitted by the applicable rules of The Nasdaq Stock Market and Section 301 of the Sarbanes-Oxley Act of 2002 (and the applicable rules thereunder), each member of the Audit Committee shall be independent as defined by such rules and Act.

3. *Financial Literacy.* Each member of the Audit Committee shall be able to read and understand fundamental financial statements, including the Company s balance sheet, income statement, and cash flow statement, at the time of his or her appointment to the Audit Committee. At least one member of the Audit Committee shall be a financial expert as defined by applicable Nasdaq and SEC rules. All members of the Audit Committee shall participate in continuing education programs as set forth in the rules developed by the Nasdaq Listing and Hearings Review Council.

4. *Chair.* Unless the Board of Directors elects a Chair of the Audit Committee, the Audit Committee shall elect a Chair by majority vote.

5. *Compensation.* The compensation of Audit Committee members shall be as determined by the Board of Directors. No member of the Audit Committee may receive any compensation from the Company other than director s fees.

6. *Selection and Removal.* Members of the Audit Committee shall be appointed by the Board of Directors. The Board of Directors may remove members of the Audit Committee from such committee, with or without cause.

C. Authority and Responsibilities

General

The Audit Committee shall discharge its responsibilities, and shall assess the information provided by the Company s management and the independent auditor, in accordance with its business judgment. The authority and responsibilities set forth in this Charter do not reflect or create any duty or obligation of the Audit Committee to plan or conduct any audit, to determine or certify that the Company s financial statements are complete, accurate, fairly presented, or in accordance with generally accepted accounting principles or applicable law, or to guarantee the independent auditor s report.

Oversight of Independent Auditors

1. *Selection.* The Audit Committee shall be solely and directly responsible for appointing, evaluating and, when necessary, terminating the independent auditor. The Audit Committee may, in its discretion, seek stockholder ratification of the independent auditor it appoints.

2. *Independence.* The Audit Committee shall take, or recommend that the full Board of Directors take, appropriate action to oversee the independence of the independent auditor. In connection with this responsibility, the Audit Committee shall obtain and review a formal written statement from the independent auditor describing all relationships between the independent auditor and the Company, including the disclosures required by Independence Standards Board Standard No. 1. The Audit Committee shall actively engage in dialogue with the independent auditor concerning any disclosed relationships or services that might impact the objectivity and independence of the auditor.

3. *Compensation.* The Audit Committee shall have sole and direct responsibility for setting the compensation of the independent auditor. The Audit Committee is empowered, without further action by the Board of Directors, to cause the Company to pay the compensation of the independent auditor established by the Audit Committee.

4. *Preapproval of Services.* The Audit Committee shall preapprove all audit services, which may entail providing comfort letters in connection with securities underwritings, and non-audit services (other than de minimis non-audit services as defined by the Sarbanes-Oxley Act of 2002 and its implementing regulations to be provided to the Company by the independent auditor). The Audit Committee shall cause the Company to disclose in its periodic SEC reports the approval by the Audit Committee of any non-audit services to be performed by the independent auditor.

5. *Oversight.* The independent auditor shall report directly to the Audit Committee and the Audit Committee shall have sole and direct responsibility for overseeing the independent auditor, including resolution of disagreements between Company management and the independent auditor regarding financial reporting. In connection with its oversight role, the Audit Committee shall from time to time, as appropriate, obtain and review the reports

required to be made by the independent auditor pursuant to paragraph (k) of Section 10A of the Securities Exchange Act of 1934 regarding:

critical accounting policies and practices;

alternative treatments of financial information within generally accepted accounting principles that have been discussed with Company management, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the independent auditor; and

other material written communications between the independent auditor and Company management.

Review of Audited Financial Statements

1. *Discussion of Audited Financial Statements.* The Audit Committee shall review and discuss with the Company s management and independent auditor the Company s audited financial statements, including the matters about which Statement on Auditing Standards No. 61 (Codification of Statements on Auditing Standards, AU §380) requires discussion.

2. *Recommendation to Board Regarding Financial Statements.* The Audit Committee shall consider whether it will recommend to the Board of Directors that the Company s audited financial statements be included in the Company s Annual Report on Form 10-K.

3. *Audit Committee Report.* The Audit Committee shall prepare for inclusion where necessary in a proxy or information statement of the Company relating to an annual meeting of security holders at which directors are to be elected (or special meeting or written consents in lieu of such meeting), the report described in Item 306 of Regulation S-K.

Review of Other Financial Disclosures

4. *Independent Auditor Review of Interim Financial Statements.* The Audit Committee shall direct the independent auditor to use its best efforts to perform all reviews of interim financial information prior to disclosure by the Company of such information and to discuss promptly with the Audit Committee and the Chief Financial Officer any matters identified in connection with the auditor s review of interim financial information which are required to be discussed by Statement on Auditing Standards Nos. 61, 71 and 90. The Audit Committee shall direct management to advise the Audit Committee in the event that the Company proposes to disclose interim financial information prior to completion of the independent auditor s review of interim financial information.

Controls and Procedures

1. *Oversight.* The Audit Committee shall coordinate the Board of Director s oversight of the Company s internal accounting controls, the Company s disclosure controls and procedures and the Company s code of conduct. The Audit Committee shall receive and review the reports of the CEO and CFO required by Section 302, and management s certifications under

section 906 and attestation under 404 of the Sarbanes-Oxley Act of 2002 (and the applicable rules thereunder) and Rule 13a-14 of the Exchange Act.

2. *Procedures for Complaints.* The Audit Committee shall establish procedures for (i) the receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls or auditing matters; and (ii) the confidential, anonymous submission by employees of the Company of concerns regarding questionable accounting or auditing matters.

3. *Related-Party Transactions.* The Audit Committee shall review all related party transactions on an ongoing basis and all such transactions must be approved by the Audit Committee.

4. *Additional Powers.* The Audit Committee shall have such other duties as may be delegated from time to time by the Board of Directors.

D. Procedures and Administration

1. *Meetings.* The Audit Committee shall meet as often as it deems necessary in order to perform its responsibilities. At least quarterly, the Audit Committee shall meet separately with: (i) the independent auditor; (ii) Company management and (iii) the Company s internal auditors, to the extent that the Company has such a function. The Audit Committee shall keep such records of its meetings as it shall deem appropriate.

2. *Subcommittees.* The Audit Committee may form and delegate authority to one or more subcommittees (including a subcommittee consisting of a single member), as it deems appropriate from time to time under the circumstances. Any decision of a subcommittee to preapprove audit or non-audit services shall be presented to the full Audit Committee at its next scheduled meeting

3. *Reports to Board.* The Audit Committee shall report regularly to the Board of Directors.

4. *Charter.* At least annually, the Audit Committee shall review and reassess the adequacy of this Charter and recommend any proposed changes to the Board for approval.

5. *Independent Advisors.* The Audit Committee shall have the authority to engage and determine funding for such independent legal, accounting and other advisors as it deems necessary or appropriate to carry out its responsibilities. Such independent advisors may be the regular advisors to the Company. The Audit Committee is empowered, without further action by the Board of Directors, to cause the Company to pay the compensation of such advisors as established by the Audit Committee.

6. *Investigations.* The Audit Committee shall have the authority to conduct or authorize investigations into any matters within the scope of its responsibilities as it shall deem appropriate, including the authority to request any officer, employee or advisor of the Company to meet with the Audit Committee or any advisors engaged by the Audit Committee.

APPENDIX B

AMENDED AND RESTATED
1999 OUTSIDE DIRECTOR STOCK OPTION PLAN

1. *Purpose*

The purpose of this Amended and Restated 1999 Outside Director Stock Option Plan (the Plan) of Art Technology Group, Inc., a Delaware corporation (the Company), is to advance the interests of the Company s stockholders by enhancing the Company s ability to attract, retain and motivate outside directors of the Company by providing such directors with equity ownership opportunities and performance-based incentives and thereby better aligning the interests of such persons with those of the Company s stockholders.

2. *Eligibility*

Each director of the Company who is not an employee of the Company (an Eligible Director) is eligible to be granted options (an Option) under the Plan. Any person who has been granted an Option under the Plan shall be deemed a Participant.

3. *Administration, Delegation*

The Plan will be administered by the Board of Directors of the Company (the Board). The Board shall have authority to adopt, amend and repeal such administrative rules, guidelines and practices relating to the Plan as it shall deem advisable. The Board may correct any defect, supply any omission or reconcile any inconsistency in the Plan or any Option in the manner and to the extent it shall deem expedient to carry the Plan into effect and it shall be the sole and final judge of such expediency. All decisions by the Board shall be made in the Board s sole discretion and shall be final and binding on all persons having or claiming any interest in the Plan or in any Option. No director or person acting pursuant to the authority delegated by the Board shall be liable for any action or determination relating to or under the Plan made in good faith.

4. *Stock Available for Options*

a. *Number of Shares.* Subject to adjustment under Section 4(b), Options may be made under the Plan for up to 800,000 shares of common stock, $.01 par value per share, of the Company (the Common Stock). If any Option expires or is terminated, surrendered or canceled without having been fully exercised or is forfeited in whole or in part or results in any Common Stock not being issued, the unused Common Stock covered by such Option shall again be available for the grant of Options under the Plan. Shares issued under the Plan may consist in whole or in part of authorized but unissued shares or treasury shares.

b. *Adjustment to Common Stock.* In the event of any stock split, stock dividend, recapitalization, reorganization, merger, consolidation, combination, exchange of shares, liquidation, spin-off or other similar change in capitalization or event, or any distribution to holders of Common Stock other than a normal cash dividend, (i) the number and class of securities available under this Plan, (ii) the number and class of securities and exercise price per share subject to each outstanding Option, and (iii) the number and class of securities available for automatic grants shall be appropriately adjusted by the Company (or substituted Options may be made, if applicable) to the extent the Board shall determine, in good faith, that such an adjustment (or substitution) is necessary and appropriate. If this Section 4(b) applies and Section 6(c) also applies to any event, Section 6(c) shall be applicable to such event, and this Section 4(b) shall not be applicable.

5. *Stock Options*

a. *Grants.* The Board may grant Options and determine the number of shares of Common Stock to be covered by each Option and the conditions and limitations applicable to the exercise of each Option, including conditions relating to applicable federal or state securities laws, as it considers necessary or advisable. None of the Options granted hereunder are intended to be Incentive Stock Options as defined in Section 422 of the Internal Revenue Code of 1986, as amended, and any regulations promulgated thereunder.

b. *Option Exercise Price.* The option exercise price per share for each Option granted under the Plan shall equal (i) the last reported sales price per share of the Company s Common Stock as listed on a nationally recognized securities exchange or the Nasdaq National Market, as the case may be, on the date of grant (or, if no such price is reported on such date, such price as reported on the nearest preceding day); or (ii) the fair market value of the stock on the date of grant, as determined by the Board of Directors, if the Common Stock is not publicly traded. Notwithstanding the preceding sentence, the option exercise price per share for each Option granted as of the Effective Date of the initial public offering shall be the price per share for which the Common Stock was offered to the public.

c. *Exercise Period.* No Option may be exercised more than one year after the Participant ceases to serve as a director of the Company. No Option shall be exercisable after the expiration of ten (10) years from the date of grant or prior to approval of the Plan by the stockholders of the Company.

d. *Payment Upon Exercise.* Common Stock purchased upon the exercise of an Option granted under the Plan shall be paid for as follows:

i. in cash or by check, payable to the order of the Company;

ii. except as the Board may otherwise provide in an Option Agreement, by delivery of an irrevocable and unconditional undertaking by a creditworthy broker to deliver promptly to the Company sufficient funds to pay the exercise price, or by delivery by the Participant to the Company of a copy of irrevocable and unconditional instructions to a creditworthy broker to deliver promptly to the Company cash or a check sufficient to pay the exercise price;

iii. to the extent permitted by the Board and explicitly provided in an Option Agreement (i) by delivery of shares of Common Stock owned by the Participant valued at their fair market value as determined by the Board in good faith (Fair Market Value), which Common Stock was owned by the Participant at least six months prior to such delivery, (ii) by delivery of a promissory note of the Participant to the Company on terms determined by the Board, or (iii) by payment of such other lawful consideration as the Board may determine; or

iv. by any combination of the above permitted forms of payment.

6. *General Provisions Applicable to Options*

a. *Transferability of Options.* Except as the Board may otherwise determine or provide in an Option, Options shall not be sold, assigned, transferred, pledged or otherwise encumbered by the person to whom they are granted, either voluntarily or by operation of law, except by will or the laws of descent and distribution, and, during the life of the Participant, shall be exercisable only by the Participant. References to a Participant, to the extent relevant in the context, shall include references to authorized transferees.

b. *Documentation.* Each Option under the Plan shall be evidenced by a written instrument in such form as the Board shall determine. Each Option may contain terms and conditions in addition to those set forth in the Plan.

c. *Acquisition Events.* The Company shall give the Participant ten (10) days notice of an Acquisition Event (as defined below), and the Option shall expire upon the Acquisition Event. An Acquisition Event shall mean: (a) any merger or consolidation which results in the voting securities of the Company outstanding immediately prior thereto representing immediately thereafter (either by remaining outstanding or by being converted into voting securities of the surviving or acquiring entity) less than 50% of the combined voting power of the voting securities of the Company or such surviving or acquiring entity outstanding immediately after such merger or consolidation; (b) any sale of all or substantially all of the assets of the Company; or (c) the complete liquidation of the Company.

d. *Conditions on Delivery of Stock.* The Company will not be obligated to deliver any shares of Common Stock pursuant to the Plan or to remove restrictions from shares previously delivered under the Plan until (i) all conditions of the Option have been met or removed to the satisfaction of the Company, (ii) in the opinion of the Company s counsel, all other legal matters in connection with the issuance and delivery of such shares have been satisfied, including any applicable securities laws and any applicable stock exchange or stock market rules and regulations, and (iii) the Participant has executed and delivered to the Company such representations or agreements as the Company may consider appropriate to satisfy the requirements of any applicable laws, rules or regulations.

7. *Miscellaneous*

a. *No Right To Board Membership or Other Status.* Neither the Plan nor the granting of an Option shall be construed as giving a Participant the right to continue as a director of the Company.

b. *No Rights As Stockholder.* Subject to the provisions of the applicable Options, no Participant or beneficiary designated by the Participant shall have any rights as a stockholder with respect to any shares of Common Stock to be distributed with respect to an Option until becoming the record holder of such shares.

c. *Effective Date and Term of Plan.* The Plan shall become effective on the date on which it is adopted by the Board. No Options shall be granted under the Plan after the completion of ten years from the date on which the Plan was adopted by the Board, but Options previously granted may extend beyond that date.

d. *Amendment of Plan.* The Board may amend, suspend or terminate the Plan or any portion thereof at any time.

e. *Governing Law.* The provisions of the Plan and all Options made hereunder shall be governed by and interpreted in accordance with the laws of the State of Delaware, without regard to any applicable conflicts of law.

PROXY

ART TECHNOLOGY GROUP, INC.

The Board of Directors of Art Technology Group, Inc. is Soliciting this Proxy

The undersigned owns shares of common stock of Art Technology Group, Inc. (the Company). The Company s 2003 Annual Meeting of Stockholders will be held on Wednesday, May 21, 2003, beginning at 10:00 a.m., local time, at the offices of Hale and Dorr LLP, 60 State Street, Boston, Massachusetts 02109. The undersigned appoints each of Robert D. Burke, Edward Terino and Michael A. Pellini acting singly, with the power of substitution to each, as attorney, agent and proxy to vote all shares of common stock that the undersigned is entitled to vote, at the meeting and at any adjournment or postponement of the meeting.

The individuals named above will vote these shares as directed by the undersigned on this proxy. IF NO PROPER VOTING INSTRUCTIONS ARE GIVEN, THE INDIVIDUALS NAMED ABOVE WILL VOTE THE SHARES OF THE UNDERSIGNED FOR THE ELECTION OF THE NOMINEES LISTED ON THE REVERSE SIDE OF THIS PROXY AS DIRECTORS OF THE COMPANY AND FOR PROPOSAL 2, PROPOSAL 3, AND PROPOSAL 4.

If any other matters are properly presented for consideration at the meeting, the individuals named above will have the discretion to vote these shares on those matters.

MARK HERE FOR ADDRESS CHANGE AND NOTE BELOW o

SEE REVERSE SIDE (Please sign and date on reverse side) SEE REVERSE SIDE

DETACH HERE

x Please mark votes as in this example.

PROPOSAL 1. To elect John R. Held, Paul G. Shorthose and Phyllis S. Swersky as Class I directors of the Company to serve until the 2006 Annual Meeting or until their successors are elected and qualified:

FOR NOMINEES	WITHHELD FROM NOMINEES
o	o

o ______________________________

(Instruction: To withhold authority to vote for any individual nominee, write that nominee s name in the space provided above.

PROPOSAL 2. To approve an amendment to our charter to decrease the number of shares of authorized common stock from 500,000,000 to 200,000,000 and the number of shares of authorized stock (including common stock) from 510,000,000 to 210,000,000.

FOR	AGAINST	ABSTAIN
o	o	o

PROPOSAL 3. To approve the Amended and Restated 1999 Outside Director Stock Option Plan.

FOR	AGAINST	ABSTAIN
o	o	o

PROPOSAL 4. To approve an amendment to our 1999 Employee Stock Purchase Plan to increase the number of shares of common stock issuable under such Plan from 3,000,000 to 5,000,000.

FOR	AGAINST	ABSTAIN
o	o	o

Mark here if you plan to attend the meeting: o

—

237

BALANCE, June 30, 2012

—

$

—

$
—

$
27,349

$
553

$
—

$
27,902

BALANCE, January 1, 2013
3,240,125

$
32

$
29,894

$
31,746

$
597

$
(2,372
)

$
59,897

Net income
—

—

—

2,321

—

—

2,321

Dividends paid ($0.05 per share)
—

—

—

(150
)

—

—

(150
)

Other comprehensive
loss, net of tax
—

—

—

—

(1,206
)

—

(1,206
)
ESOP shares allocated
—

—

85

—

—

132

217

BALANCE, June 30, 2013
3,240,125

$
32

$
29,979

$
33,917

$
(609
)

$
(2,240
)

$
61,079

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, 2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$2,321	$898
Adjustments to reconcile net income to net cash from operating activities		
Provision for loan losses	1,200	1,065
Depreciation, amortization and accretion	513	756
ESOP compensation expense for allocated shares	217	—
Provision for deferred income taxes	981	296
Valuation allowance on deferred income taxes	—	(296)
Gain on sale of loans held for sale	(3,779)	(551)
Origination of loans held for sale	(132,168)	(35,134)
Proceeds from sale of loans held for sale	133,978	31,440
Gain on sale of investment securities	(264)	(106)
Loss on sale of other real estate owned	—	52
Recovery of loss on mortgage servicing rights	(100)	(3)
Impairment loss on other real estate owned	195	594
Changes in operating assets and liabilities		
Accrued interest receivable	(69)	(109)
Other assets	(1,368)	(115)
Other liabilities	(52)	(142)
Net cash from (used by) operating activities	1,605	(1,355)
CASH FLOWS FROM INVESTING ACTIVITIES		
Activity in securities available-for-sale:		
Proceeds from sale of investment securities	8,786	2,432
Maturities, prepayments, and calls	1,676	5,741
Purchases	(13,083)	(19,083)
Loan originations and principal collections, net	(9,496)	(30,147)
Proceeds from sale of other real estate owned	163	1,966
Purchase of premises and equipment	(1,289)	(1,723)
Net cash used by investing activities	(13,243)	(40,814)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	11,964	60,952
Proceeds from borrowings	76,454	12,900
Repayments of borrowings	(69,630)	(17,700)
Dividends paid	(150)	—
Net cash from financing activities	18,638	56,152
NET INCREASE IN CASH AND CASH EQUIVALENTS	7,000	13,983
CASH AND CASH EQUIVALENTS, beginning of period	6,787	19,253
CASH AND CASH EQUIVALENTS, end of period	$13,787	$33,236
SUPPLEMENTARY DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid during the period for:		
Interest	$1,017	$1,269

Income taxes	$210	$—
SUPPLEMENTARY DISCLOSURES OF NONCASH OPERATING, INVESTING AND FINANCING ACTIVITIES		
Change in unrealized gain (loss) on investment securities	$(1,827)	$237
Property taken in settlement of loans	$(36)	$(921)
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, 2012 filed with the Securities and Exchange Commission ("SEC") on April 1, 2013. These unaudited financial statements include all normal and recurring adjustments that management believes are necessary in order to conform to U.S. GAAP and have been reflected as required by Article 10 of Regulation S-X as promulgated by the SEC. The results for the three and six months ended June 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013 or any other future period. Amounts presented in the financial statements and footnote tables are rounded and presented in thousands of dollars. In the narrative footnote discussion amounts are rounded and presented in millions of dollars to one decimal point if the amounts are above $1.0 million. Amounts below $1.0 million are rounded and presented in dollars to the nearest thousands. Certain prior year amounts have been reclassified to conform to the 2013 presentation with no change to net income or equity previously reported. Earnings per share and share calculations prior to June 30, 2012 are not available as the Company completed its stock conversion and became a public company on July 9, 2012.

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

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

Use of Estimates – The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements. Actual results could differ from these estimates. Material estimates that are particularly susceptible to change in the near term are allowances for loan losses, fair value of measurements, and the estimated realizability related to the deferred tax asset.

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

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

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

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

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

Deposits in Other Financial Institutions – The Company held interest-bearing certificates of deposits at other financial institutions with a cost basis of $14.1 million and $5.4 million as of June 30, 2013 and December 31, 2012, respectively. Certificates of deposits in the amount of $2.6 million with original maturity dates greater than 90 days were excluded from cash and cash equivalents as of June 30, 2013 and December 31, 2012.

RECENT ACCOUNTING PRONOUNCEMENTS

For the quarter ended June 30, 2013, there were no new accounting standards during the period that, when implemented, would 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 carrying amount of securities available-for-sale and their approximate fair values at June 30, 2013 and December 31, 2012 were as follows:

	June 30, 2013				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses (less than 1 year)	Gross Unrealized Losses (more than 1 year)	Estimated Fair Values
Securities available-for-sale					
Federal agency securities	$11,321	$44	$(328)	$—	$11,037
Municipal bonds	9,325	43	(332)	—	9,036
Corporate securities	3,503	1	(34)	—	3,470
Mortgage-backed securities	20,959	56	(372)	—	20,643
Total securities available-for-sale	$45,108	$144	$(1,066)	$—	$44,186

	December 31, 2012				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses (less than 1 year)	Gross Unrealized Losses (more than 1 year)	Estimated Fair Values
Securities available-for-sale					
Federal agency securities	$12,287	$281	$(16)	$—	$12,552
Municipal bonds	8,863	202	(5)	—	9,060
Corporate securities	2,492	—	(4)	—	2,488
Mortgage-backed securities	18,766	447	—	—	19,213
Total securities available-for-sale	$42,408	$930	$(25)	$—	$43,313

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

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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, 2013 were as follows:

	June 30, 2013	
	Amortized Cost	Fair Value
No contractual maturity	$—	$—
Due in one year or less	2,025	2,038
Due after one year through five years	4,379	4,412
Due after five years through ten years	17,150	16,744
Due after ten years	21,554	20,992
Total	$45,108	$44,186

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

	Three Months Ended 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	$—

	Three Months Ended June 30, 2012			Six Months Ended June 30, 2012		
	Proceeds	Gross Gains	Gross Losses	Proceeds	Gross Gains	Gross Losses
Securities available-for-sale	$1,647	$94	$—	$2,432	$106	$—

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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 was as follows at June 30, 2013 and December 31, 2012:

	June 30, 2013	December 31, 2012
REAL ESTATE LOANS		
Commercial	$34,762	$33,250
Construction and development	43,177	31,893
Home equity	15,356	15,474
One-to-four-family	16,366	13,976
Multi-family	4,145	3,202
Total real estate loans	113,806	97,795
CONSUMER LOANS		
Indirect home improvement	94,058	86,249
Recreational	20,520	17,968
Automobile	1,485	2,416
Home improvement	558	651
Other	1,309	1,386
Total consumer loans	117,930	108,670
COMMERCIAL BUSINESS LOANS	53,966	73,465
Total loans	285,702	279,930
Allowance for loan losses	(5,276)	(4,698)
Deferred costs, fees, and discounts, net	(15)	(283)
Total loans receivable, net	$280,411	$274,949

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

Real Estate Loans

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

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

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

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

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FS BANCORP, INC. AND SUBSIDIARY
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NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

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

Consumer Lending

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

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

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

Commercial Business Loans

Commercial Business Lending. Commercial business loans originated by the Company to local small and mid-sized businesses in our Puget Sound market area are secured by accounts receivable, inventory or 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, 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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NOTE 3 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (Continued)

	At or For the Three Months Ended June 30, 2012				
ALLOWANCE FOR LOAN LOSSES	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance	$938	$2,487	$618	$157	$4,200
Provision for loan losses	447	(155)	44	214	550
Charge-offs	(264)	(479)	(2)	—	(745)
Recoveries	2	325	—	—	327
Net charge-offs	(262)	(154)	(2)	—	(418)
Ending balance	$1,123	$2,178	$660	$371	$4,332
Period end amount allocated to:					
Loans individually evaluated for impairment	$82	$—	$37	$—	$119
Loans collectively evaluated for impairment	1,041	2,178	623	371	4,213
Ending balance	$1,123	$2,178	$660	$371	$4,332
LOANS RECEIVABLE					
Loans individually evaluated for impairment	$3,310	$—	$357	$—	$3,667
Loans collectively evaluated for impairment	74,421	114,652	56,595	—	245,668
Ending balance	$77,731	$114,652	$56,952	$—	$249,335

	At or For the Six Months Ended June 30, 2012				
ALLOWANCE FOR LOAN LOSSES	Real Estate	Consumer	Commercial Business	Unallocated	Total
Beginning balance	$803	$2,846	$511	$185	$4,345
Provision for loan losses	581	49	249	186	1,065
Charge-offs	(264)	(1,304)	(100)	—	(1,668)
Recoveries	3	587	—	—	590
Net charge-offs	(261)	(717)	(100)	—	(1,078)
Ending balance	$1,123	$2,178	$660	$371	$4,332
Period end amount allocated to:					
Loans individually evaluated for impairment	$82	$—	$37	$—	$119
Loans collectively evaluated for impairment	1,041	2,178	623	371	4,213
Ending balance	$1,123	$2,178	$660	$371	$4,332
LOANS RECEIVABLE					
Loans individually evaluated for impairment	$3,310	$—	$357	$—	$3,667
Loans collectively evaluated for impairment	74,421	114,652	56,595	—	245,668
Ending balance	$77,731	$114,652	$56,952	$—	$249,335

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

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

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

	June 30, 2013 Loans Past Due and Still Accruing						
	30-59 Days	60-89 Days	90 Days or More Past Due	Total Past Due	Non-Accrual	Current	Total Loans Receivable
REAL ESTATE LOANS							
Commercial	$—	$—	$—	$—	$ 1,447	$33,315	$34,762
Construction and development	—	—	—	—	—	43,177	43,177
Home equity	48	461	—	509	115	14,732	15,356
One-to-four-family	—	—	—	—	360	16,006	16,366
Multi-family	—	—	—	—	—	4,145	4,145
Total real estate loans	48	461	—	509	1,922	111,375	113,806
CONSUMER							
Indirect home improvement	395	302	—	697	247	93,114	94,058
Recreational	40	17	—	57	—	20,463	20,520
Automobile	24	14	—	38	—	1,447	1,485
Home improvement	8	—	—	8	31	519	558
Other	20	6	—	26	—	1,283	1,309
Total consumer loans	487	339	—	826	278	116,826	117,930
COMMERCIAL BUSINESS LOANS	—	—	—	—	94	53,872	53,966
Total	$535	$800	$—	$1,335	$ 2,294	$282,073	$285,702

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

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

	December 31, 2012						
	Loans Past Due and Still Accruing						
	30-59 Days	60-89 Days	90 Days or More Past Due	Total Past Due	Non-Accrual	Current	Total Loans Receivable
REAL ESTATE LOANS							
Commercial	$—	$—	$—	$—	$ 783	$32,467	$33,250
Construction and development	—	—	—	—	—	31,893	31,893
Home equity	192	484	—	676	248	14,550	15,474
One-to-four-family	—	—	—	—	344	13,632	13,976
Multi-family	—	—	—	—	—	3,202	3,202
Total real estate loans	192	484	—	676	1,375	95,744	97,795
CONSUMER							
Indirect home improvement	653	300	—	953	295	85,001	86,249
Recreational	128	2	—	130	—	17,838	17,968
Automobile	68	1	—	69	10	2,337	2,416
Home improvement	—	—	—	—	32	619	651
Other	8	11	—	19	—	1,367	1,386
Total consumer loans	857	314	—	1,171	337	107,162	108,670
COMMERCIAL BUSINESS LOANS	—	—	—	—	194	73,271	73,465
Total	$1,049	$798	$—	$1,847	$ 1,906	$276,177	$279,930

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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 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, 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	45	—	45	—	45	44	—
One-to-four-family	1,302	(170)	1,132	—	1,132	1,109	31
Multi-family	—	—	—	—	—	—	—
Indirect home improvement	—	—	—	—	—	—	—
Recreational	—	—	—	—	—	—	—
Automobile	—	—	—	—	—	—	—
Home improvement	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—
Commercial business loans	166	(72)	94	—	94	94	—
Subtotal loans	1,513	(242)	1,271	—	1,271	1,247	31
WITH AN ALLOWANCE RECORDED							
Commercial	3,201	(225)	2,976	(217)	2,759	2,993	46
Construction and development	—	—	—	—	—	—	—
Home equity	45	—	45	(16)	29	45	—
One-to-four-family	—	—	—	—	—	—	—
Multi-family	—	—	—	—	—	—	—
Indirect home improvement	—	—	—	—	—	—	—
Recreational	—	—	—	—	—	—	—
Automobile	—	—	—	—	—	—	—
Home improvement	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—
Commercial business	61	(3)	58	(6)	52	62	3

loans						
Subtotal loans	3,307	(228)	3,079	(239)	2,840	3,100	49
Total	$4,820	$(470)	$4,350	$(239)	$4,111	$4,347	$80

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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, 2012						
	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	111	—	111	—	111	112	3
One-to-four-family	1,295	(170)	1,125	—	1,125	1,172	30
Multi-family	—	—	—	—	—	—	—
Indirect home improvement	—	—	—	—	—	—	—
Recreational	—	—	—	—	—	—	—
Automobile	—	—	—	—	—	—	—
Home improvement	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—
Commercial business loans	241	(111)	130	—	130	172	—
Subtotal loans	1,647	(281)	1,366	—	1,366	1,456	33
WITH AN ALLOWANCE RECORDED							
Commercial	950	(167)	783	(39)	744	893	7
Construction and development	—	—	—	—	—	—	—
Home equity	1,625	(38)	1,587	(79)	1,508	1,616	68
One-to-four-family	—	—	—	—	—	—	—
Multi-family	—	—	—	—	—	—	—
Indirect home improvement	—	—	—	—	—	—	—
Recreational	—	—	—	—	—	—	—
Automobile	—	—	—	—	—	—	—
Home improvement	—	—	—	—	—	—	—
Other	—	—	—	—	—	—	—

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

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

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

Credit Quality Indicators

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

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

A description of the 10 risk grades is as follows:

- Grades 1 and 2 – These grades include loans to very high quality borrowers with excellent or desirable business credit.
- Grade 3 – This grade includes loans to borrowers of good business credit with moderate risk.
- Grades 4 and 5 – These grades include "Pass" grade loans to borrowers of average credit quality and risk.
- Grade 6 – This grade includes loans on management's "Watch" list and is intended to be utilized on a temporary basis for "Pass" grade borrowers where frequent and thorough monitoring is required due to credit weaknesses and where significant risk-modifying action is anticipated in the near term.
- Grade 7 – This grade is for "Other Assets Especially Mentioned (OAEM)" in accordance with regulatory guidelines and includes borrowers where performance is poor or significantly less than expected.
- Grade 8 – This grade includes "Substandard" loans in accordance with regulatory guidelines which represent an unacceptable business credit where a loss is possible if loan weakness is not corrected.
- Grade 9 – This grade includes "Doubtful" loans in accordance with regulatory guidelines where a loss is highly probable.
- Grade 10 – This grade includes "Loss" loans in accordance with regulatory guidelines for which total loss is expected and when identified are charged off.

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

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

The following tables summarize risk rated loan balances by category:

	June 30, 2013					
	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful(9)	Total
REAL ESTATE LOANS						
Commercial	$28,484	$3,302	$—	$2,976	$—	$34,762
Construction and development	43,177	—	—	—	—	43,177
Home equity	15,241	—	—	115	—	15,356
One-to-four-family	15,234	—	—	1,132	—	16,366
Multi-family	4,145	—	—	—	—	4,145
Total real estate loans	106,281	3,302	—	4,223	—	113,806
CONSUMER						
Indirect home improvement	93,811	—	—	247	—	94,058
Recreational	20,520	—	—	—	—	20,520
Automobile	1,485	—	—	—	—	1,485
Home improvement	527	—	—	31	—	558
Other	1,309	—	—	—	—	1,309
Total consumer loans	117,652	—	—	278	—	117,930
COMMERCIAL BUSINESS LOANS	53,150	664	—	152	—	53,966
Total	$277,083	$3,966	$—	$4,653	$—	$285,702

	December 31, 2012					
	Pass (1 - 5)	Watch (6)	Special Mention (7)	Substandard (8)	Doubtful(9)	Total
REAL ESTATE LOANS						
Commercial	$29,145	$3,322	$—	$783	$—	$33,250
Construction and development	30,306	—	—	1,587	—	31,893
Home equity	15,226	—	—	248	—	15,474
One-to-four-family	12,851	—	—	1,125	—	13,976
Multi-family	3,202	—	—	—	—	3,202
Total real estate loans	90,730	3,322	—	3,743	—	97,795
CONSUMER						
Indirect home improvement	85,954	—	—	295	—	86,249
Recreational	17,968	—	—	—	—	17,968
Automobile	2,406	—	—	10	—	2,416
Home improvement	619	—	—	32	—	651
Other	1,386	—	—	—	—	1,386
Total consumer loans	108,333	—	—	337	—	108,670
COMMERCIAL BUSINESS LOANS	72,596	—	675	194	—	73,465
Total	$271,659	$3,322	$675	$4,274	$—	$279,930

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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

The Company had five and three troubled debt restructured ("TDR") loans still on accrual and included in impaired loans at June 30, 2013 and at December 31, 2012, respectively. In addition, at June 30, 2013 and December 31, 2012 the Company had two and three loans on non-accrual of $807,000 and $892,000, respectively. The two non-accrual loans at June 30, 2013 consisted of one commercial real estate loan and one home equity loan. The Company had no commitments to lend additional funds on these restructured loans.

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

	June 30, 2013	December 31, 2012
Troubled debt restructured loans still on accrual	$2,360	$2,368
Troubled debt restructured loans on non-accrual	807	892
Total troubled debt restructured loans	$3,167	$3,260

The following table presents loans that became TDRs during the six months ended June 30, 2013:

	At or For the Six Months Ended June 30, 2013			
	Number of Contracts	Recorded Investment	Increase in the Allowance	Charge-offs to the Allowance
Commercial Business Loans	1	$35	$—	$35
Total	1	$35	$—	$35

During the three month period ended June 30, 2013 and June 30, 2012, the Company restructured no loans and one commercial business loan of $70,000 considered to be troubled debt restructured, respectively. No other TDRs that were modified in the previous 12 months subsequently defaulted in the reporting period.

During the six month period ended June 30, 2013, the Company restructured one loan of $35,000 considered to be troubled debt restructured which subsequently defaulted and was fully charged off during the same period. For the six month period ended June 30, 2012, the Company restructured one commercial business loan of $70,000 considered to be troubled debt restructured. No other TDRs that were modified in the previous 12 months subsequently defaulted in the reporting period.

The recorded investments in the table above are period end balances that are inclusive of all partial pay-downs and charge-offs since the modification date. Loans modified in a TDR that were fully paid down, charged off, or foreclosed upon by the period end are not included.

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

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

NOTE 4 – MORTGAGE SERVICING RIGHTS

Mortgage loans serviced for others are not included on the consolidated balance sheets. The unpaid principal balances of mortgage loans serviced for others were $199.6 million and $130.5 million at June 30, 2013 and December 31, 2012, respectively. The fair market value of the mortgage servicing rights' asset at June 30, 2013 and December 31, 2012 was $2.0 million and $1.1 million, respectively. Fair value adjustments to the mortgage servicing rights were mainly due to market based assumptions associated with mortgage prepayment speeds and changes in interest rates.

The following table summarizes mortgage servicing rights activity for the three and six months ended June 30, 2013 and 2012:

	At or For the Three Months Ended June 30,	
	2013	2012
Beginning balance	$1,404	$246
Additions	494	203
Mortgage servicing rights amortized	(91)	(26)
(Impairment) recovery of loss on mortgage servicing rights	(22)	2
Ending balance	$1,785	$425

	At or For the Six Months Ended June 30,	
	2013	2012
Beginning balance	$1,064	$200
Additions	790	269
Mortgage servicing rights amortized	(169)	(47)
Recovery of loss on mortgage servicing rights	100	3
Ending balance	$1,785	$425

NOTE 5 - DERIVATIVES

The Company regularly enters into commitments to originate and sell loans held for sale. Such commitments are considered derivatives but have not been designated as hedging instruments. Rather, they are accounted for as free-standing derivatives, or economic hedges, with changes in the fair value of the derivatives reported in noninterest income. The Company recognizes all derivative instruments as either other assets or other liabilities on the consolidated balance sheet and measures those instruments at fair value.

As of June 30, 2013, the Company had fallout adjusted interest rate lock commitments with customers of $22.0 million, with a fair value of $128,000. The Company also had mandatory and best effort forward commitments with investors with a notional balance of $11.3 million, and a fair market value of $767,000, included in other assets.

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 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

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

NOTE 5 - DERIVATIVES (Continued)

value of the derivatives reported in noninterest income. These instruments are measured at fair value and are recognized as either other assets or other liabilities on the consolidated balance sheet.

The Company had forward TBA mortgage-backed securities of $19.5 million at June 30, 2013, with a fair value of $376,000. The Company also had TBA mortgage-backed securities forward sales that had been paired off with investors of $22.0 million, with the fair value of these pair off commitments of $753,000 at June 30, 2013 included in other assets.

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

NOTE 6 – OTHER REAL ESTATE OWNED

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2013	2012	2013	2012
Beginning balance	$1,956	$2,789	$2,127	$4,589
Additions	36	921	36	921
Fair value write-downs	(117)	(216)	(195)	(594)
Disposition of assets	(70)	(544)	(163)	(1,966)
Ending balance	$1,805	$2,950	$1,805	$2,950

At June 30, 2013, OREO consisted of four properties located in Washington, with balances ranging from $36,000 to $892,000. For the three months ended June 30, 2013 and 2012, the Company recorded no net loss, and for the six months ended June 30, 2013 and 2012, the Company recorded none and $52,000 net loss, respectively, on disposals of OREO. Holding costs associated with OREO were $16,000 and $64,000, for the three months ended June 30, 2013 and 2012, and $38,000 and $98,000, for the six months ended June 30, 2013 and 2012, respectively.

NOTE 7 – DEPOSITS

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

	June 30, 2013	December 31, 2012
Interest-bearing checking	$23,288	$24,348
Noninterest-bearing checking	37,105	34,165
Savings	14,744	11,812
Money market	117,706	114,246
Certificates of deposits of less than $100,000[1]	41,806	40,119
Certificates of deposits of $100,000 through $250,000	43,286	43,810
Certificates of deposits of more than $250,000	22,978	20,449
Total	$300,913	$288,949

(1): Includes $16.9 million and $13.9 million of brokered deposits as of June 30, 2013 and December 31, 2012, 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, 2013
2013	$ 23,464
2014	33,751
2015	34,212
2016	8,399
2017	4,907
Thereafter	3,337
Total	$ 108,070

The Bank pledged two securities held at the Federal Home Loan Bank ("FHLB") of Seattle with a fair value of $1.2 million to secure Washington State public deposits of $1.9 million with a collateral requirement of $117,000, at June 30, 2013.

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

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

	For Three Months Ended June 30,		For Six Months Ended June 30,	
	2013	2012	2013	2012
Interest-bearing checking	$ 8	$ 13	$ 16	$ 30
Savings and money market	124	146	258	310
Certificates of deposit	332	410	662	832
Total	$ 464	$ 569	$ 936	$ 1,172

NOTE 8 – INCOME TAXES

The Company recorded a provision for income taxes of $1.2 million during the six months ended June 30, 2013. There was no provision for federal income tax expense during the six months ended June 30, 2012 as the Company had concluded at that time that a full valuation allowance against its deferred tax asset of $2.9 million was required. A valuation allowance must be used to reduce deferred tax assets if it is “more likely than not” that some portion of, or all of the deferred tax assets will not be realized. During the second half of 2012, the valuation allowance on deferred tax assets of $3.2 million was entirely reversed.

At June 30, 2013, the Company had net operating loss carryforwards of approximately $2.3 million, which begin to expire in 2028. The Company files a consolidated U.S. Federal income tax return, which is subject to examinations by tax authorities for years 2009 and later. At June 30, 2013, the Company had no uncertain tax positions. The Company recognizes interest and penalties in tax expense and at June 30, 2013, the Company had recognized no interest and penalties.

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

NOTE 8 – INCOME TAXES (Continued)

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

NOTE 9 – COMMITMENTS AND CONTINGENCIES

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

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

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

	June 30, 2013	December 31, 2012
COMMITMENTS TO EXTEND CREDIT		
REAL ESTATE LOANS		
Construction and development	$21,882	$27,347
One-to-four-family	31,036	19,313
Home equity	11,692	11,928
Commercial/Multi-family	538	3,241
Total real estate loans	65,148	61,829
CONSUMER LOANS		
Indirect home improvement	433	568
Other	6,255	6,225
Total consumer loans	6,688	6,793
COMMERCIAL BUSINESS LOANS	47,803	41,025
Total commitments to extend credit	$119,639	$109,647

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

Unfunded commitments under commercial lines-of-credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines-of-credit are uncollateralized and usually do not contain a specified maturity date and ultimately may not be drawn upon to the total extent to which the Company is committed. The Company has established reserves for estimated losses from unfunded commitments of $44,000 and $49,000 as of June 30, 2013 and December 31, 2012, respectively. One-to-four-family commitments listed above are accounted for as fair value derivatives and do not carry an associated loss reserve.

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

NOTE 9 – COMMITMENTS AND CONTINGENCIES (Continued)

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

Because of the nature of our activities, the Company is subject to various pending and threatened legal actions, which arise in the ordinary course of business. From time to time, subordination liens may create litigation which requires us to defend our lien rights. In the opinion of management, liabilities arising from these claims, if any, will not have a material effect on our financial position.
In the ordinary course of business, the Company sells loans without recourse that may have to subsequently be repurchased due to defects that occurred during the origination of the loan. The defects are categorized as documentation errors, underwriting errors, early payment defaults, breach of representation or warranty, and fraud. When a loan sold to an investor without recourse fails to perform according to its contractual terms, the investor will typically review the loan file to determine whether defects in the origination process occurred. If a defect is identified, the Company may be required to either repurchase the loan or indemnify the investor for losses sustained. If there are no such defects, the Company has no commitment to repurchase the loan. The Company has recorded a $128,000 reserve to cover loss exposure related to these guarantees for one-to-four-family loans sold into the secondary market. In December 2012, the Company sold a portion of the consumer loan portfolio with an unpaid principal balance of approximately $12.6 million. Under the terms of this sale, the Company had recourse for loans that default before June 12, 2013 and had recorded a reserve of $67,000 for potential defaults. As of June 30, 2013, the Company had satisfied its obligation according to the purchase agreement without utilizing any of the recourse reserve and accordingly, the full reserve was reversed in the second quarter of 2013 and reported 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.

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

NOTE 11 – REGULATORY CAPITAL (Continued)

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, 2013 and December 31, 2012, the Bank was categorized as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total Risk-Based, Tier 1 Risk-Based, and Tier 1 Leverage ratios as set forth in the table below. There are no conditions or events since that notification that management believes have changed the Bank’s category. At June 30, 2013, the Bank exceeded all regulatory capital requirements with Tier 1 Leverage-Based Capital, Tier 1 Risk- Based Capital and Total Risk-Based Capital ratios of 13.1%, 15.7%, and 16.9%, respectively.

The Bank’s actual capital amounts and ratios at June 30, 2013 and December 31, 2012 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, 2013									
Total Risk-Based Capital (to Risk-weighted Assets)	$53,563	16.91	%	$25,333	8.00	%	$31,666	10.00	%
Tier 1 Risk-Based Capital (to Risk-weighted Assets)	$49,586	15.66	%	$12,667	4.00	%	$19,000	6.00	%
Tier 1 Leverage Capital (to Average Assets)	$49,586	13.11	%	$15,131	4.00	%	$18,914	5.00	%
As of December 31, 2012									
Total Risk-Based Capital (to Risk-weighted Assets)	$50,591	16.00	%	$25,294	8.00	%	$31,617	10.00	%
Tier 1 Risk-Based Capital (to Risk-weighted Assets)	$46,627	14.75	%	$12,647	4.00	%	$18,970	6.00	%
Tier 1 Leverage Capital (to Average Assets)	$46,627	13.26	%	$14,066	4.00	%	$17,583	5.00	%

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

NOTE 11 - REGULATORY CAPITAL (Continued)

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

	Company		Bank	
	June 30, 2013	December 31, 2012	June 30, 2013	December 31, 2012
Equity	$61,079	$59,897	$48,977	$47,836
Unrealized loss (gain) on securities available-for-sale	609	(597)	609	(597)
Disallowed deferred tax assets	—	(506)	—	(506)
Disallowed servicing assets	—	(106)	—	(106)
Total Tier 1 capital	61,688	58,688	49,586	46,627
Allowance for loan and lease losses for regulatory capital purposes	3,977	3,964	3,977	3,964
Total risk-based capital	$65,665	$62,652	$53,563	$50,591

The Company exceeded all regulatory capital requirements as of June 30, 2013. The regulatory capital ratios calculated for the Company as of June 30, 2013 were 16.3% for Tier 1 Leverage-Based Capital, 19.5% for Tier 1 Risk-Based Capital and 20.7% 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 2).

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

NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

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

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

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

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

	Securities Available-for-Sale			
	Level 1	Level 2	Level 3	Total
June 30, 2013				
Federal agency securities	$—	$11,037	$—	$11,037
Municipal bonds	—	9,036	—	9,036
Corporate securities	—	3,470	—	3,470
Mortgage-backed securities	—	20,643	—	20,643
Total	$—	$44,186	$—	$44,186

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

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

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

NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

	Interest Rate Lock Commitments with Customers			
	Level 1	Level 2	Level 3	Total
June 30, 2013	$—	$—	$128	$128
December 31, 2012	$—	$—	$45	$45

	Forward Sale Commitments with Investors			
	Level 1	Level 2	Level 3	Total
June 30, 2013	$—	$376	$767	$1,143
December 31, 2012	$—	$—	$48	$48

	Paired Off Commitments with Investors			
	Level 1	Level 2	Level 3	Total
June 30, 2013	$—	$753	$—	$753
December 31, 2012	$—	$—	$—	$—

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

	Impaired Loans				
	Level 1	Level 2	Level 3	Total	Total Impairment
June 30, 2013	$—	$—	$4,350	$4,350	$(239)
December 31, 2012	$—	$—	$3,800	$3,800	$(125)

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

NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

	OREO				
	Level 1	Level 2	Level 3	Total	Total Impairment
June 30, 2013	$—	$—	$1,805	$1,805	$(195)
December 31, 2012	$—	$—	$2,127	$2,127	$(812)

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

	Mortgage Servicing Rights				
	Level 1	Level 2	Level 3	Total	Total Impairment/ (Recovery)
June 30, 2013	$—	$—	$2,047	$2,047	$(100)
December 31, 2012	$—	$—	$1,064	$1,064	$112

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, 2013 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%	93.91%
Forward sale commitments with investors	Quoted market prices	Pull-through expectations	80% - 99%	93.91%
NONRECURRING				

Impaired loans	Fair value of underlying collateral	Discount applied to the obtained appraisal	0% - 10%	5.49%
OREO	Fair value of collateral	Discount applied to the obtained appraisal	9% - 19%	12.89%
Mortgage servicing rights	Discounted cash flow	Weighted average prepayment speed	7.5% - 10.5%	7.50%

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

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

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

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

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

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
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12 – FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

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

	June 30, 2013		December 31, 2012	
	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	$16,413	$16,413	$9,413	$9,413
Level 2 inputs:				
Securities available-for-sale	44,186	44,186	43,313	43,313
Loans held for sale	13,146	13,146	8,870	8,870
Federal Home Loan Bank stock	1,733	1,733	1,765	1,765
Accrued interest receivable	1,292	1,292	1,223	1,223
Forward sale commitments with investors	376	376	—	—
Paired off commitments with investors	753	753	—	—
Level 3 inputs:				
Loans receivable, net	280,411	312,523	274,949	306,695
Mortgage servicing rights	1,785	2,047	1,064	1,064
Fair value interest rate locks with customers	318	318	79	79
Forward sale commitments with investors	773	773	54	54
Financial Liabilities				
Level 2 inputs:				
Deposits	300,913	315,500	288,949	304,257
Borrowings	13,664	13,732	6,840	7,059
Accrued interest payable	18	18	12	12
Level 3 inputs:				
Fair value interest rate locks with customers	190	190	34	34
Forward sale commitments with investors	6	6	6	6

NOTE 13 - EMPLOYEE BENEFITS

Employee Stock Ownership Plan

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

The ESOP borrowed $2.6 million from FS Bancorp, Inc. and used those funds to acquire 259,210 shares of FS Bancorp, Inc. common stock in the open market at an average price of $10.17 per share. It is anticipated that the Bank will make contributions to the ESOP in amounts necessary to amortize the ESOP loan payable to FS Bancorp, Inc. over a period of 10 years, bearing interest at 2.30%. Intercompany expenses associated with the ESOP are eliminated in consolidation.

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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, 2012, the ESOP paid the first annual installment of principal in the amount of $267,000, plus accrued interest of $28,000 pursuant to the ESOP loan. No payment of principal or interest was made during the six months ended June 30, 2013.

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

Compensation expense related to the ESOP for the six months ended June 30, 2013 and June 30, 2012 was $217,000 and none, respectively.

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

	Balances
Allocated shares	25,921
Committed to be released shares	12,960
Unallocated shares	220,329
Total ESOP shares	259,210
Fair value of unallocated shares (in thousands)	$3,699

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

NOTE 14 - EARNINGS PER SHARE
Basic earnings per share are computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity.

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

	At or For the Three Months Ended June 30, 2013	2012	At or For the Six Months Ended June 30, 2013	2012
Numerator:				
Net Income (in thousands)	$1,086	$621	$2,321	$898
Denominator:				
Denominator for basic earnings per share- weighted average common shares outstanding	3,019,797	n/a(1)	3,019,797	n/a(1)
Denominator for diluted earnings per share- weighted average common shares outstanding	3,019,797	n/a(1)	3,019,797	n/a(1)
Basic earnings per share	$0.36	n/a(1)	$0.77	n/a(1)
Diluted earnings per share	$0.36	n/a(1)	$0.77	n/a(1)

(1) Earnings per share and share calculations are not available (n/a) as the Company completed its stock conversion and became a public company on July 9, 2012.
The Company purchased 259,210 shares in the open market during the year ended December 31, 2012, for the ESOP. For earnings per share calculations, the ESOP shares, committed to be released shares are included as outstanding shares. There were 220,329 shares in the ESOP that were not committed to be released as of June 30, 2013.

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

Forward-Looking Statements

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

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

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

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

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

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

Overview

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

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

The Company is a diversified lender with a focus on the origination of indirect home improvement loans, also referred to as fixture secured loans, commercial real estate mortgage loans, home loans, commercial business loans and second mortgage/home equity loan products. Consumer loans, in particular indirect home improvement loans to finance window replacement, gutter replacement, siding replacement, and other improvement renovations, represent the largest portion of the loan portfolio and have traditionally been the mainstay of our lending strategy. As of June 30, 2013, consumer loans represented 41.3% of the Company's total portfolio, up from 38.8% at December 31, 2012 due to growth in the indirect home improvement channel, with indirect home improvement loans representing 79.8% of the total consumer loan portfolio.

Indirect home improvement lending is reliant on the Bank’s relationships with home improvement contractors and dealers. The Bank has funded 1,044 loans during the quarter ended June 30, 2013 using the indirect home improvement contractor/dealer network located throughout Washington, Oregon and California with four contractors/dealers responsible for a majority or 56.3% 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 $10.3 million. During the three months ended June 30, 2013, the Company originated $3.8 million of consumer loans. As of June 30, 2013, the Company had $8.6 million of consumer indirect loans outstanding. Management has established a limit of no more than 20% of the total consumer loan portfolio for loans in California. As of June 30, 2013, the limit would be $23.6 million.

Going forward, the Company will focus on diversifying our lending products by expanding commercial real estate, home lending, commercial business and residential construction lending, while maintaining the current size of the Bank's consumer loan portfolio. The Company's lending strategies are intended to take advantage of: (1) the Bank's historical strength in indirect consumer lending, (2) recent market dislocation that has created new lending opportunities and the availability of experienced bankers, and (3) strength in relationship lending. Retail deposits will continue to serve as a primary funding source.

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

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

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

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

- not being required to comply with the auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act of 2002 (the Company also will not be subject to the auditor attestation requirements of Section 404(b) as long as the Company is a “smaller reporting company,” which includes issuers that had a public float of less than $75 million as of the last business day of their most recently completed second fiscal quarter);
- reduced disclosure obligations regarding executive compensation in periodic reports and proxy statements; and
- exemptions from the requirements of holding a nonbinding advisory vote on executive compensation and shareholder approval of any golden parachute payments not previously approved.

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

Critical Accounting Policies and Estimates

Certain of the Company's accounting policies are important to the portrayal of the Company's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Facts and circumstances which could affect these judgments include, but are not limited to, changes in interest rates, changes in the performance of the economy and changes in the financial condition

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of borrowers. Management believes that its critical accounting policies include determining the allowance for loan losses, the fair value of other real estate owned and the need for a valuation allowance related to the deferred tax asset.

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

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

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

Other Real Estate Owned. Property acquired by foreclosure or deed in lieu of foreclosure is recorded at fair value, less cost to sell. Development and improvement costs relating to the property are capitalized. The carrying value of the property is periodically evaluated by management and, if necessary, allowances are established to reduce the carrying value to net realizable value. Gains or losses at the time the property is sold are charged or credited to operations in the period in which they are realized. The amounts that will be ultimately realize 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. As of June 30, 2013, and December 31, 2012, the Company had net deferred tax assets of $1.3 million and $1.9 million, respectively and determined that no valuation allowance was required.

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

Assets. Total assets increased $19.9 million, or 5.5%, to $378.9 million at June 30, 2013 from $359.0 million at December 31, 2012, primarily as a result of a $7.0 million, or 74.4% increase in cash and interest-bearing deposits at other financial institutions, a $5.5 million or 2.0% increase in net loans receivable, a $4.3 million, or 48.2% increase in loans held for sale, and a $2.2 million, or 79.9% increase in other assets.

Net loans receivable increased $5.5 million, or 2.0%, to $280.4 million at June 30, 2013 from $274.9 million at December 31, 2012. Real estate secured loans increased $16.0 million, or 16.4% to $113.8 million at June 30, 2013 from $97.8 million at December 31, 2012, primarily as a result of a $11.3 million, or 35.4%, increase in residential construction and development loans, a $2.4 million, or 17.1% increase in one-to-four-family loans, a $1.5 million, or 4.6% increase in commercial real estate loans, and a $943,000, or 29.5% increase in multi-family loans. Consumer loans increased $9.2 million, or 8.5%, to $117.9 million at June 30, 2013 from $108.7 million at December 31, 2012, as a result of a $7.8 million, or 9.1%, increase in indirect home improvement loans, and a $2.6 million, or 14.2% increase in recreational loans partially offset by a $931,000, or 38.5%, decrease in automobile loans. Commercial business loans decreased $19.5 million, or 26.5%, to $54.0 million at June 30, 2013 from $73.5 million at December 31, 2012. The period over period decrease in commercial business loans reflects the lower usage of warehouse lending lines with the rise in mortgage interest rates and the planned runoff off two larger participations in the Shared National Credit Program totaling $5.7 million. The utilization of warehouse lending lines as well as the Company's ability to generate loans held for sale may be adversely affected by the recent rise in mortgage interest rates, which may result in a decrease in refinancing activity driving increased home lending operations.

Loans held for sale increased $4.3 million to $13.1 million at June 30, 2013 from $8.9 million at December 31, 2012. 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, 2013, the Company sold $89.9 million of one-to-four-family mortgage loans compared to $41.2 million for the preceding quarter and $24.0 million for the same quarter one year ago. The Company also held $2.7 million in consumer loans and $529,000 in commercial real estate loans expected to be sold during the third quarter of 2013 that are included in held for sale balances.

The allowance for loan losses at June 30, 2013 was $5.3 million, or 1.9% of gross loans receivable, compared to $4.7 million, or 1.7% of gross loans receivable, at December 31, 2012. Non-performing loans, consisting of non-accruing loans, increased to $2.3 million at June 30, 2013 from $1.9 million at December 31, 2012. At June 30, 2013, non-performing loans consisted of $1.4 million of commercial real estate loans, $360,000 of one-to-four-family loans, $115,000 of home equity loans, $278,000 of consumer loans, and $94,000 of commercial business loans. Non-performing loans to total gross loans increased to 0.8% at June 30, 2013 from 0.7% at December 31, 2012. OREO totaled $1.8 million at June 30, 2013, compared to $2.1 million at December 31, 2012. The $322,000 or 15.1% reduction in OREO reflects the sale of $163,000 in OREO properties and write-downs to fair value of $195,000 during the period ended June 30, 2013. At June 30, 2013, the Company also had $3.2 million in TDRs of which $2.4 million were performing in accordance with their modified payment terms and $807,000 were on non-accrual.

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

	June 30, 2013	December 31, 2012
Non-performing assets-		
Non-accrual loans	$2,294	$1,906
Other real estate owned	1,805	2,127
Other assets	68	31
Total non-performing assets	$4,167	$4,064

Liabilities. Total liabilities increased $18.7 million, or 6.2%, to $317.8 million at June 30, 2013, from $299.1 million at December 31, 2012. Deposits increased $12.0 million, or 4.1%, to $300.9 million at June 30, 2013 from $288.9 million at December 31, 2012. The increase in deposits was due to a $6.4 million, or 5.1%, increase in money market and savings accounts, a $3.7 million, or 3.5%, increase in time deposits including brokered deposits, and a $2.9 million, or 8.6% increase in noninterest-bearing checking accounts partially offset by a $1.1 million, or 4.4%, decrease in interest-bearing checking accounts. The Company continues its focus on relationship deposit growth with new and existing customers.
Total borrowings, which consisted of FHLB advances, increased $6.8 million, or 99.8%, to $13.7 million at June 30, 2013 from $6.8 million at December 31, 2012 with the majority of this increase in long-term borrowings of over three years. The increase in long-term borrowings is part of the Company's interest rate risk management strategy.

Stockholders' Equity. Total stockholders' equity increased $1.2 million, or 2.0%, to $61.1 million at June 30, 2013 from $59.9 million at December 31, 2012. The increase in stockholders' equity was predominantly a result of net income of $2.3 million offset by a decline of $1.2 million in accumulated other comprehensive income, which includes the unrealized loss on securities available-for-sale, net of tax, and a dividend payment of $150,000. Bond prices in the second quarter of 2013 declined as a result of the rise in long-term interest rates which is reflected in the unrealized loss associated with securities available-for-sale. Book value per common share was $20.23 at June 30, 2013 compared to $19.92 at December 31, 2012.

Comparison of Results of Operations for the Three and Six Months Ended June 30, 2013 and 2012

General. Net income for the three months ended June 30, 2013 was $1.1 million compared to net income of $621,000 for the three months ended June 30, 2012. The increase in net income was primarily attributable to a $1.8 million, or 161.2%, increase in noninterest income and a $1.0 million, or 26.5%, increase in net interest income partially offset by a $1.8 million, or 45.8% increase in noninterest expense and a $566,000, or 100.0% increase in the provision for income taxes. The increase in noninterest income was primarily the result of $1.8 million in gains on sale of loans from the Company's residential home lending operations. The increase in noninterest expense was primarily related to $1.6 million of expenses associated with expanding our lending channels.

Net income for the six months ended June 30, 2013 was $2.3 million compared to net income of $898,000 for the six months ended June 30, 2012. The increase in net income was primarily attributable to a $3.3 million, or 181.5%, increase in noninterest income and a $2.0 million, or 27.1%, increase in net interest income partially offset by a $2.6 million, or 35.7% increase in noninterest expense and a $1.2 million, or 100.0% increase in the provision for income taxes. The increase in noninterest income was primarily the result of $3.2 million in gains on sale of loans from the Company's residential home lending operations. The increase in noninterest expense was primarily related to $2.7 million of expenses associated with expanding the Company's loan origination platforms through additional personnel and adding to our indirect home improvement dealer network.

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Net Interest Income. Net interest income increased $1.0 million, or 26.5%, to $4.9 million for the three months ended June 30, 2013, from $3.9 million for the three months ended June 30, 2012. The increase in net interest income was attributable to a $932,000 increase in interest income resulting from an increase in the average balance of the loan portfolio as well as a shift of funds throughout the period from lower yielding cash and cash equivalents to higher yielding investment securities and loans, and a $101,000 decrease in interest expense, primarily due to a reduction of the overall cost of funds.

Net interest income increased $2.1 million, or 27.1%, to $9.6 million for the six months ended June 30, 2013, from $7.5 million for the six months ended June 30, 2012. The increase in net interest income was attributable to a $1.8 million increase in interest income resulting from an increase in the average balance of the loan portfolio as well as a shift of funds throughout the period from lower yielding cash and cash equivalents to higher yielding investment securities and loans, and a $239,000 decrease in interest expense, primarily due to a reduction of the cost of funds.

The net interest margin increased four basis points to 5.46% for the six months ended June 30, 2013, from 5.42% for the same period of the prior year, primarily due to a shift in funds during the period from lower yielding cash and cash equivalents into higher yielding investment securities and loans and a lower level of non-performing loans, coupled with a 26 basis point decline in the cost of funds.

Interest Income. Interest income for the three months ended June 30, 2013 increased $932,000, or 20.7%, to $5.4 million, from $4.5 million for the three months ended June 30, 2012. The increase during the period was primarily attributable to the increase in the average balance of the loan portfolio to $301.5 million for the three months ended June 30, 2013 compared to $236.7 million for the three months ended June 30, 2012, as well as a shift of funds during the period from lower yielding cash and cash equivalents to higher yielding investment securities and loans during the three months ended June 30, 2013 compared to the same period last year.

Interest income for the six months ended June 30, 2013 increased $1.8 million, or 20.5%, to $10.6 million, from $8.8 million for the six months ended June 30, 2012. The increase during the period was primarily attributable to the increase in the average balance of the loan portfolio to $291.3 million for the six months ended June 30, 2013 compared to $231.0 million for the six months ended June 30, 2012, as well as a shift of funds during the period from lower yielding cash and cash equivalents to higher yielding investment securities/loans during the six months ended June 30, 2013 compared to the same period last year.

Interest Expense. Interest expense decreased $101,000, or 16.5%, to $512,000 for the three months ended June 30, 2013, from $613,000 for the same period of the prior year. As a result of general decline in market rates, the average cost of funds for total interest-bearing liabilities decreased 22 basis points to 0.75% for the three months ended June 30, 2013, compared to 0.97% for the three months ended June 30, 2012. The decrease was due to a decline in rates paid on certificates of deposit, and a higher average balance in money market accounts which carry a lower cost of funds. The average balance of total interest-bearing liabilities increased $21.4 million, or 8.4%, to $275.2 million for the six months ended June 30, 2013, from $253.8 million for the six months ended June 30, 2012.

Interest expense decreased $239,000, or 18.9%, to $1.0 million for the six months ended June 30, 2013, from $1.3 million for the same period of the prior year. As a result of general decline in market rates, the average cost of funds for total interest-bearing liabilities decreased 26 basis points to 0.76% for the six months ended June 30, 2013, compared to 1.02% for the six months ended June 30, 2012. The decrease was due to a decline in rates paid on certificates of deposit, and a higher average balance in money market accounts which carry a lower cost of funds. The average balance of total interest-bearing liabilities increased $24.8 million, or 10.0%, to $271.8 million for the quarter ended June 30, 2013, from $247.0 million for the quarter ended June 30, 2012.

Provision for Loan Losses. The provision for loan losses was $600,000 for the three months ended June 30, 2013, compared to $550,000 for the three months ended June 30 2012. The $50,000 increase in the provision during the current quarter over the comparable quarter last year primarily relates to higher loan balances and an increase in the origination of construction and development and consumer loans during the three months ended June 30, 2013. New lending categories are allocated a higher reserve until historical performance by the borrower can be documented. Over

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time, the provision per category is expected to reduce assuming consistent borrower performance in line with current performance.

The provision for loan losses was $1.2 million for the six months ended June 30, 2013, compared to $1.1 million for the six months ended June 30 2012. The $135,000 increase in the provision primarily relates to higher loan balances and an increase in the origination of construction and development and consumer loans during the six months ended June 30, 2013. Non-performing loans were $2.3 million or 0.8% of total loans at June 30, 2013, compared to $1.7 million, or 0.7% of total loans at June 30, 2012. During the six months ended June 30, 2013, net charge-offs totaled $622,000 compared to $1.1 million during the six months ended June 30, 2012.

Noninterest Income. Noninterest income increased $1.8 million, or 161.2%, to $2.9 million for the three months ended June 30, 2013, from $1.1 million for the three months ended June 30, 2012. The increase during the period was primarily attributable to $1.8 million in gains associated with the sale of mortgage loans in the secondary market as part of the home lending initiative.

Noninterest income increased $3.4 million, or 181.5%, to $5.2 million for the six months ended June 30, 2013, from $1.8 million for the six months ended June 30, 2012. The increase during the period was primarily due to $3.2 million in gains associated with the sale of mortgage loans in the secondary market as part of the home lending initiative.

Noninterest Expense. Noninterest expense increased $1.8 million or 45.8% to $5.6 million for the three months ended June 30, 2013, from $3.8 million for the three months ended June 30, 2012. Changes in noninterest expense included a $1.3 million, or 68.2%, increase in salaries and benefit costs primarily as a result of variable commission based expenses of $950,000 related to increases in loan volume, a $167,000 or 100.6% increase in legal fees associated with public company reporting obligations, a $147,000, or 74.2% increase in loan costs associated with increased lending activities, a $135,000 or 21.6% increase in cost of operations, and a $91,000 or 135.8% increase in marketing and advertising fees, partially offset by a $99,000 decrease in write-downs of other real estate owned to fair value.

Noninterest expense increased $2.7 million or 35.7% to $10.1 million for the six months ended June 30, 2013, from $7.4 million for the six months ended June 30, 2012. Changes in noninterest expense included a $2.1 million, or 57.6%, increase in salaries and benefit costs primarily as a result of variable commission based expenses of $1.4 million related to increases in loan volume, a $386,000 or 34.1% increase in cost of operations, a $308,000, or 91.4% increase in loan costs associated with increased lending activities, a $260,000, or 85.8% increase in professional and board fees, and a $123,000, or 102.5% increase in marketing and advertising fees, partially offset by a $451,000 decrease in write-downs of other real estate owned to fair value.

The efficiency ratio, which is noninterest expense as a percentage of net interest income and noninterest income, improved to 71.3% for the three months ended June 30, 2013 compared to 76.6% for the three months ended June 30, 2012 and was 68.1% for the six months ended June 30, 2013 compared to 79.1% for the six months ended June 30, 2012 primarily as a result of the increase in noninterest income.

Provision for Income Tax. For the six months ended June 30, 2013, the Company recorded a provision for income tax expense of $1.2 million on pre-tax income as compared to none for the six months ended June 30, 2012. The effective tax rates for the periods ended June 30, 2013 and 2012 were 33.6% and 0.0%, respectively. The effective tax rate in the quarter ended June 30, 2012 was zero as the Company had a full valuation allowance on deferred tax assets at that date. In the third quarter of 2012, after the initial public offering, the valuation allowance on deferred tax assets was reversed.

Liquidity

Management maintains a liquidity position that it believes will adequately provide funding for loan demand and deposit run-off 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.

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As of June 30, 2013, the Bank's total borrowing capacity was $38.4 million with the FHLB of Seattle, with unused borrowing capacity of $24.7 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, 2013, the Bank held approximately $52.0 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 $74.5 million at June 30, 2013, and a $6.0 million unsecured, variable rate, overnight short-term borrowing line with Pacific Coast Bankers' Bank. The Federal Reserve Bank borrowing limit is based on certain categories of loans, primarily consumer loans that qualify as collateral for Federal Reserve Bank line of credit. As of June 30, 2013, the Bank held approximately $113.5 million in loans that qualify as collateral for the Federal Reserve Bank line of credit.

As of June 30, 2013, $13.7 million in FHLB advances were outstanding and no advances were outstanding against the Federal Reserve Bank line of credit or Pacific Coast Bankers' Bank line of credit. The Bank's Asset Liability Management Policy permits management to utilize brokered deposits up to 20% of deposits or $62.6 million as of June 30, 2013. Total brokered deposits as of June 30, 2013 were $16.9 million.

Liquidity management is both a daily and long-term function of Company management. Excess liquidity is generally invested in short-term investments, such as overnight deposits and federal funds. On a longer-term basis, a strategy is maintained of investing in various lending products and investment securities, including U.S. Government obligations and federal agency securities. The Company uses sources of funds primarily to meet ongoing commitments, pay maturing deposits and fund withdrawals, and to fund loan commitments. At June 30, 2013, the approved outstanding loan commitments, including unused lines of credit, amounted to $119.6 million. Certificates of deposit scheduled to mature in six months or less at June 30, 2013, totaled $23.5 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, 2013, the Bank exceeded these requirements as of that date. Consistent with our goals to operate a sound and profitable organization, our policy is for the Bank to maintain a “well capitalized” status under the capital categories of the FDIC. Based on capital levels at June 30, 2013, the Bank was considered to be "well capitalized". At June 30, 2013, the Bank exceeded all regulatory capital requirements with Tier 1 Leverage-Based Capital, Tier 1 Risk-Based Capital and Total Risk-Based Capital ratios of 13.1%, 15.7%, and 16.9%, respectively. For additional information regarding the Bank's regulatory capital compliance, see the discussion included in Note 11 to the Notes to Consolidated Financial Statements included in Part I. Item 1 of this report.

The Company exceeded all regulatory capital requirements as of June 30, 2013. The estimated regulatory capital ratios calculated for the Company as of June 30, 2013 were 16.3% for Tier 1 Leverage-Based Capital, 19.5% for Tier 1 Risk- Based Capital and 20.7% for Total Risk-Based Capital.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

Not required for smaller reporting companies.

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

(b) Changes in Internal Controls.

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

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

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

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

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

Not applicable.

Item 3. Defaults Upon Senior Securities

Not applicable.

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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, Steven L. Haynes and Drew B. Ness (1)

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 Annual Report on Form 10-Q for the quarter ended June 30, 2013, 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 (333-35817) and incorporated by reference.

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

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SIGNATURES

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

FS BANCORP, INC.

Date: August 14, 2013	By:	/s/Joseph C. Adams Joseph C. Adams, Chief Executive Officer (Duly Authorized Officer)
Date: August 14, 2013	By:	/s/Matthew D. Mullet Matthew D. Mullet Secretary, Treasurer and Chief Financial Officer (Principal Financial and Accounting Officer)