FS Bancorp, Inc.
Form 10-K
April 01, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K
(Mark one)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2012 OR

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

Commission File Number: 001-35589

FS BANCORP, INC.
(Exact name of registrant as specified in its charter)

Washington (State or other jurisdiction of incorporation or organization)	45-4585178 (I.R.S. Employer Identification Number)
6920 220th Street SW, Mountlake Terrace, Washington (Address of principal executive offices)	98043 (Zip Code)
Registrant's telephone number, including area code:	(425) 771-5299
Securities registered pursuant to Section 12(b) of the Act:	None
Securities registered pursuant to Section 12(g) of the Act:	Common Stock, par value $0.01 per share (Title of Each Class)

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES [ ] NO [X]

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES [ ] NO [X]

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

NO [ ]

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

Indicate by check mark whether disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or other information statements incorporated by reference in Part III of this Form 10-K or any amendments to this Form 10-K. [X]

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

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

Indicate by check mark whether the Registrant is a shell company (as defined in Exchange Act Rule 12b-2). YES [ ] NO [X]

As of March 27, 2013, there were 3,240,125 shares of the Registrant's common stock outstanding. The Registrant's common stock is listed on the NASDAQ Capital Market under the symbol "FSBW." The aggregate market value of the common stock held by non affiliates of the Registrant, based on the closing sales price of the Registrant's common stock as quoted on the NASDAQ Capital Market on June 30, 2012, was not applicable as no stock was outstanding. On July 9, 2012 the 1st Security Bank of Washington completed its conversion from a mutual savings bank to a stock savings bank and the Company issued an aggregate of 3,240,125 shares of common stock on that date in connection with the mutual to stock conversion.

DOCUMENTS INCORPORATED BY REFERENCE

1. Portions of the Annual Report to Shareholders are incorporated by reference into Part II.

2. Portions of the definitive Proxy Statement for the 2013 Annual Meeting of Shareholders ("Proxy Statement") are incorporated by reference into Part III.

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As used in this report, the terms “we,” “our,” “us,” and “FS Bancorp” refer to FS Bancorp, Inc. and its consolidated subsidiary, 1st Security Bank of Washington, unless the context indicates otherwise.

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Forward Looking Statements

This Form 10-K contains 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:

- 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, 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
- other economic, competitive, governmental, regulatory and technical factors affecting our operations, pricing, products and services and other risks described elsewhere in this Form 10-K and our other reports filed with the U.S. Securities and Exchange Commission.

Any of the forward looking statements that we make in this Form 10-K 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. Because of these and other uncertainties, our actual future results may be materially different from the results indicated by these forward looking statements and you should not rely on such statements.

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Available Information

The Company provides a link on its investor information page at www.fsbwa.com to filings with the U.S. Securities and Exchange Commission ("SEC") for purposes of providing copies of its annual report to shareholders, annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and press releases. Other than an investor's own internet access charges, these filings are available free of charge and also can be obtained by calling the SEC at 1-800-SEC-0330. The information contained on the Company's website is not included as part of, or incorporated by reference into, this Annual Report on Form 10-K.

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PART 1
Item 1. Business

General
FS Bancorp, Inc. (“FS Bancorp” or the “Company”), a Washington corporation, was organized in September 2011 for the purpose of becoming the holding company of 1st Security Bank of Washington (“1st Security Bank of Washington” or the “Bank”) upon the Bank’s conversion from a mutual to a stock savings bank (“Conversion”). The Conversion was completed on July 9, 2012. At December 31, 2012, the Company had consolidated total assets of $359.0 million, total deposits of $288.9 million and stockholders’ equity of $59.9 million. The Company has not engaged in any significant activity other than holding the stock of the Bank. Accordingly, the information set forth in this Annual Report on Form 10-K (“Form 10-K”), including the consolidated financial statements and related data, relates primarily to the Bank.

1st Security Bank of Washington is a relationship-driven community bank. The Bank delivers banking and financial services to local families, local and regional businesses and industry niches within distinct Puget Sound area communities. The Bank emphasizes long-term relationships with families and businesses within the communities served, working with them to meet their financial needs. The Bank is also actively involved in community activities and events within these market areas, which further strengthens relationships within these markets. The Bank has been serving the Puget Sound area since 1936. Originally chartered as a credit union, and known as Washington’s Credit Union, the Bank served various select employment groups. On April 1, 2004, the Bank converted from a credit union to a Washington state-chartered mutual savings bank. Upon completion of the Conversion in July 2012, 1st Security Bank of Washington became a Washington state-chartered stock savings bank and the wholly owned subsidiary of the Company. At December 31, 2012, the Bank maintained six bank branch locations and one loan origination branch, along with the headquarters.

1st Security Bank of Washington is a diversified lender with a focus on the origination of home improvement loans, commercial real estate mortgage loans, commercial business loans and second mortgage/home equity loan products. Consumer loans, in particular indirect home improvement loans, represent the largest portion of the loan portfolio and have traditionally been the mainstay of the Bank’s lending strategy, a carryover from its days as a credit union. Going forward, the Bank plans to place more emphasis on certain lending products, such as commercial real estate, commercial business and residential construction lending, while maintaining the current size of the consumer loan portfolio. The Bank also reintroduced in-house originations of residential mortgage loans in 2012, primarily for sale into the secondary market, through a mortgage banking program. Future 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 (3) relationship lending. Retail deposits will continue to serve as an important funding source. For more information regarding the business and operations of 1st Security Bank of Washington, see Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

1st Security Bank of Washington is examined and regulated by the Washington Department of Financial Institutions (“DFI”), its primary regulator, and by the Federal Deposit Insurance Corporation (“FDIC”). 1st Security Bank of Washington is required to have certain reserves set by the Board of Governors of the Federal Reserve System (“Federal Reserve”) and is a member of the Federal Home Loan Bank of Seattle (“FHLB” or “FHLB of Seattle”), which is one of the 12 regional banks in the Federal Home Loan Bank System.

The principal executive offices of the Company are located at 6920 220th Street SW, Mountlake Terrace, Washington 98043 and its telephone number is (425) 771-5299.

Market Area

The Bank conducts operations out of the main administrative office, one home lending office and six full-service bank branch offices in the Puget Sound region of Washington. The administrative office is located in Mountlake Terrace, in

Snohomish County, Washington. The home lending office is located in Bellevue, in King County, Washington. Three branch offices are located in Snohomish County, while there is one office each in King and Pierce Counties to the south and Kitsap County to the west. One branch is scheduled to open in the second quarter of 2013 and will be located in Seattle, King County, Washington.

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The primary market area for business operations is the Seattle-Tacoma-Bellevue, WA Metropolitan Statistical Area (the “Seattle MSA”). Kitsap County, though not in the Seattle MSA, is also part of the Bank’s market area. This overall region is typically known as the “Puget Sound” region. The population of the Puget Sound region was an estimated 3.8 million in 2011, over half of the state’s population, representing a large population base for potential business. The region has a well-developed urban area in the western portion along Puget Sound, with the north, central and eastern portions containing a mixture of developed residential and commercial neighborhoods and undeveloped, rural neighborhoods.

The Puget Sound region is the largest business center in both the state of Washington and the Pacific Northwest. Currently, key elements of the economy are aerospace, military bases, clean technology, biotechnology, education, information technology, logistics, international trade and tourism. The region is well known for the long presence of The Boeing Corporation and Microsoft, two major industry leaders, and for its leadership in technology. The workforce in general is well-educated and strong in technology. Washington state’s location with regard to the Pacific Rim, along with a deepwater port has made international trade a significant part of the regional economy. Tourism has also developed into a major industry for the area, due to the scenic beauty, temperate climate and easy accessibility. King County, the location of the city of Seattle, has the largest employment base and overall level of economic activity. King County’s largest employers include The Boeing Company, Microsoft Corporation, and the University of Washington. Companies that are headquartered in King County include Alaska Airlines, Amazon.com, Costco, Starbucks and Microsoft. Pierce County’s economy is also well diversified with the presence of military related government employment (Joint Base Lewis-McChord), along with health care (the Franciscan Health System and the Multicare Health System). In addition, there is a large employment base in the economic sectors of shipping (the Port of Tacoma) and aerospace employment (Boeing). Snohomish County to the north has an economy based on aerospace employment (Boeing), military (the Everett Naval Station) along with additional employment concentrations in biotechnology, electronics/computers, and wood products. Eight of the largest employers in the state are headquartered in King County.

The United States Navy is a key element for Kitsap County’s economy. The United States Navy is the largest employer in the county, with installations at Puget Sound Naval Shipyard, Naval Undersea Warfare Center Keyport and Naval Base Kitsap (which comprises former Naval Submarine Base Bangor, and Naval Station Bremerton). The largest private employers in the county are the Harrison Medical Center, Wal-Mart, and Port Madison Enterprises.

The 2011 median household income and per capita income levels in King, Snohomish, and Kitsap Counties were higher than the state and national averages, while Pierce County reported income levels slightly below the Washington state average. Approximately 86.6% of King County households had income levels in excess of $50,000 annually in 2010, compared to 82.5% for the state of Washington and 79.2% for the United States. In 2008, the U.S. Census Bureau determined that Seattle has the highest percentage of college and university graduates of any U.S. city; it was listed as the most literate or second most literate city of the country every year since 2005. Seattle’s high income and education levels, especially compared to other major cities, result in King County ranking in the top 100 wealthiest counties in the United States.

Unemployment in Washington was an estimated 7.6% as of December 31, 2012, down from a high of 10.2% in March 2010, closely paralleling national trends. Unemployment rates in Pierce, Kitsap, King, Snohomish counties have improved in the last 24 months after dropping from their 2010 first quarter highs. As of December 2012, Kitsap County and King County reported rates slightly lower that the state and national averages, at 6.1% and 7.0%, respectively. Year end 2012 estimated unemployment in Pierce County was 8.5%, and estimated unemployment in Snohomish County was 6.7%. Of the four counties, Snohomish and King Counties reflected the largest improvement year over year with unemployment dropping 1.3% in Snohomish County and 1.0% in King County.

According to the Washington Center for Real Estate Research, home values in the state of Washington began improving in the first half of 2012. For the quarter ended June 30, 2012, the average home value was $261,000 in Snohomish County, $195,000 in Pierce County, $371,000 in King County, and $242,000 in Kitsap County. Compared to the statewide average increase in home values of 4.0% over the second quarter, Snohomish and King counties have performed at the highest level, with 8.2% and 6.5% increases, respectively. Kitsap County increased 3.1% year over year, slightly below the state average. Pierce County continued to experience a slight decline with home prices declining 0.9% year over year. King County has experienced a dramatic increase in building permits with a 100.5% increase year over year as of December 31, 2012.

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For a discussion regarding the competition in the Company’s primary market area, see “—Competition.”

Lending Activities

General. Historically, while operating as a credit union, the primary emphasis was the origination of consumer loans (primarily indirect home improvement and automobile-secured loans), one-to-four-family residential first mortgages, and second mortgage/home equity loan products. More recently, while maintaining the active indirect consumer lending program, the Bank has shifted the lending focus to non-mortgage commercial business loans, as well as commercial real estate and residential construction and development loans. The Bank has also reintroduced in-house originations of residential mortgage loans in 2012, primarily for sale in the secondary market. While maintaining the Bank’s historical strength in consumer lending, the Bank recently added management and personnel in the commercial lending area to take advantage of the relatively favorable long-term business and economic environments prevailing in the markets for small business lending.

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Loan Portfolio Analysis. The following table sets forth the composition of the loan portfolio by type of loan at the dates indicated.

	December 31,									
	2012		2011		2010		2009		2008	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Perce
	(Dollars in thousands)									
Real estate loans										
Commercial	$33,250	11.88 %	$28,931	13.09 %	$28,061	11.86 %	$29,099	12.20 %	$25,872	11.33
Construction and development	31,893	11.39	10,144	4.59	9,805	4.15	17,390	7.29	23,861	10.45
Home equity	15,474	5.53	14,507	6.56	15,655	6.62	16,448	6.90	18,689	8.19
One-to-four-family(1)	13,976	4.99	8,752	3.96	13,218	5.59	8,233	3.45	6,969	3.05
Multi-family	3,202	1.14	1,175	0.53	1,159	0.49	409	0.17	408	0.18
Total real estate loans	97,795	34.93	63,509	28.73	67,898	28.71	71,579	30.01	75,799	33.20
Consumer Loans										
Indirect home improvement	86,249	30.82	81,143	36.70	94,833	40.10	89,883	37.68	75,203	32.94
Recreational	17,968	6.42	24,471	11.07	24,105	10.19	18,011	7.55	12,165	5.33
Automobile	2,416	0.86	5,832	2.64	12,645	5.35	23,359	9.79	30,514	13.37
Home improvement	651	0.23	934	0.42	1,295	0.55	1,725	0.72	2,203	0.96
Other	1,386	0.50	1,826	0.83	2,887	1.21	4,277	1.80	6,190	2.71
Total consumer loans	108,670	38.83	114,206	51.66	135,765	57.40	137,255	57.54	126,275	55.31
Commercial business loans	73,465	26.24	43,337	19.61	32,841	13.89	29,699	12.45	26,218	11.49
Total gross loans receivable	279,930	100.00 %	221,052	100.00 %	236,504	100.00 %	238,533	100.00 %	228,292	100.0
Less:										
Deferred costs, fees and discounts, net	(283)		424		223		313		280	
Allowance for loan losses	(4,698)		(4,345)		(5,905)		(7,405)		(5,598)	
Total loans receivable, net	$274,949		$217,131		$230,822		$231,441		$222,974	

(1) Excludes loans held for sale.

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The following table shows the composition of the loan portfolio by fixed- and adjustable-rate loans at the dates indicated.

	December 31, 2012 Amount	Percent	2011 Amount	Percent	2010 Amount	Percent	2009 Amount	Percent	2008 Amount
	(Dollars in thousands)								
Fixed-rate loans:									
Real estate loans									
Commercial	$20,947	7.48 %	$ 17,578	7.95 %	$16,333	6.90 %	$15,729	6.59 %	$16,449
Construction and development	3,958	1.41	3,407	1.54	1,556	0.66	501	0.21	105
Home equity	2,557	0.91	2,154	0.97	2,784	1.18	3,839	1.61	5,399
One-to-four-family(1)	8,328	2.98	5,452	2.47	6,585	2.79	4,552	1.91	6,159
Multi-family	2,053	0.73	1,175	0.53	1,159	0.49	409	0.17	405
Total real estate loans	37,843	13.51	29,766	13.46	28,417	12.02	25,030	10.49	28,517
Consumer	108,500	38.76	114,201	51.65	135,752	57.39	137,231	57.53	126,221
Commercial business	16,959	6.06	8,971	4.07	1,049	0.45	870	0.36	454
Total fixed-rate loans	163,302	58.33	152,938	69.18	165,218	69.86	163,131	68.38	155,192
Adjustable-rate loans:									
Real estate loans									
Commercial	12,303	4.40	11,353	5.14	11,728	4.96	13,370	5.61	9,423
Construction and development	27,935	9.98	6,737	3.05	8,249	3.49	16,889	7.08	23,756
Home equity	12,917	4.61	12,353	5.59	12,871	5.44	12,609	5.29	13,290
One-to-four-family(1)	5,648	2.02	3,300	1.49	6,633	2.80	3,681	1.54	810
Multi-family	1,149	0.41	—	—	—	—			

								Environmental Technologies		Specialty Materials	Life Sciences	All Other
Three months ended September 30, 2009												
Net sales	$ 679	$450	$167	$90	$ 92	$	1	$	1,479			
Depreciation (1)	$ 146	$35	$25	$13	$ 5	$	3	$	227			
Amortization of purchased intangibles		$3						$	3			
Research, development and engineering expenses (2)	$ 19	$21	$30	$17	$ 3	$	20	$	110			
Restructuring, impairment and other (credits) charges	$ (5)		$3	$(1)	$ 1			$	(2)			
Equity in earnings of affiliated companies	$ 317		$2			$	3	$	322			
Income tax (provision) benefit	$ (83)	$(11)	$3	$6	$ (6)	$	7	$	(84)			
Net income (loss) (3)	$ 600	$21	$(4)	$(11)	$ 12	$	(17)	$	601			
Three months ended September 30, 2008												
Net sales	$ 696	$496	$177	$101	$ 83	$	2	$	1,555			

Depreciation (1)	$ 95	$30	$24	$9	$	3	$	3	$	164
Amortization of purchased intangibles		$2							$	2
Research, development and engineering expenses (2)	$ 30	$24	$29	$13	$	2	$	43	$	141
Restructuring, impairment and other credits		$(2)							$	(2)
Equity in earnings of affiliated companies	$ 264		$1				$	13	$	278
Income tax provision	$ (46)	$(9)	$(5)		$	(4)			$	(64)
Net income (loss) (3)	$ 635	$25	$15	$(1)	$	11	$	(54)	$	631
Nine months ended September 30, 2009										
Net sales	$ 1,709	$1,272	$409	$221	$	249	$	3	$	3,863
Depreciation (1)	$ 359	$99	$74	$35	$	13	$	9	$	589
Amortization of purchased intangibles		$8							$	8
Research, development and engineering expenses (2)	$ 60	$68	$87	$40	$	8	$	90	$	353
Restructuring, impairment and other charges	$ 29	$15	$22	$17	$	8	$	4	$	95
Equity in earnings (loss) of affiliated companies	$ 781	$(4)	$6				$	31	$	814
Income tax (provision) benefit	$ (184)	$(24)	$31	$25	$	(14)	$	32	$	(134)
Net income (loss) (3)	$ 1,373	$38	$(57)	$(48)	$	29	$	(51)	$	1,284
Nine months ended September 30, 2008										
Net sales	$ 2,334	$1,394	$583	$288	$	251	$	14	$	4,864
Depreciation (1)	$ 277	$88	$72	$24	$	11	$	9	$	481
Amortization of purchased intangibles		$7							$	7
Research, development and engineering expenses (2)	$ 83	$73	$94	$33	$	6	$	121	$	410
Restructuring, impairment and other credits		$(3)							$	(3)
Equity in earnings of affiliated companies	$ 718		$3				$	54	$	775
Income tax provision	$ (171)	$(16)	$(12)		$	(10)	$	(3)	$	(212)
Net income (loss) (3)	$ 1,999	$59	$56	$(1)	$	37	$	(118)	$	2,032

(1) Depreciation expense for Corning s reportable segments includes an allocation of depreciation of corporate property not specifically identifiable to a segment.

(2) Research, development, and engineering expense includes direct project spending which is identifiable to a segment.

(3) Effective January 1, 2009, we began providing U.S. income tax expense (or benefit) on U.S. earnings (losses) due to the change in our conclusion about the realizability of our U.S. deferred tax assets in 2008. As a result of the change in our tax position, we adjusted the allocation of taxes to our operating segments in 2009 to reflect this difference.

(4) Many of Corning s administrative and staff functions are performed on a centralized basis. Where practicable, Corning charges these expenses to segments based upon the extent to which each business uses a centralized function. Other staff functions, such as corporate finance, human resources and legal are allocated to segments, primarily as a percentage of sales. In the nine months ended September 30, 2008, net income of the Display Technologies segment included a $12 million litigation settlement charge. In the three and nine months ended September 30, 2008, net loss of the All Other segment included a $14 million loss on the sale of Corning s Steuben glass business.

CORNING INCORPORATED AND SUBSIDIARY COMPANIES

SEGMENT RESULTS

(Unaudited; in millions)

A reconciliation of reportable segment net income to consolidated net income follows (in millions):

	Three months ended September 30,		Nine months ended September 30,	
	2009	2008	2009	2008
Net income of reportable segments	$ 618	$ 685	$ 1,335	$ 2,150
Non-reportable segments	(17)	(54)	(51)	(118)
Unallocated amounts:				
Net financing costs (1)	(35)	4	(86)	17
Stock-based compensation expense	(30)	(26)	(97)	(104)
Exploratory research	(15)	(17)	(46)	(52)
Corporate contributions	(8)	(8)	(23)	(26)
Equity in earnings of affiliated companies, net of impairments (2)	96	112	160	294
Asbestos litigation (3)	(6)	(6)	(15)	312
Other corporate items (4)	40	78	91	2,535
Net income	$ 643	$ 768	$ 1,268	$ 5,008

(1) Net financing costs include interest income, interest expense, and interest costs and investment gains associated with benefit plans.

(2) Includes the equity earnings of Dow Corning Corporation. In the nine months ended September 30, 2009, equity earnings of affiliated companies, net of impairments includes a charge of $29 million representing restructuring charges at Dow Corning Corporation. In the three and nine months ended September 30, 2008, equity earnings of affiliated companies, net of impairments includes a charge of $18 million representing an other-than-temporary impairment of auction rate securities at Dow Corning.

(3) In the three and nine months ended September 30, 2009, Corning recorded charges of $6 million and $15 million, respectively, to adjust the asbestos liability for the change in value of certain components of the Amended PCC Plan and the estimated liability for non-PCC asbestos claims. In the three and nine months ended September 30, 2008, Corning recorded charges of $6 million and $15 million, respectively, to adjust the asbestos liability for the change in value of certain components of the Amended PCC Plan and the estimated liability for non-PCC asbestos claims. In the first quarter of 2008, Corning reduced its liability for asbestos litigation by $327 million as a result of the increase in the likelihood of a settlement under recently proposed terms and a corresponding decrease in the likelihood of a settlement under terms established in 2003.

(4) In the three and nine months ended September 30, 2009, other corporate items included $12 million ($8 million after-tax) and $80 million ($52 million after-tax) of restructuring charges, respectively. In the three months ended September 30, 2008, Corning released an additional $70 million of valuation allowance on our U.S. deferred tax assets as a result of a change in our estimate regarding 2008 U.S. taxable income. Also, in the three months ended September 30, 2008, Corning recorded a $43 million gain related to a favorable tax settlement with the Canadian Revenue Agency. In the three and nine months ended September 30, 2008, Corning recorded net losses of $39 million on short-term investments. In the nine months ended September 30, 2008, Corning recorded a $2.4 billion tax benefit from the release of a valuation allowance on U.S. tax benefits due to sustained profitability and positive future earnings projections for U.S. entities.

CORNING INCORPORATED AND SUBSIDIARY COMPANIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Restructuring

In the third quarter of 2009, we recorded a charge of $10 million ($7 million after-tax) which was comprised of severance costs for a restructuring plan in the Environmental Technologies segment and asset disposal costs in other segments.

2. Asbestos Litigation

On March 28, 2003, Corning announced that it had reached agreement with the representatives of asbestos claimants for the settlement of all current and future asbestos claims against Corning and Pittsburgh Corning Corporation (PCC) which might arise from PCC products or operations (the 2003 Plan). On December 21, 2006, the Bankruptcy Court issued an order denying confirmation of the 2003 Plan. On January 10, 2008, some of the parties in the proceeding advised the Bankruptcy Court that they had made substantial progress on an amended plan of reorganization (the Amended PCC Plan) that resolved issues raised by the Court in denying the confirmation of the 2003 Plan.

As a result of progress in the parties continuing negotiations, Corning believes the Amended PCC Plan now represents the most probable outcome of this matter and the probability that the 2003 plan will become effective has diminished. The proposed settlement under the Amended PCC Plan requires Corning to contribute its equity interest in PCC and Pittsburgh Corning Europe, N.V. (PCE) and to contribute a fixed series of cash payments recorded at present value. Corning will have the option to contribute shares rather than cash, but the liability is fixed by dollar value and not number of shares. As a result, the estimated asbestos litigation liability is no longer impacted by movements in the value of Corning common stock. The Amended PCC Plan does not include non-PCC asbestos claims that may be or have been raised against Corning. Corning has recorded an additional amount for such claims in its estimated asbestos litigation liability.

In the third quarter of 2009, we recorded charges of $6 million ($4 million after-tax) to adjust the asbestos litigation liability for the change in value of the components of the Amended PCC Plan.

3. Weighted Average Shares Outstanding

Weighted average shares outstanding are as follows (in millions):

	Three months ended September 30,		**Three months ended**
	2009	**2008**	**June 30, 2009**
Basic	1,550	1,558	1,550
Diluted	1,569	1,578	1,567
Diluted used for non-GAAP measures	1,569	1,578	1,567

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CORNING INCORPORATED AND SUBSIDIARY COMPANIES

QUARTERLY SALES INFORMATION

(Unaudited; in millions)

	2009			
	Three Months Ended			**Nine Months Ended**
	March 31	**June 30**	**Sept. 30**	**Sept. 30**
Display Technologies	$ 357	$ 673	$ 679	$ 1,709
Telecommunications				
Fiber and cable	192	235	251	678
Hardware and equipment	193	202	199	594
	385	437	450	1,272
Environmental Technologies				
Automotive	64	85	103	252
Diesel	46	47	64	157
	110	132	167	409
Specialty Materials	60	71	90	221
Life Sciences	76	81	92	249
Other	1	1	1	3
Total	$ 989	$ 1,395	$ 1,479	$ 3,863

	2008				
	Q1	**Q2**	**Q3**	**Q4**	**Total**
Display Technologies	$ 829	$ 809	$ 696	$ 390	$ 2,724
Telecommunications					
Fiber and cable	214	248	258	200	920
Hardware and equipment	207	229	238	205	879
	421	477	496	405	1,799
Environmental Technologies					
Automotive	137	132	112	77	458
Diesel	60	77	65	51	253
	197	209	177	128	711
Specialty Materials	83	104	101	84	372
Life Sciences	81	87	83	75	326
Other	6	6	2	2	16
Total	$ 1,617	$ 1,692	$ 1,555	$ 1,084	$ 5,948

The above supplemental information is intended to facilitate analysis of Corning s businesses.

CORNING INCORPORATED AND SUBSIDIARY COMPANIES

RECONCILIATION OF NON-GAAP FINANCIAL MEASURE TO GAAP FINANCIAL MEASURE

Three Months Ended September 30, 2009

(Unaudited; amounts in millions, except per share amounts)

Corning s net income and earnings per share (EPS) excluding special items for the third quarter of 2009 are non-GAAP financial measures within the meaning of Regulation G of the Securities and Exchange Commission. Non-GAAP financial measures are not in accordance with, or an alternative to, generally accepted accounting principles (GAAP). The company believes presenting non-GAAP net income and EPS is helpful to analyze financial performance without the impact of unusual items that may obscure trends in the company s underlying performance. A detailed reconciliation is provided below outlining the differences between these non-GAAP measures and the directly related GAAP measures.

	Per Share	**Income Before Income Taxes**	**Net Income**
Earnings per share (EPS) and net income, excluding special items	$ 0.42	$ 691	$ 654
Special items:			
Restructuring charges (a)	(0.01)	(10)	(7)
Asbestos litigation (b)	-	(6)	(4)
Total EPS and net income	$ 0.41	$ 675	$ 643

(a) In the third quarter of 2009, Corning recorded a charge of $10 million ($7 million after-tax), which was comprised of severance costs for a restructuring plan in the Environmental Technologies segment and asset disposal costs in other segments.

(b) In the third quarter of 2009, Corning recorded a charge of $6 million ($4 million after-tax) to adjust the asbestos liability for change in value of the components of the Amended PCC Plan.

CORNING INCORPORATED AND SUBSIDIARY COMPANIES

RECONCILIATION OF NON-GAAP FINANCIAL MEASURE TO GAAP FINANCIAL MEASURE

Three Months Ended June 30, 2009

(Unaudited; amounts in millions, except per share amounts)

Corning s net income and earnings per share (EPS) excluding special items for the second quarter of 2009 are non-GAAP financial measures within the meaning of Regulation G of the Securities and Exchange Commission. Non-GAAP financial measures are not in accordance with, or an alternative to, generally accepted accounting principles (GAAP). The company believes presenting non-GAAP net income and EPS is helpful to analyze financial performance without the impact of unusual items that may obscure trends in the company s underlying performance. A detailed reconciliation is provided below outlining the differences between these non-GAAP measures and the directly related GAAP measures.

	Per Share	**Income Before Income Taxes**	**Net Income**
Earnings per share (EPS) and net income, excluding special items	$ 0.39	$ 612	$ 614
Special items:			
Asbestos litigation (a)	-	(5)	(3)
Total EPS and net income	$ 0.39	$ 607	$ 611

(a) In the second quarter of 2009, Corning recorded a charge of $5 million ($3 million after-tax) to adjust the asbestos liability for change in value of the components of the Amended PCC Plan.

CORNING INCORPORATED AND SUBSIDIARY COMPANIES

RECONCILIATION OF NON-GAAP FINANCIAL MEASURE TO GAAP FINANCIAL MEASURE

Three Months Ended September 30, 2008

(Unaudited; amounts in millions, except per share amounts)

Corning s net income and earnings per share (EPS) excluding special items for the third quarter of 2008 are non-GAAP financial measures within the meaning of Regulation G of the Securities and Exchange Commission. Non-GAAP financial measures are not in accordance with, or an alternative to, generally accepted accounting principles (GAAP). The company believes presenting non-GAAP net income and EPS is helpful to analyze financial performance without the impact of unusual items that may obscure trends in the company s underlying performance. A detailed reconciliation is provided below outlining the differences between these non-GAAP measures and the directly related GAAP measures.

	Per Share	Income Before Income Taxes	Net Income
Earnings per share (EPS) and net income, excluding special items	$ 0.46	$ 385	$ 732
Special items:			
Asbestos settlement (a)	-	(6)	(6)
Available-for-sale securities (b)	(0.02)	(39)	(39)
Loss on sale of business (c)	(0.01)	(14)	(14)
Valuation allowance release (d)	0.04	-	70
Tax revenue settlement (e)	0.03	-	43
Equity in earnings of affiliated companies (f)	(0.01)	-	(18)
Total EPS and net income	$ 0.49	$ 326	$ 768

(a) In the third quarter of 2008, Corning recorded a charge of $6 million to adjust the asbestos liability for the change in value of certain components of the Amended PCC Plan and the estimated liability for non-PCC asbestos claims.

(b) In the third quarter of 2008, Corning recorded net losses of $39 million on certain available-for-sale securities included in cash and short-term investments.

(c) In the third quarter of 2008, Corning incurred a $14 million loss on the sale of a business.

(d) In the third quarter of 2008, Corning recorded a valuation allowance release of $70 million resulting from a change in our estimate of current-year U.S. taxable income.

(e) In the third quarter of 2008, Corning recorded a $43 million gain related to a favorable tax settlement with the Canadian Revenue Agency.

(f) In the third quarter of 2008, equity earnings of affiliated companies included an $18 million charge for our share of an other-than-temporary impairment of auction rate securities at Dow Corning Corporation.

CORNING INCORPORATED AND SUBSIDIARY COMPANIES

RECONCILIATION OF NON-GAAP FINANCIAL MEASURE TO GAAP FINANCIAL MEASURE

Three Months Ended September 30, 2009

(Unaudited; amounts in millions)

Corning s free cash flow financial measure for the three months ended September 30, 2009 is a non-GAAP financial measure within the meaning of Regulation G of the Securities and Exchange Commission. Non-GAAP financial measures are not in accordance with, or an alternative to, generally accepted accounting principles (GAAP). The company believes presenting non-GAAP financial measures are helpful to analyze financial performance without the impact of unusual items that may obscure trends in the company s underlying performance. A detailed reconciliation is provided below outlining the differences between this non-GAAP measure and the directly related GAAP measures.

	Three months ended September 30, 2009	**Nine months ended September 30, 2009**
Cash flows from operating activities	$ 532	$ 1,164
Less: Cash flows from investing activities	(774)	(1,139)
Plus: Short-term investments acquisitions	471	876
Less: Short-term investments liquidations	(343)	(859)
Free cash flow	$ (114)	$ 42