

F5 NETWORKS INC  
Form 10-Q  
May 09, 2013  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended March 31, 2013

**OR**

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

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

Commission File Number 000-26041

**F5 NETWORKS, INC.**

(Exact name of registrant as specified in its charter)

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**WASHINGTON**  
(State or other jurisdiction of  
incorporation or organization)

**91-1714307**  
(I.R.S. Employer  
Identification No.)

**401 Elliott Avenue West**

**Seattle, Washington 98119**

(Address of principal executive offices and zip code)

**(206) 272-5555**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☐ No ☒

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

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

Large accelerated filer ☐

Accelerated filer ☒

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

Smaller reporting company ☒

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

The number of shares outstanding of the registrant's common stock as of May 3, 2013 was 78,799,170.

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**F5 NETWORKS, INC.**

**QUARTERLY REPORT ON FORM 10-Q**

**For the Quarter Ended March 31, 2013**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****F5 NETWORKS, INC.****CONSOLIDATED BALANCE SHEETS**

(unaudited, in thousands)

	<b>March 31, 2013</b>	<b>September 30, 2012</b>
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 229,662	\$ 211,181
Short-term investments	293,186	320,970
Accounts receivable, net of allowances of \$3,113 and \$3,254	192,796	185,172
Inventories	17,963	17,410
Deferred tax assets	10,578	10,362
Other current assets	60,239	30,986
<b>Total current assets</b>	<b>804,424</b>	<b>776,081</b>
Property and equipment, net	63,182	59,604
Long-term investments	662,822	662,803
Deferred tax assets	31,165	35,478
Goodwill	447,799	348,239
Other assets, net	56,517	28,996
<b>Total assets</b>	<b>\$ 2,065,909</b>	<b>\$ 1,911,201</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities		
Accounts payable	\$ 39,100	\$ 27,026
Accrued liabilities	84,966	86,409
Deferred revenue	396,678	352,594
<b>Total current liabilities</b>	<b>520,744</b>	<b>466,029</b>
Other long-term liabilities	23,006	21,078
Deferred revenue, long-term	93,980	94,694
<b>Total long-term liabilities</b>	<b>116,986</b>	<b>115,772</b>
Commitments and contingencies (Note 5)		
Shareholders' equity		
Preferred stock, no par value; 10,000 shares authorized, no shares outstanding		
Common stock, no par value; 200,000 shares authorized, 78,380 and 78,715 shares issued and outstanding	294,875	326,922
Accumulated other comprehensive loss	(5,908)	(3,829)
Retained earnings	1,139,212	1,006,307
<b>Total shareholders' equity</b>	<b>1,428,179</b>	<b>1,329,400</b>

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Total liabilities and shareholders' equity	\$ 2,065,909	\$ 1,911,201
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The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****F5 NETWORKS, INC.****CONSOLIDATED INCOME STATEMENTS**

(unaudited, in thousands, except per share data)

	<b>Three months ended March 31,</b>		<b>Six months ended March 31,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Net revenues				
Products	\$ 185,107	\$ 205,165	\$ 389,819	\$ 401,719
Services	165,125	134,457	325,864	260,335
Total	350,232	339,622	715,683	662,054
Cost of net revenues				
Products	29,773	33,668	61,565	66,868
Services	30,529	23,926	59,622	46,332
Total	60,302	57,594	121,187	113,200
Gross profit	289,930	282,028	594,496	548,854
Operating expenses				
Sales and marketing	119,031	110,995	241,299	217,233
Research and development	52,534	43,568	101,075	82,690
General and administrative	25,889	22,785	50,562	44,462
Total	197,454	177,348	392,936	344,385
Income from operations	92,476	104,680	201,560	204,469
Other income, net	2,118	1,428	3,668	3,289
Income before income taxes	94,594	106,108	205,228	207,758
Provision for income taxes	31,182	37,467	72,323	72,625
Net income	\$ 63,412	\$ 68,641	\$ 132,905	\$ 135,133
Net income per share basic	\$ 0.81	\$ 0.87	\$ 1.69	\$ 1.71
Weighted average shares basic	78,601	79,156	78,696	79,214
Net income per share diluted	\$ 0.80	\$ 0.86	\$ 1.68	\$ 1.69
Weighted average shares diluted	79,114	79,775	79,263	79,853

The accompanying notes are an integral part of these consolidated financial statements.

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**F5 NETWORKS, INC.**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(unaudited, in thousands)

	<b>Three months ended March 31,</b>		<b>Six months ended March 31,</b>	
	<b>2013</b>	<b>2012</b>	<b>2013</b>	<b>2012</b>
Net income	\$ 63,412	\$ 68,641	\$ 132,905	\$ 135,133
Other comprehensive income:				
Foreign currency translation adjustment	(1,235)	90	(1,492)	(173)
Unrealized (loss) gain on securities, net of tax	(134)	620	(587)	533
Total other comprehensive (loss) income	(1,369)	710	(2,079)	360
Comprehensive income	\$ 62,043	\$ 69,351	\$ 130,826	\$ 135,493

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****F5 NETWORKS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(unaudited, in thousands)

	<b>Six months ended March 31,</b>	
	<b>2013</b>	<b>2012</b>
<b>Operating activities</b>		
Net income	\$ 132,905	\$ 135,133
Adjustments to reconcile net income to net cash provided by operating activities:		
Realized (gain) loss on disposition of assets and investments	(217)	457
Stock-based compensation	54,320	45,468
Provisions for doubtful accounts and sales returns	578	633
Depreciation and amortization	19,913	14,935
Deferred income taxes	(1,313)	(1,645)
Changes in operating assets and liabilities, net of amounts acquired:		
Accounts receivable	(8,202)	(18,139)
Inventories	(553)	125
Other current assets	(29,198)	(17,252)
Other assets	621	688
Accounts payable and accrued liabilities	13,243	3,933
Deferred revenue	43,371	69,147
Net cash provided by operating activities	225,468	233,483
<b>Investing activities</b>		
Purchases of investments	(446,978)	(482,403)
Maturities of investments	329,141	375,746
Sales of investments	138,171	76,444
Increase in restricted cash	(729)	(25)
Acquisition of intangible assets		(250)
Acquisition of businesses, net of cash acquired	(124,918)	(128,335)
Purchases of property and equipment	(14,769)	(12,818)
Net cash used in investing activities	(120,082)	(171,641)
<b>Financing activities</b>		
Excess tax benefit from stock-based compensation	2,395	5,456
Proceeds from the exercise of stock options and purchases of stock under employee stock purchase plan	12,040	10,093
Repurchase of common stock	(100,000)	(84,776)
Net cash used in financing activities	(85,565)	(69,227)
Net increase (decrease) in cash and cash equivalents	19,821	(7,385)
Effect of exchange rate changes on cash and cash equivalents	(1,340)	60
Cash and cash equivalents, beginning of period	211,181	216,784
Cash and cash equivalents, end of period	\$ 229,662	\$ 209,459

The accompanying notes are an integral part of these consolidated financial statements.





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**F5 NETWORKS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)**

**1. Summary of Significant Accounting Policies**

**Description of Business**

F5 Networks, Inc. (the "Company") provides products and services to help companies manage their Internet Protocol (IP) traffic and file storage infrastructure efficiently and securely. The Company's application delivery networking products improve the performance, availability and security of servers and other network resources. Internet traffic between network-based applications and clients passes through these devices where the content is inspected to ensure that it is safe and modified as necessary to ensure that it is delivered securely and in a way that optimizes the performance of both the network and the applications. The Company's principal products are application delivery controllers that include the BIG-IP family of appliances and a line of scalable VIPRION systems. The Company's recently acquired line of Diameter signaling and routing products enable full connectivity, enhanced scalability, and comprehensive control of signaling traffic in service providers' evolving packet core networks. The Company's storage virtualization products simplify and reduce the cost of managing files and file storage devices, and ensure fast, secure, easy access to files for users and applications. In February 2013, the Company acquired LineRate Systems, Inc., a developer of software defined network services technology. The Company also offers a broad range of services that include consulting, training, maintenance and other technical support services.

**Basis of Presentation**

The year-end condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. In the opinion of management, the unaudited consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary for their fair statement in conformity with accounting principles generally accepted in the United States of America. Certain information and footnote disclosures normally included in annual financial statements have been condensed or omitted in accordance with the rules and regulations of the Securities and Exchange Commission. The information included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended September 30, 2012.

Certain prior year amounts, specifically relating to cash flows in connection with the disposition of investments, have been reclassified from sales of investments to maturities of investments to conform to the current year presentation in the Consolidated Statement of Cash Flows. There was no change to the net cash used in investing activities as a result of this reclassification. This reclassification did not affect total revenue, operating income or net income.

**Revenue Recognition**

The Company sells products through distributors, resellers, and directly to end users. Revenue is recognized provided that all of the following criteria have been met:

Persuasive evidence of an arrangement exists. Evidence of an arrangement generally consists of a purchase order issued pursuant to the terms and conditions of a distributor, reseller or end user agreement.

Delivery has occurred. The Company uses shipping or related documents, or written evidence of customer acceptance, when applicable, to verify delivery or completion of any performance terms.

The sales price is fixed or determinable. The Company assesses whether the sales price is fixed or determinable based on payment terms associated with the transaction and whether the sales price is subject to refund or adjustment.

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Collectability is reasonably assured. The Company assesses collectability primarily based on the creditworthiness of the customer as determined by credit checks and related analysis, as well as the Customer's payment history.

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Revenue from the sale of products is generally recognized when the product has been shipped and the customer is obligated to pay for the product. When rights of return are present and the Company cannot estimate returns, revenue is recognized when such rights of return lapse. In certain regions where the Company does not have the ability to reasonably estimate returns, the Company defers revenue on sales to its distributors until information is received from the channel partner indicating that the product has been sold to the end-user customer. Payment terms to domestic customers are generally net 30 days to net 45 days. Payment terms to international customers range from net 30 days to net 120 days based on normal and customary trade practices in the individual markets. The Company offers extended payment terms to certain customers, in which case, revenue is recognized when payments are due.

Revenues for post-contract customer support (PCS) are recognized on a straight-line basis over the service contract term. PCS includes a limited period of telephone support updates, repair or replacement of any failed product or component that fails during the term of the agreement, bug fixes and rights to upgrades, when and if available. Consulting services are customarily billed at fixed hourly rates, plus out-of-pocket expenses, and revenues are recognized when the consulting has been completed. Training revenue is recognized when the training has been completed.

The majority of the Company's products are hardware appliances which contain software essential to the overall functionality of the products. Hardware appliances are generally sold with PCS and on occasion, with consulting and/or training services. Arrangement consideration in such multiple element transactions is allocated to each element based on a fair value hierarchy, where the selling price for an element is based on vendor specific objective evidence (VSOE), if available, third-party evidence (TPE), if available and VSOE is not available; or the best estimate of selling price (BESP), if neither VSOE or TPE is available.

For sales of nonessential and stand-alone software, the Company allocates revenue for arrangements with multiple elements based on software revenue recognition guidance. Software revenue recognition guidance requires revenue earned on software arrangements involving multiple elements to be allocated to each element based on the relative fair values of those elements. The fair value of an element must be based on VSOE. Where fair value of delivered elements is not available, revenue is recognized on the residual method based on the fair value of undelivered elements. If evidence of fair value of one or more undelivered elements does not exist, all revenue is deferred and recognized at the earlier of the delivery of those elements or the establishment of fair value of the remaining undelivered elements.

The Company establishes VSOE for its products, PCS, consulting and training services based on the sales price charged for each element when sold separately. The sales price is discounted from the applicable list price based on various factors including the type of customer, volume of sales, geographic region and program level. The Company's list prices are generally not fair value as discounts may be given based on the factors enumerated above. The Company uses historical sales transactions to determine whether VSOE can be established for each of the elements. In most instances, VSOE of fair value is the sales price of actual standalone (unbundled) transactions within the past 12 month period, when a substantial majority of transactions are priced within a narrow range, which the Company has determined to be plus or minus 15% of the median sales price.

The Company believes that the VSOE of fair value of training and consulting services is represented by the billable rate per hour, based on the rates charged to customers when they purchase standalone training or consulting services. The price of consulting services is not based on the type of customer, volume of sales, geographic region or program level.

The Company is typically not able to determine TPE for its products or services. TPE is determined based on competitor prices for similar elements when sold separately. Generally, the Company's go-to-market strategy differs from that of other competitive products or services in its markets and the Company's offerings contain a significant level of differentiation such that the comparable pricing of products with similar functionality cannot be obtained. Furthermore, the Company is unable to reliably determine the selling prices on a stand-alone basis of similar products offered by its competitors.

When the Company is unable to establish selling price using VSOE or TPE, the Company uses BESP in its allocation of arrangement consideration. The objective of BESP is to determine the price at which the Company would transact a sale if the product or service were sold on a stand-alone basis. The Company is generally not able to establish VSOE for non-software product sales. Instead, the Company has been able to establish BESP through the list price, less a discount deemed appropriate to maintain a reasonable gross margin. Management regularly reviews the gross margin information. Non-software product BESP is determined through the Company's review of historical sales transactions within the past 12 month period. Additional factors considered in determining an appropriate BESP include, but are not limited to, cost of products, pricing practices, geographies, customer classes, and distribution channels.

The Company regularly validates the VSOE of fair value and BESP for elements in its multiple element arrangements. The Company accounts for taxes collected from customers and remitted to governmental authorities on a net basis and excluded from revenues.



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### **Goodwill and Acquired Intangible Assets**

Goodwill represents the excess purchase price over the estimated fair value of net assets acquired as of the acquisition date. The Company tests goodwill for impairment on an annual basis and between annual tests when impairment indicators are identified, and goodwill is written down when impaired. Goodwill was recorded in connection with the acquisition of LineRate Systems, Inc. in February 2013, Traffix Systems in fiscal year 2012, Acopia Networks, Inc. in fiscal year 2007, Swan Labs, Inc. in fiscal year 2006, MagniFire Websystems, Inc. in fiscal year 2004 and uRoam, Inc. in fiscal year 2003. For its annual goodwill impairment test, the Company operates under one reporting unit and the fair value of its reporting unit is determined by the Company's enterprise value. The Company performs its annual goodwill impairment test during the second fiscal quarter.

As part of the annual goodwill impairment test, the Company first performs a qualitative assessment to determine whether further impairment testing is necessary. If, as a result of its qualitative assessment, it is more-likely-than-not (i.e. greater than 50% chance) that the fair value of the Company's reporting unit is less than its carrying amount, the quantitative impairment test will be required. Otherwise, no further testing will be required.

Examples of events and circumstances that might indicate that a reporting unit's fair value is less than its carrying amount include macro-economic conditions such as deterioration in the entity's operating environment or industry or market considerations; entity-specific events such as increasing costs, declining financial performance, or loss of key personnel; or other events such as an expectation that a reporting unit will be sold or a sustained decrease in the stock price on either an absolute basis or relative to peers.

If it is determined, as a result of the qualitative assessment, that it is more-likely-than-not that the fair value of the Company's reporting unit is less than its carrying amount, the provisions of authoritative guidance require that the Company perform a two-step impairment test on goodwill. The first step of the test identifies whether potential impairment may have occurred, while the second step of the test measures the amount of the impairment, if any. Impairment is recognized when the carrying amount of goodwill exceeds its fair value. In March 2013, the Company completed a qualitative assessment of potential impairment indicators and concluded that it was more-likely-than-not that the fair value of its reporting unit exceeded its carrying amount.

Acquired in-process research and development (IPR&D) are intangible assets initially recognized at fair value and classified as indefinite-lived assets until the successful completion or abandonment of the associated research and development efforts. During the development period, these assets will not be amortized as charges to earnings; instead these assets will be tested for impairment on an annual basis or more frequently if impairment indicators are identified. IPR&D was recorded in connection with the acquisition of LineRate Systems, Inc. in February 2013.

### **Stock-Based Compensation**

The Company accounts for stock-based compensation using the straight-line attribution method for recognizing compensation expense. The Company recognized \$27.6 million and \$23.3 million of stock-based compensation expense for the three months ended March 31, 2013 and 2012, respectively, and \$54.3 million and \$45.5 million for the six months ended March 31, 2013 and 2012, respectively. As of March 31, 2013, there was \$118.6 million of total unrecognized stock-based compensation cost, the majority of which will be recognized over the next two years. Going forward, stock-based compensation expenses may increase as the Company issues additional equity-based awards to continue to attract and retain key employees.

The Company issues incentive awards to its employees through stock-based compensation consisting of restricted stock units (RSUs). The value of RSUs is determined using the fair value method, which in this case, is based on the number of shares granted and the quoted price of the Company's common stock on the date of grant.

The Company recognizes compensation expense for only the portion of restricted stock units that are expected to vest. Therefore, the Company applies estimated forfeiture rates that are derived from historical employee termination behavior. Based on historical differences with forfeitures of stock-based awards granted to the Company's executive officers and Board of Directors versus grants awarded to all other employees, the Company has developed separate forfeiture expectations for these two groups. The Company's estimated forfeiture rate in the second quarter of fiscal year 2013 is 5.3% for grants awarded to the Company's executive officers and Board of Directors, and 7.6% for grants awarded to all other employees. If the actual number of forfeitures differs from those estimated by management, additional adjustments to compensation expense may be required in future periods.

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In November 2012, the Company granted 290,415 RSUs to certain current executive officers as part of the annual equity awards program. Fifty percent of the aggregate number of RSUs vest in equal quarterly increments over four years, until such portion of the grant is fully vested on November 1, 2016. One-eighth of the RSU grant, or a portion thereof, is subject to the Company achieving specified quarterly revenue and EBITDA goals during fiscal year 2013. In each case, 50% of the quarterly performance stock grant is based on achieving at least 80% of the quarterly revenue goal and the other 50% is based on achieving at least 80% of the quarterly EBITDA goal. The quarterly performance stock grant is paid linearly above 80% of the targeted goals. At least 100% of both goals must be attained in order for the quarterly performance stock grant to be awarded over 100%. Each goal is evaluated individually and subject to the 80% achievement threshold and 100% over-achievement threshold. The remaining 37.5% of this annual equity awards RSU grant shall be subject to quarterly performance based vesting for fiscal years 2014, 2015 and 2016 (12.5% in each period). The Compensation Committee of the Board of Directors will set applicable performance targets and vesting formulas for each of these periods.

In November 2011, as part of the annual review of executive compensation by the Compensation Committee of the Board of Directors and a change in the grant date for the Company's annual equity awards program for the executive officers from August 1 to November 1, the Company granted 82,968 RSUs to certain current executive officers. Fifty percent of the aggregate number of RSUs vest in equal quarterly increments over three years, until such portion of the grant is fully vested on November 1, 2014. One-sixth of the RSU grant, or a portion thereof, was subject to the Company achieving specified quarterly revenue and EBITDA goals during fiscal year 2012. In each case, 50% of the quarterly performance stock grant is based on achieving at least 80% of the quarterly revenue goal and the other 50% is based on achieving at least 80% of the quarterly EBITDA goal. The quarterly performance stock grant is paid linearly above 80% of the targeted goals. At least 100% of both goals must be attained in order for the quarterly performance stock grant to be awarded over 100%. Each goal is evaluated individually and subject to the 80% achievement threshold and 100% over-achievement threshold. The remaining 33.33% of this annual equity awards RSU grant shall be subject to quarterly performance based vesting for fiscal years 2013 and 2014 (16.66% in each period). The Compensation Committee of the Board of Directors will set applicable performance targets and vesting formulas for each of these periods.

In August 2011, the Company granted 170,390 RSUs to certain current executive officers as part of the annual equity awards program. Fifty percent of the aggregate number of RSUs granted as part of the annual equity awards program vest in equal quarterly increments over three years, until such portion of the grant is fully vested on August 1, 2014. One-sixth of the annual equity awards RSU grant, or a portion thereof, was subject to the Company achieving specified quarterly revenue and EBITDA goals during the period beginning in the fourth quarter of fiscal year 2011 through the third quarter of fiscal year 2012. In each case, 50% of the quarterly performance stock grant is based on achieving at least 80% of the quarterly revenue goal and the other 50% is based on achieving at least 80% of the quarterly EBITDA goal. The quarterly performance stock grant is paid linearly above 80% of the targeted goals. At least 100% of both goals must be attained in order for the quarterly performance stock grant to be awarded over 100%. Each goal is evaluated individually and subject to the 80% achievement threshold and 100% over-achievement threshold. The remaining 33.33% of this annual equity awards RSU grant shall be subject to performance based vesting for each of the four quarter periods beginning with the fourth quarters of fiscal years 2012 and 2013 (16.66% in each period). The Compensation Committee of the Board of Directors will set applicable performance targets and vesting formulas for each of these periods.

In August 2010, the Company granted 181,334 and 83,000 RSUs to certain current executive officers as part of the annual equity and retention awards programs, respectively. Fifty percent of the aggregate number of RSUs granted as part of the annual equity awards program vest in equal quarterly increments over three years, until such portion of the grant is fully vested on August 1, 2013. One-sixth of the annual equity awards RSU grant, or a portion thereof, was subject to the Company achieving specified quarterly revenue and EBITDA goals during the period beginning in the fourth quarter of fiscal year 2010 through the third quarter of fiscal year 2011. In each case, 50% of the quarterly performance stock grant is based on achieving at least 80% of the quarterly revenue goal and the other 50% is based on achieving at least 80% of the quarterly EBITDA goal. The quarterly performance stock grant is paid linearly above 80% of the targeted goals. At least 100% of both goals must be attained in order for the quarterly performance stock grant to be awarded over 100%. Each goal is evaluated individually and subject to the 80% achievement threshold and 100% over-achievement threshold. The remaining 33.33% of this annual equity awards RSU grant shall be subject to performance based vesting for each of the four quarter periods beginning with the fourth quarters of fiscal years 2011 and 2012 (16.66% in each period). The Compensation Committee of the Board of Directors will set applicable performance targets and vesting formulas for each of these periods. All RSUs granted as part of the retention awards program fully vest on August 1, 2013.

The Company recognizes compensation costs for awards with performance conditions when it concludes it is probable that the performance condition will be achieved. The Company reassesses the probability of vesting at each balance sheet date and adjusts compensation costs based on the probability assessment.

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On April 24, 2013, the Company announced that its Board of Directors authorized an additional \$200 million for its common stock share repurchase program. This new authorization is incremental to the existing \$600 million program, initially approved in October 2010 and expanded in August 2011 and October 2011. Acquisitions for the share repurchase programs will be made from time to time in private transactions or open market purchases as permitted by securities laws and other legal requirements. The programs can be terminated at any time. As of May 3, 2013, the Company had repurchased and retired 10,300,034 shares at an average price of \$70.13 per share and the Company had \$277.2 million remaining to purchase shares as part of its repurchase programs.

**Earnings Per Share**

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of common and dilutive common stock equivalent shares outstanding during the period. The Company's nonvested restricted stock awards and restricted stock units do not have nonforfeitable rights to dividends or dividend equivalents.

The following table sets forth the computation of basic and diluted net income per share (in thousands, except per share data):

	Three months ended March 31,		Six months ended March 31,	
	2013	2012	2013	2012
<b>Numerator</b>				
Net income	\$ 63,412	\$ 68,641	\$ 132,905	\$ 135,133
<b>Denominator</b>				
Weighted average shares outstanding basic	78,601	79,156	78,696	79,214
Dilutive effect of common shares from stock options and restricted stock units	513	619	567	639
Weighted average shares outstanding diluted	79,114	79,775	79,263	79,853
Basic net income per share	\$ 0.81	\$ 0.87	\$ 1.69	\$ 1.71
Diluted net income per share	\$ 0.80	\$ 0.86	\$ 1.68	\$ 1.69

An immaterial amount of common shares potentially issuable from stock options for the three and six months ended March 31, 2013 and 2012, are excluded from the calculation of diluted earnings per share because the exercise price was greater than the average market price of common stock for the respective period.

**Comprehensive Income**

Comprehensive income includes certain changes in equity that are excluded from net income. Specifically, unrealized gains or losses on securities and foreign currency translation adjustments are included in accumulated other comprehensive loss.

**Recent Accounting Pronouncements**

In February 2013, the FASB issued ASU 2013-02, *Comprehensive Income (Topic 220): Reporting of Amounts Reclassified out of Accumulated Other Comprehensive Income* (ASU 2013-02), to improve the reporting of reclassifications out of accumulated other comprehensive income. ASU 2013-02 requires presentation, either on the face of the financial statements or in the notes, of amounts reclassified out of accumulated other comprehensive income by component and by net income line item. ASU 2013-02 is effective prospectively for fiscal years, and interim periods within those years, beginning after December 15, 2012. The Company will adopt ASU 2013-02 in the first quarter of fiscal 2014 and does not expect the adoption of this standard to have an impact on its consolidated financial statements.



## **2. Fair Value Measurements**

In accordance with the authoritative guidance on fair value measurements and disclosure under GAAP, the Company determines fair value using a fair value hierarchy that distinguishes between market participant assumptions developed based on market data obtained from sources independent of the reporting entity, and the reporting entity's own assumptions about market participant assumptions developed based on the best information available in the circumstances and expands disclosure about fair value measurements.

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Fair value is the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants at the measurement date, essentially the exit price.

The levels of fair value hierarchy are:

**Level 1:** Quoted prices in active markets for identical assets and liabilities at the measurement date that the Company has the ability to access.

**Level 2:** Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

**Level 3:** Unobservable inputs for which there is little or no market data available. These inputs reflect management's assumptions of what market participants would use in pricing the asset or liability.

Level 1 investments are valued based on quoted market prices in active markets and include the Company's cash equivalent investments. Level 2 investments, which include investments that are valued based on quoted prices in markets that are not active, broker or dealer quotations, actual trade data, benchmark yields or alternative pricing sources with reasonable levels of price transparency, include the Company's certificates of deposit, corporate bonds and notes, municipal bonds and notes, U.S. government securities and U.S. government agency securities. Fair values for the Company's level 2 investments are based on similar assets without applying significant judgments. In addition, all of the Company's level 2 investments have a sufficient level of trading volume to demonstrate that the fair values used are appropriate for these investments.

A financial instrument's level within the fair value hierarchy is based upon the lowest level of any input that is significant to the fair value measurement. However, the determination of what constitutes observable requires significant judgment by the Company. The Company considers observable data to be market data which is readily available, regularly distributed or updated, reliable and verifiable, not proprietary, and provided by independent sources that are actively involved in the relevant market.

The Company's financial assets measured at fair value on a recurring basis subject to the disclosure requirements at March 31, 2013, were as follows (in thousands):

		Fair Value Measurements at Reporting Date Using			Fair Value at March 31, 2013
		Quoted Prices in Active Markets for Identical Securities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Cash equivalents		\$ 21,026	\$	\$	\$ 21,026
<b>Short-term investments</b>					
Available-for-sale securities	corporate bonds and notes		157,174		157,174
Available-for-sale securities	municipal bonds and notes		62,826		62,826
Available-for-sale securities	U.S. government securities		4,994		4,994
Available-for-sale securities	U.S. government agency securities		68,192		68,192
<b>Long-term investments</b>					
Available-for-sale securities	corporate bonds and notes		214,743		214,743
Available-for-sale securities	municipal bonds and notes		22,901		22,901
Available-for-sale securities	U.S. government securities		4,997		4,997
Available-for-sale securities	U.S. government agency securities		416,133		416,133
Available-for-sale securities	auction rate securities			4,048	4,048
Total		\$ 21,026	\$ 951,960	\$ 4,048	\$ 977,034

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The Company's financial assets measured at fair value on a recurring basis subject to the disclosure requirements at September 30, 2012, were as follows (in thousands):

		Fair Value Measurements at Reporting Date Using			Fair Value at September 30, 2012
		Quoted Prices in Active Markets for Identical Securities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Cash equivalents		\$ 35,658	\$	\$	\$ 35,658
<b>Short-term investments</b>					
Available-for-sale securities	certificates of deposit		3,533		3,533
Available-for-sale securities	corporate bonds and notes		193,990		193,990
Available-for-sale securities	municipal bonds and notes		63,422		63,422
Available-for-sale securities	U.S. government agency securities		60,025		60,025
<b>Long-term investments</b>					
Available-for-sale securities	corporate bonds and notes		229,441		229,441
Available-for-sale securities	municipal bonds and notes		30,307		30,307
Available-for-sale securities	U.S. government securities		4,995		4,995
Available-for-sale securities	U.S. government agency securities		393,310		393,310
Available-for-sale securities	auction rate securities			4,750	4,750
<b>Total</b>		<b>\$ 35,658</b>	<b>\$ 979,023</b>	<b>\$ 4,750</b>	<b>\$ 1,019,431</b>

Due to the auction failures of the Company's auction rate securities (ARS) that began in the second quarter of fiscal year 2008, there are still no quoted prices in active markets for similar assets as of March 31, 2013. Therefore, the Company has classified its ARS as level 3 financial assets. The following table provides a reconciliation between the beginning and ending balances of items measured at fair value on a recurring basis in the table above that used significant unobservable inputs (Level 3) (in thousands):

	Three months ended March 31,		Six months ended March 31,	
	2013	2012	2013	2012
<b>Balance, beginning of period</b>	\$ 4,600	\$ 13,064	\$ 4,750	\$ 13,010
Total gains (losses) realized or unrealized:				
Included in other comprehensive income	48	129	(102)	183
Settlements	(600)		(600)	
<b>Balance, end of period</b>	<b>\$ 4,048</b>	<b>\$ 13,193</b>	<b>\$ 4,048</b>	<b>\$ 13,193</b>

Unrealized gains (losses) attributable to assets still held as of end of period 48 129 (102) 183

Financial assets are considered Level 3 when their fair values are determined using pricing models, discounted cash flow methodologies or similar techniques and at least one significant model assumption or input is unobservable or there is limited market activity such that the determination of fair value requires significant judgment or estimation. Level 3 investment securities primarily include certain ARS for which there was a decrease in the observation of market pricing. At March 31, 2013, the values of these securities were estimated primarily using discounted cash flow analysis that incorporated transaction details such as contractual terms, maturity, timing and amount of future cash flows, as well as assumptions about liquidity and credit valuation adjustments of marketplace participants at March 31, 2013. Significant fluctuations in any of these inputs in isolation would result in changes in the fair value of the Company's ARS.

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The Company uses the fair value hierarchy for financial assets and liabilities. The Company's non-financial assets and liabilities, which include goodwill, intangible assets, and long-lived assets, are not required to be carried at fair value on a recurring basis. These non-financial assets and liabilities are measured at fair value on a non-recurring basis when there is an indicator of impairment, and they are recorded at fair value only when impairment is recognized. The Company reviews goodwill and intangible assets for impairment annually, during the second quarter of each fiscal year, or as circumstances indicate the possibility of impairment. The Company monitors the carrying value of long-lived assets for impairment whenever events or changes in circumstances indicate its carrying amount may not be recoverable. During the three months ended March 31, 2013, the Company did not recognize any impairment charges related to goodwill, intangible assets, or long-lived assets.

**3. Short-Term and Long-Term Investments**

Short-term investments consist of the following (in thousands):

	Cost or Amortized	Gross Unrealized	Gross Unrealized	Fair Value
March 31, 2013	Cost	Gains	Losses	
Corporate bonds and notes	\$ 156,831	\$ 357	\$ (14)	\$ 157,174
Municipal bonds and notes	62,725	103	(2)	62,826
U.S. government securities	4,995		(1)	4,994
U.S. government agency securities	68,176	20	(4)	68,192
	\$ 292,727	\$ 480	\$ (21)	\$ 293,186

	Cost or Amortized	Gross Unrealized	Gross Unrealized	Fair Value
September 30, 2012	Cost	Gains	Losses	
Certificates of deposit	\$ 3,528	\$ 5	\$	\$ 3,533
Corporate bonds and notes	193,548	482	(40)	193,990
Municipal bonds and notes	63,371	61	(10)	63,422
U.S. government agency securities	60,010	15		60,025
	\$ 320,457	\$ 563	\$ (50)	\$ 320,970

Long-term investments consist of the following (in thousands):

	Cost or Amortized	Gross Unrealized	Gross Unrealized	Fair Value
March 31, 2013	Cost	Gains	Losses	
Corporate bonds and notes	\$ 214,287	\$ 593	\$ (137)	\$ 214,743
Municipal bonds and notes	22,816	85		22,901
Auction rate securities	4,400		(352)	4,048
U.S. government securities	4,986	11		4,997
U.S. government agency securities	415,965	261	(93)	416,133
	\$ 662,454	\$ 950	\$ (582)	\$ 662,822

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	Cost or Amortized	Gross Unrealized	Gross Unrealized	Fair Value
September 30, 2012	Cost	Gains	Losses	
Corporate bonds and notes	\$ 228,438	\$ 1,063	\$ (60)	\$ 229,441
Municipal bonds and notes	30,177	138	(8)	30,307
Auction rate securities	5,000		(250)	4,750
U.S. government securities	4,983	12		4,995
U.S. government agency securities	392,959	389	(38)	393,310
	\$ 661,557	\$ 1,602	\$ (356)	\$ 662,803

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The amortized cost and fair value of fixed maturities at March 31, 2013, by contractual years-to-maturity, are presented below (in thousands):

	Cost or Amortized	Fair Value
	Cost	
One year or less	\$ 292,727	\$ 293,186
Over one year	662,454	662,822
	\$ 955,181	\$ 956,008

The following table summarizes investments that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for more than 12 months as of March 31, 2013 (in thousands):

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
<b>March 31, 2013</b>						
Corporate bonds and notes	\$ 110,750	\$ (146)	\$ 3,710	\$ (5)	\$ 114,460	\$ (151)
Municipal bonds and notes	6,727	(2)			6,727	(2)
Auction rate securities			4,048	(352)	4,048	(352)
U.S. government securities	4,994	(1)			4,994	(1)
U.S. government agency securities	173,061	(97)			173,061	(97)
Total	\$ 295,532	\$ (246)	\$ 7,758	\$ (357)	\$ 303,290	\$ (603)

The Company invests in securities that are rated investment grade or better. The unrealized losses on investments for the first six months of fiscal year 2013 were primarily caused by reductions in the values of the ARS due to the illiquid markets.

ARS are variable-rate debt securities. The Company limits its investments in ARS to securities that carry an AAA/A- (or equivalent) rating from recognized rating agencies and limits the amount of credit exposure to any one issuer. At the time of the Company's initial investment and at the date of this report, all ARS were in compliance with the Company's investment policy. In the past, the auction process allowed investors to obtain immediate liquidity if so desired by selling the securities at their face amounts. Liquidity for these securities has historically been provided by an auction process that resets interest rates on these investments on average every 7-35 days. However, as has been reported in the financial press, the disruptions in the credit markets adversely affected the auction market for these types of securities. The Company does not intend to sell nor is it more likely than not that it will be required to sell these investments before their anticipated recovery.

**4. Inventories**

The Company outsources the manufacturing of its pre-configured hardware platforms to contract manufacturers, who assemble each product to the Company's specifications. As protection against component shortages and to provide replacement parts for its service teams, the Company also stocks limited supplies of certain key product components. The Company reduces inventory to net realizable value based on excess and obsolete inventories determined primarily by historical usage and forecasted demand. Inventories consist of hardware and related component parts and are recorded at the lower of cost or market (as determined by the first-in, first-out method).

Inventories consist of the following (in thousands):

	March 31, 2013	September 30, 2012
Finished goods	\$ 13,543	\$ 13,565

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Raw materials	4,420	3,845
	\$ 17,963	\$ 17,410

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### **5. Commitments and Contingencies**

#### **Guarantees and Product Warranties**

In the normal course of business to facilitate sales of its products, the Company indemnifies other parties, including customers, resellers, lessors, and parties to other transactions with the Company, with respect to certain matters. The Company has agreed to hold the other party harmless against losses arising from a breach of representations or covenants, or out of intellectual property infringement or other claims made against certain parties. These agreements may limit the time within which an indemnification claim can be made and the amount of the claim. The Company has entered into indemnification agreements with its officers and directors, and the Company's bylaws contain similar indemnification obligations to the Company's agents. It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement.

The Company offers warranties of one year for hardware for those customers without service contracts, with the option of purchasing additional warranty coverage in yearly increments. The Company accrues for warranty costs as part of its cost of sales based on associated material product costs and technical support labor costs. Accrued warranty costs as of March 31, 2013 and March 31, 2012 were not material.

#### **Commitments**

As of March 31, 2013, the Company's principal commitments consisted of obligations outstanding under operating leases. The Company leases its facilities under operating leases that expire at various dates through 2023. There have been no material changes in the Company's principal lease commitments compared to those discussed in the Form 10-K.

The Company currently has arrangements with contract manufacturers and other suppliers for the manufacturing of its products. The arrangement with the primary contract manufacturer allows them to procure component inventory on the Company's behalf based on a rolling production forecast provided by the Company. The Company is obligated to the purchase of component inventory that the contract manufacturer procures in accordance with the forecast, unless they give notice of order cancellation in advance of applicable lead times. As of March 31, 2013, the Company was committed to purchase approximately \$18.1 million of such inventory during the next 30 day period.

#### **Legal Proceedings**

The Company is not aware of any pending legal proceedings that, individually or in the aggregate, would have a material adverse effect on the Company's business, operating results, or financial condition. The Company may in the future be party to litigation arising in the ordinary course of business, including claims that we allegedly infringe upon third-party intellectual property rights. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

### **6. Income Taxes**

The effective tax rate was 33.0% and 35.3% for the three months ended March 31, 2013 and 2012, respectively. The decrease in effective tax rate is primarily due to the tax benefit received as a result of the reinstatement of the United States federal Credit for Increasing Research Activities retroactive to January 1, 2012.

The effective tax rate was 35.2% and 35.0% for the six months ended March 31, 2013 and 2012, respectively. The tax benefit received as a result of the reinstatement of the United States federal Credit for Increasing Research Activities for the six months ended March 31, 2013 was offset by an increase in nondeductible expenses, primarily stock-based compensation, compared to the six months ended March 31, 2012.

As of March 31, 2013, the Company has \$7.9 million of unrecognized tax benefits that, if recognized, would affect the effective tax rate. It is reasonably possible that the Company's existing liabilities for unrecognized tax benefits may change within the next twelve months primarily due to the expiration of statutes of limitations. The Company recognizes interest and, if applicable, penalties for any uncertain tax positions as a component of income tax expense.

The Company and its subsidiaries are subject to U.S. federal income tax as well as the income tax of multiple state and foreign jurisdictions. The Company has concluded all U.S. federal income tax matters for fiscal years through September 30, 2008. Major jurisdictions where there are wholly owned subsidiaries of F5 Networks, Inc. which require income tax filings include the United Kingdom, Japan, Australia and Germany. The earliest periods open for review by local taxing authorities are fiscal years 2010 for the United Kingdom and Japan, and 2007 for Australia and Germany. Within the next four fiscal quarters, the statute of limitations will begin to close on the fiscal years ended 2008 and 2009 tax returns filed in various states and the fiscal year ended 2009 federal income tax return.





**Table of Contents****7. Geographic Sales and Significant Customers**

Operating segments are defined as components of an enterprise for which separate financial information is available and evaluated regularly by the chief operating decision-maker, or decision-making group, in deciding how to allocate resources and in assessing performance. The Company does business in four main geographic regions: the Americas (primarily the United States); Europe, the Middle East, and Africa (EMEA); Japan; and the Asia Pacific region (APAC). The Company's chief operating decision-making group reviews financial information presented on a consolidated basis accompanied by information about revenues by geographic region. The Company's foreign offices conduct sales, marketing and support activities. Revenues are attributed by geographic location based on the location of the customer. The Company's assets are primarily located in the United States and not allocated to any specific region. Therefore, geographic information is presented only for net revenue.

The following presents revenues by geographic region (in thousands):

	Three months ended March 31,		Six months ended March 31,	
	2013	2012	2013	2012
Americas:				
United States	\$ 172,410	\$ 181,218	\$ 367,248	\$ 352,205
Other	17,381	16,513	35,560	35,234
Total Americas	189,791	197,731	402,808	387,439
EMEA	80,930	71,348	163,788	139,420
Japan	21,852	22,947	39,895	43,149
Asia Pacific	57,659	47,596	109,192	92,046
	\$ 350,232	\$ 339,622	\$ 715,683	\$ 662,054

Three worldwide distributors of the Company's products accounted for 16.3%, 13.4%, and 11.1% of total net revenue for the three month period ended March 31, 2013. Three worldwide distributors of the Company's products accounted for 16.6%, 14.3%, and 11.1% of total net revenue for the six month period ended March 31, 2013. Two worldwide distributors of the Company's products accounted for 16.6% and 13.9% of total net revenue for the three month period ended March 31, 2012. Two worldwide distributors accounted for 17.2% and 13.8% of total net revenue for the six month period ended March 31, 2012. One worldwide distributor accounted for 13.5% of the Company's accounts receivable as of March 31, 2013. One worldwide distributor accounted for 18.0% of the Company's accounts receivable as of March 31, 2012. No other distributors accounted for more than 10% of total net revenue or receivables.

**8. Business Combinations**

The Company's acquisitions are accounted for under the acquisition method. The total purchase price is allocated to the tangible and intangible assets acquired and the liabilities assumed based on their estimated fair values. The excess of the purchase price over those fair values is recorded as goodwill. The fair value assigned to the tangible and intangible assets acquired and liabilities assumed are based on estimates and assumptions provided by management. Goodwill is not amortized but instead is tested for impairment at least annually, as described in Note 1.

***Fiscal Year 2013 Acquisition of LineRate Systems, Inc.***

On February 11, 2013, the Company acquired all issued and outstanding shares of LineRate Systems, Inc. (LineRate Systems), a privately held Delaware corporation headquartered in Louisville, Colorado for \$125.3 million. Direct transaction costs associated with the acquisition were approximately \$0.3 million and were expensed in the second quarter of fiscal 2013. LineRate Systems is a developer of software defined network service solutions for packet core operators, and cloud and web service providers. Through this acquisition, the Company gains access to LineRate Systems' layer 7+ networking services technology, intellectual property, and engineering talent. As a result of the acquisition, the Company acquired all the assets and assumed all the liabilities of LineRate Systems. The results of operations of LineRate Systems have been included in the Company's consolidated financial statements from the date of acquisition. Pro forma results of operations for this acquisition have not been presented as this transaction is not considered a material acquisition and the effects were not material to the Company's financial results for the three and six months ended March 31, 2013.



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The purchase price allocation is as follows (in thousands):

<b>Assets acquired</b>	
Cash	\$ 82
Current assets	556
Property and equipment, net	415
In-process research and development	29,853
Goodwill	99,560
<b>Total assets acquired</b>	<b>\$ 130,466</b>
<b>Liabilities assumed</b>	
Accrued liabilities	\$ (396)
Deferred tax liabilities, net	(4,763)
<b>Total liabilities assumed</b>	<b>(5,159)</b>
<b>Net assets acquired</b>	<b>\$ 125,307</b>

Of the total estimated purchase price, \$29.9 million was allocated to in-process research and development (IPR&D), which consists of existing research and development projects at the time of acquisition. IPR&D acquired from LineRate Systems is included in other assets, net on the balance sheet as of March 31, 2013. IPR&D assets are initially recognized at fair value and are classified as indefinite-lived assets until the successful completion or abandonment of the associated research and development efforts. Accordingly, during the development period after the acquisition date, this asset will not be amortized as charges to earnings; instead this asset will be subject to periodic impairment testing. Upon successful completion of the development process for the acquired IPR&D project, the asset would then be considered a finite-lived intangible asset and amortization of the asset will commence. The Company expects to complete the IPR&D project in 2014, at which point amortization will begin over its estimated useful life of ten years. To determine the fair value of IPR&D, the multi-period excess earnings method under the income approach was used, which included estimates and assumptions provided by LineRate Systems and Company management. The income approach estimates the fair value of an asset based on its earnings and cash flow capacity, which are discounted to present value. A discount rate of 35% was used to value the project based on the implied rate of return of the transaction, adjusted to reflect additional risks inherent in the acquired project. Goodwill generated from this transaction is primarily related to expected synergies, and is not expected to be deductible for federal tax purposes.

The fair value of replacement stock-based compensation awards issued by the Company attributable to precombination services was immaterial and has not been reflected in the consideration transferred.

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

The following discussion of our financial condition and results of operations contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. These statements include, but are not limited to, statements about our plans, objectives, expectations, strategies, intentions or other characterizations of future events or circumstances and are generally identified by the words expects, anticipates, intends, plans, believes, seeks, estimates, and similar expressions. These forward-looking statements are based on current information and expectations and are subject to a number of risks and uncertainties. Our actual results could differ materially from those expressed or implied by these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed under Item 1A. Risk Factors herein and in other documents we file from time to time with the Securities and Exchange Commission. We assume no obligation to revise or update any such forward-looking statements.

**Overview**

We offer a range of integrated software and hardware solutions within an intelligent services framework built on a common full proxy architecture. Organizations rely on these solutions to deliver and secure their applications and services while ensuring maximum availability and reliability for their customers, partners, and employees. We market and sell our products primarily through multiple



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indirect sales channels in the Americas (primarily the United States); Europe, the Middle East, and Africa (EMEA); Japan; and the Asia Pacific region (APAC). Enterprise customers (Fortune 1000 or Business Week Global 1000 companies) in the technology, telecommunications, financial services, transportation, education, manufacturing and health care industries, along with government customers, continue to make up the largest percentage of our customer base.

Our management team monitors and analyzes a number of key performance indicators in order to manage our business and evaluate our financial and operating performance on a consolidated basis. Those indicators include:

*Revenues.* The majority of our revenues are derived from sales of our application delivery networking (ADN) products including our high end VIPRION chassis and related software modules; BIG-IP Local Traffic Manager, BIG-IP Global Traffic Manager, BIG-IP Link Controller, BIG-IP Application Security Manager, BIG-IP Edge Gateway, BIG-IP WAN Optimization module, BIG-IP Access Policy Manager, WebAccelerator; FirePass SSL VPN appliance; Traffix diameter signaling products; and ARX file virtualization products. We also derive revenues from the sales of services including annual maintenance contracts, training and consulting services. We carefully monitor the sales mix of our revenues within each reporting period. We believe customer acceptance rates of our new products and feature enhancements are indicators of future trends. We also consider overall revenue concentration by customer and by geographic region as additional indicators of current and future trends.

*Cost of revenues and gross margins.* We strive to control our cost of revenues and thereby maintain our gross margins. Significant items impacting cost of revenues are hardware costs paid to our contract manufacturers, third-party software license fees, amortization of developed technology and personnel and overhead expenses. Our margins have remained relatively stable; however, factors such as sales price, product mix, inventory obsolescence, returns, component price increases and warranty costs could significantly impact our gross margins from quarter to quarter and represent significant indicators we monitor on a regular basis.

*Operating expenses.* Operating expenses are substantially driven by personnel and related overhead expenses. Existing headcount and future hiring plans are the predominant factors in analyzing and forecasting future operating expense trends. Other significant operating expenses that we monitor include marketing and promotions, travel, professional fees, computer costs related to the development of new products, facilities and depreciation expenses.

*Liquidity and cash flows.* Our financial condition remains strong with significant cash and investments and no long term debt. The increase in cash and investments for the first six months of fiscal year 2013 was primarily due to net income from operations, with operating activities providing cash of \$225.5 million. This increase was partially offset by \$100.0 million of cash used to repurchase outstanding common stock under our stock repurchase program in the first six months of fiscal year 2013. Going forward, we believe the primary driver of cash flows will be net income from operations. On February 11, 2013, we acquired all issued and outstanding shares of LineRate Systems, Inc. (LineRate Systems) for \$124.9 million in cash. Capital expenditures for the first six months of fiscal year 2013 were comprised primarily of information technology infrastructure and equipment purchases to support the growth of our core business activities, and expenses related to the addition and expansion of our worldwide facilities. We will continue to evaluate possible acquisitions of, or investments in businesses, products, or technologies that we believe are strategic, which may require the use of cash.

*Balance sheet.* We view cash, short-term and long-term investments, deferred revenue, accounts receivable balances and days sales outstanding as important indicators of our financial health. Deferred revenues increased in the second quarter of fiscal year 2013 due to growth in the amount of annual maintenance contracts purchased on new products and maintenance renewal contracts related to our existing product installation base. Our days sales outstanding for the second quarter of fiscal year 2013 was 50.

### **Summary of Critical Accounting Policies and Estimates**

The preparation of our financial condition and results of operations requires us to make judgments and estimates that may have a significant impact upon our financial results. We believe that, of our significant accounting policies, the following require estimates and assumptions that require complex, subjective judgments by management, which can materially impact reported results: revenue recognition; reserve for doubtful accounts; reserve for product returns; reserve for warranties; accounting for income taxes; stock-based compensation; investments; goodwill impairment; and the fair value measurements of financial assets and liabilities. None of these accounting policies and estimates have significantly changed since our annual report on Form 10-K for the year ended September 30, 2012 (Form 10-K). Critical accounting policies

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and estimates are more fully described in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Form 10-K. Actual results may differ from these estimates under different assumptions or conditions.

**Table of Contents****Results of Operations**

The following discussion and analysis should be read in conjunction with our consolidated financial statements, related notes and risk factors included elsewhere in this Quarterly Report on Form 10-Q.

	Three months ended March 31,		Six months ended March 31,	
	2013	2012	2013	2012
	(in thousands, except percentages)			
Net Revenues				
Products	\$ 185,107	\$ 205,165	\$ 389,819	\$ 401,719
Services	165,125	134,457	325,864	260,335
Total	\$ 350,232	\$ 339,622	\$ 715,683	\$ 662,054
Percentage of net revenues				
Products	52.9%	60.4%	54.5%	60.7%
Services	47.1	39.6	45.5	39.3
Total	100.0%	100.0%	100.0%	100.0%

*Net revenues.* Total net revenues increased 3.1% and 8.1% for the three and six months ended March 31, 2013, respectively, from the same periods in the prior year. Overall revenue growth for the three and six months ended March 31, 2013 was primarily due to increased service revenues as a result of our increased installed base of products. International revenues represented 50.8% and 48.7% of total net revenues for the three and six months ended March 31, 2013, respectively, compared to 46.6% and 46.8% for the same periods in the prior year, respectively. We expect international sales will continue to represent a significant portion of net revenues, although we cannot provide assurance that international revenues as a percentage of net revenues will remain at current levels.

Net product revenues decreased 9.8% and 3.0% for the three and six months ended March 31, 2013, respectively, from the same periods in the prior year. The decrease in net product revenues for the three and six months ended March 31, 2013 was primarily due to a decrease of \$19.1 and \$10.8 million in sales of our ADN products from the same periods in the prior year, respectively. Sales of our ADN products represented 98.8% of product revenues for both the three and six months ended March 31, 2013, compared to 98.4% and 98.6% of product revenues for the three and six months ended March 31, 2012, respectively.

Net service revenues increased 22.8% and 25.2% for the three and six months ended March 31, 2013, respectively, from the same periods in the prior year. The increase in net service revenues was primarily due to increases in the purchase or renewal of maintenance contracts driven by additions to our installed base of products.

Avnet Technology Solutions, Ingram Micro, and Westcon, three of our worldwide distributors, accounted for 16.3%, 13.4%, and 11.1% of our total net revenue for the three months ended March 31, 2013, respectively. Avnet Technology Solutions, Ingram Micro, and Westcon accounted for 16.6%, 14.3%, and 11.1% of our total net revenue for the six months ended March 31, 2013, respectively. Avnet Technology Solutions and Ingram Micro accounted for 16.6% and 13.9% of our total net revenue for the three months ended March 31, 2012, respectively. Avnet Technology Solutions and Ingram Micro accounted for 17.2% and 13.8% of our total net revenue for the six months ended March 31, 2012, respectively. Avnet Technology Solutions accounted for 13.5% of our accounts receivable as of March 31, 2013. Ingram Micro accounted for 18.0% of our accounts receivable as of March 31, 2012. No other distributors accounted for more than 10% of total net revenue or receivables.

	Three months ended March 31,		Six months ended March 31,	
	2013	2012	2013	2012
	(in thousands, except percentages)			
<b>Cost of net revenues and Gross Margin</b>				
Products	\$ 29,773	\$ 33,668	\$ 61,565	\$ 66,868



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Services	30,529	23,926	59,622	46,332
Total	60,302	57,594	121,187	113,200
Gross profit	\$ 289,930	\$ 282,028	\$ 594,496	\$ 548,854
<b>Percentage of net revenues and Gross Margin (as a percentage of related net revenue)</b>				
Products	16.1%	16.4%	15.8%	16.6%
Services	18.5	17.8	18.3	17.8
Total	17.2	17.0	16.9	17.1
Gross profit	82.8%	83.0%	83.1%	82.9%

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*Cost of net product revenues.* Cost of net product revenues consist of finished products purchased from our contract manufacturers, manufacturing overhead, freight, warranty, provisions for excess and obsolete inventory and amortization expenses in connection with developed technology from acquisitions. Cost of net product revenues decreased 11.6% and 7.9% for the three and six months ended March 31, 2013, respectively, as compared to the same periods in the prior year. The decrease in cost of net product revenues is primarily due to a reduction in the volume of product sales.

*Cost of net service revenues.* Cost of net service revenues consist of the salaries and related benefits of our professional services staff, travel, facilities and depreciation expenses. For the three and six months ended March 31, 2013, cost of net service revenues as a percentage of net service revenues were 18.5% and 18.3%, compared to 17.8% for both the three and six months ended March 31, 2012, respectively. Professional services headcount at the end of March 2013 increased to 707 from 583 at the end of March 2012. In addition, cost of net service revenues included stock-based compensation expense of \$2.7 million and \$5.3 million for the three and six months ended March 31, 2013, respectively, compared to \$2.2 million and \$4.4 million for the same periods in the prior year, respectively.

	Three months ended March 31,		Six months ended March 31,	
	2013	2012	2013	2012
	(in thousands, except percentages)			
<b>Operating expenses</b>				
Sales and marketing	\$ 119,031	\$ 110,995	\$ 241,299	\$ 217,233
Research and development	52,534	43,568	101,075	82,690
General and administrative	25,889	22,785	50,562	44,462
<b>Total</b>	<b>\$ 197,454</b>	<b>\$ 177,348</b>	<b>\$ 392,936</b>	<b>\$ 344,385</b>
<b>Operating expenses (as a percentage of net revenue)</b>				
Sales and marketing	34.0%	32.7%	33.7%	32.8%
Research and development	15.0	12.8	14.1	12.5
General and administrative	7.4	6.7	7.1	6.7
<b>Total</b>	<b>56.4%</b>	<b>52.2%</b>	<b>54.9%</b>	<b>52.0%</b>

*Sales and marketing.* Sales and marketing expenses consist of salaries, commissions and related benefits of our sales and marketing staff, the costs of our marketing programs, including public relations, advertising and trade shows, travel, facilities, and depreciation expenses. Sales and marketing expenses increased 7.2% and 11.1% for the three and six months ended March 31, 2013, respectively, from the comparable periods in the prior year. The increase in sales and marketing expense was primarily due to an increase of \$6.1 million and \$17.8 million in commissions and personnel costs for the three and six months ended March 31, 2013, respectively, from the comparable periods in the prior year. The increased commissions and personnel costs were driven primarily by growth in sales and marketing employee headcount for the corresponding periods. Sales and marketing headcount at the end of March 2013 increased to 1,291 from 1,198 at the end of March 2012. Sales and marketing expense included stock-based compensation expense of \$10.7 million and \$21.3 million for the three and six months ended March 31, 2013, respectively, compared to \$9.4 million and \$18.4 million for the same periods in the prior year, respectively. The increase in sales and marketing expense was also due to investments in marketing promotions and initiatives aimed at promoting our brand and creating market awareness of our technology and our products.

*Research and development.* Research and development expenses consist of the salaries and related benefits of our product development personnel, prototype materials and other expenses related to the development of new and improved products, facilities and depreciation expenses. Research and development expenses increased 20.6% and 22.2% for the three and six months ended March 31, 2013, respectively, from the comparable periods in the prior year. The increase in research and development expense was primarily due to an increase of \$6.5 million and \$13.9 million in personnel costs for the three and six months ended March 31, 2013, respectively, from the comparable periods in the prior year. Research and development headcount at the end of March 2013 increased to 835 from 721 at the end of March 2012. Research and development expense included stock-based compensation expense of \$8.3 million and \$16.1 million for the three and six months ended March 31, 2013, respectively, compared to \$6.5 million and \$12.3 million for the same periods in the prior year, respectively. We expect research and development expenses to remain consistent as a percentage of net revenue in the foreseeable future.



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*General and administrative.* General and administrative expenses consist of the salaries, benefits and related costs of our executive, finance, information technology, human resource and legal personnel, third-party professional service fees, bad debt charges, facilities and depreciation expenses. General and administrative expenses increased 13.6% and 13.7% for the three and six months ended March 31, 2013, respectively, from the comparable periods in the prior year. The increase in general and administrative expense was primarily due to an increase of \$1.2 million and \$2.7 million in personnel costs for the three and six months ended March 31, 2013, respectively, from the comparable periods in the prior year. In addition, fees paid to outside consultants for legal, audit and tax services increased \$0.9 million and \$1.3 million for the three and six months ended March 31, 2013, respectively, from the comparable periods in the prior year. Stock-based compensation expense was \$5.7 million and \$11.1 million for the three and six months ended March 31, 2013, respectively, compared to \$4.9 million and \$9.6 million for the same periods in the prior year, respectively. General and administrative headcount at the end of March 2013 increased to 322 from 303 at the end of March 2012.

	Three months ended March 31,		Six months ended March 31,	
	2013	2012	2013	2012
	(in thousands, except percentages)			
Other income and income taxes				
Income from operations	\$ 92,476	\$ 104,680	\$ 201,560	\$ 204,469
Other income, net	2,118	1,428	3,668	3,289
Income before income taxes	94,594	106,108	205,228	207,758
Provision for income taxes	31,182	37,467	72,323	72,625
Net income	\$ 63,412	\$ 68,641	\$ 132,905	\$ 135,133
Other income and income taxes (as percentage of net revenue)				
Income from operations	26.4%	30.8%	28.2%	30.9%
Other income, net	0.6	0.4	0.5	0.5
Income before income taxes	27.0	31.2	28.7	31.4
Provision for income taxes	8.9	11.0	10.1	11.0
Net income	18.1%	20.2%	18.6%	20.4%

*Other income, net.* Other income, net consists primarily of interest income and foreign currency transaction gains and losses. Other income, net for the three and six months ended March 31, 2013, remained relatively consistent compared to the same periods in the prior year.

*Provision for income taxes.* The effective tax rate was 33.0% and 35.3% for the three months ended March 31, 2013 and 2012, respectively. The decrease in the effective tax rate compared to the three month period ended March 31, 2012 is primarily due to the tax benefit received as a result of the reinstatement of the United States federal Credit for Increasing Research Activities retroactive to January 1, 2012.

The effective tax rate was 35.2% and 35.0% for the six months ended March 31, 2013 and 2012, respectively. The tax benefit received as a result of the reinstatement of the United States federal Credit for Increasing Research Activities for the six months ended March 31, 2013 was offset by an increase in nondeductible expenses, primarily stock-based compensation, compared to the six months ended March 31, 2012.

We record a valuation allowance to reduce our deferred tax assets to the amount we believe is more likely than not to be realized. In making these determinations we consider historical and projected taxable income, and ongoing prudent and feasible tax planning strategies in assessing the appropriateness of a valuation allowance. Our net deferred tax assets at March 31, 2013 and March 31, 2012 were \$41.7 million and \$44.5 million, respectively.

Our worldwide effective tax rate may fluctuate based on a number of factors including variations in projected taxable income in the various geographic locations in which we operate, changes in the valuation of our net deferred tax assets, resolution of potential exposures, tax positions taken on tax returns filed in the various geographic locations in which we operate, and the introduction of new accounting standards or changes in tax laws or interpretations thereof in the various geographic locations in which we operate. We have recorded liabilities to address potential tax exposures related to business and income tax positions we have taken that could be challenged by taxing authorities. The ultimate resolution

of these potential exposures may be greater or less than the liabilities recorded which could result in an adjustment to our future tax expense.

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### **Liquidity and Capital Resources**

Cash and cash equivalents, short-term investments and long-term investments totaled \$1,185.7 million as of March 31, 2013, compared to \$1,195.0 million as of September 30, 2012, representing a decrease of \$9.3 million. The decrease was primarily due to cash requirements of \$124.9 million for the purchase of LineRate Systems in the second fiscal quarter, and \$100.0 million of cash required for the repurchase of outstanding common stock under our stock repurchase program for the six months ended March 31, 2013. The decrease was partially offset by \$225.5 million of cash provided by operating activities. Cash provided by operating activities for the first six months of fiscal year 2013 resulted from net income of \$132.9 million combined with changes in operating assets and liabilities, as adjusted for various non-cash items including stock-based compensation, depreciation and amortization charges. Based on our current operating and capital expenditure forecasts, we believe that our existing cash and investment balances, excluding auction rate securities (ARS), together with cash generated from operations should be sufficient to meet our operating requirements for at least the next twelve months.

Cash used in investing activities was \$120.1 million for the six months ended March 31, 2013, compared to cash used in investing activities of \$171.6 million for the same period in the prior year. Investing activities include purchases, sales and maturities of available-for-sale securities, business acquisitions, capital expenditures and changes in restricted cash requirements. The amount of cash used in investing activities for the six months ended March 31, 2013 was primarily due to the purchase of investments and capital expenditures related to maintaining our operations worldwide, as well as \$124.9 million of cash payments to shareholders of LineRate Systems, which was acquired in February 2013, partially offset by the sales and maturity of investments.

Cash used in financing activities was \$85.6 million for the six months ended March 31, 2013, compared to cash used in financing activities of \$69.2 million for the same period in the prior year. Our financing activities for the six months ended March 31, 2013 consisted primarily of cash required for the repurchase of outstanding common stock under our stock repurchase program of \$100.0 million, partially offset by cash received from the exercise of employee stock options and stock purchases under our employee stock purchase plan of \$12.0 million.

### **Obligations and Commitments**

As of March 31, 2013, our principal commitments consisted of obligations outstanding under operating leases. We lease our facilities under operating leases that expire at various dates through 2023. There have been no material changes in our principal lease commitments compared to those discussed in the Form 10-K.

We outsource the manufacturing of our pre-configured hardware platforms to contract manufacturers who assemble each product to our specifications. Our agreement with our largest contract manufacturer allows them to procure component inventory on our behalf based upon a rolling production forecast. We are contractually obligated to purchase the component inventory in accordance with the forecast, unless we give notice of order cancellation in advance of applicable lead times. As of March 31, 2013, we were committed to purchase approximately \$18.1 million of such inventory during the next 30 day period.

### **Recent Accounting Pronouncements**

The anticipated impact of recent accounting pronouncements is discussed in Note 1 to the accompanying Notes to Consolidated Financial Statements of this Quarterly Report on Form 10-Q.

### **Risk Factors that May Affect Future Results**

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. Our business, operating results, financial performance and share price may be materially adversely affected by a number of factors, including but not limited to the following risk factors, any one of which could cause actual results to vary materially from anticipated results or from those expressed in any forward-looking statements made by us in this Quarterly Report on Form 10-Q or in other reports, press releases or other statements issued from time to time. Additional factors that may cause such a difference are set forth elsewhere in this Quarterly Report on Form 10-Q.

### ***Our quarterly and annual operating results may fluctuate in future periods, which may cause our stock price to fluctuate***

Our quarterly and annual operating results have varied significantly in the past and could vary significantly in the future, which makes it difficult for us to predict our future operating results. Our operating results may fluctuate due to a variety of factors, many of which are outside of our control, including the changing and recently volatile U.S. and global economic environment, which may



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cause our stock price to fluctuate. In particular, we anticipate that the size of customer orders may increase as we continue to focus on larger business accounts. A delay in the recognition of revenue, even from just one account, may have a significant negative impact on our results of operations for a given period. In the past, a majority of our sales have been realized near the end of a quarter. Accordingly, a delay in an anticipated sale past the end of a particular quarter may negatively impact our results of operations for that quarter, or in some cases, that fiscal year. Additionally, we have exposure to the credit risks of some of our customers and sub-tenants. Although we have programs in place that are designed to monitor and mitigate the associated risk, there can be no assurance that such programs will be effective in reducing our credit risks adequately. We monitor individual payment capability in granting credit arrangements, seek to limit the total credit to amounts we believe our customers can pay and maintain reserves we believe are adequate to cover exposure for potential losses. If there is a deterioration of a sub-tenant's or a major customer's creditworthiness or actual defaults are higher than expected, future losses, if incurred, could harm our business and have a material adverse effect on our operating results. Further, our operating results may be below the expectations of securities analysts and investors in future quarters or years. Our failure to meet these expectations will likely harm the market price of our common stock. Such a decline could occur, and has occurred in the past, even when we have met our publicly stated revenue and/or earnings guidance.

*In addition to other risks listed in this Risk Factors section, factors that may affect our operating results include, but are not limited to:*

fluctuations in demand for our products and services due to changing market conditions, pricing conditions, technology evolution, seasonality, or other changes in the global economic environment;

changes or fluctuations in sales and implementation cycles for our products and services;

reduced visibility into our customers' spending and implementation plans;

reductions in customers' budgets for data center and other IT purchases or delays in these purchases;

fluctuations in our gross margins, including the factors described herein, which may contribute to such fluctuations;

our ability to control costs, including operating expenses, the costs of hardware and software components, and other manufacturing costs;

our ability to develop, introduce and gain market acceptance of new products, technologies and services, and our success in new and evolving markets;

any significant changes in the competitive environment, including the entry of new competitors or the substantial discounting of products or services;

the timing and execution of product transitions or new product introductions, and related inventory costs;

variations in sales channels, product costs, or mix of products sold;

our ability to establish and manage our distribution channels, and the effectiveness of any changes we make to our distribution model;



the ability of our contract manufacturers and suppliers to provide component parts, hardware platforms and other products in a timely manner;

benefits anticipated from our investments in sales, marketing, product development, manufacturing or other activities;

changes in tax laws or regulations, or other accounting rules; and

general economic conditions, both domestically and in our foreign markets

***Our success depends on our timely development of new products and features, market acceptance of new product offerings and proper management of the timing of the life cycle of our products***

The application delivery networking and file virtualization markets are characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. Our continued success depends on our ability to identify and develop new products and new features for our existing products to meet the demands of these changes, and the acceptance of those products and features by our existing and target customers. If we are unable to identify, develop and deploy new products and new product features on a timely basis, our business and results of operations may be harmed.

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The current development cycle for our products is on average 12-24 months. The introduction of new products or product enhancements may shorten the life cycle of our existing products, or replace sales of some of our current products, thereby offsetting the benefit of even a successful product introduction, and may cause customers to defer purchasing our existing products in anticipation of the new products. This could harm our operating results by decreasing sales, increasing our inventory levels of older products and exposing us to greater risk of product obsolescence. We have also experienced, and may in the future experience, delays in developing and releasing new products and product enhancements. This has led to, and may in the future lead to, delayed sales, increased expenses and lower quarterly revenue than anticipated. Also, in the development of our products, we have experienced delays in the prototyping of our products, which in turn has led to delays in product introductions. In addition, complexity and difficulties in managing product transitions at the end-of-life stage of a product can create excess inventory of components associated with the outgoing product that can lead to increased expenses. Any or all of the above problems could materially harm our business and results of operations.

### ***Our success depends on sales and continued innovation of our application delivery networking product lines***

For the fiscal year ended September 30, 2012 and the six months ended March 31, 2013, we derived approximately 98.6% and 98.8% of our net product revenues, respectively, or approximately 58.6% and 53.8% of our total net revenues, respectively, from sales of our application delivery networking (ADN) product lines. We expect to continue to derive a significant portion of our net revenues from sales of our ADN products in the future. Implementation of our strategy depends upon these products being able to solve critical network availability, performance, and security problems for our customers. If our ADN products are unable to solve these problems for our customers or if we are unable to sustain the high levels of innovation in our ADN product feature set needed to maintain leadership in what will continue to be a competitive market environment, our business and results of operations will be harmed.

### ***We may not be able to compete effectively in the emerging application delivery networking and file virtualization markets***

The markets we serve are new, rapidly evolving and highly competitive, and we expect competition to persist and intensify in the future. Our principal competitors in the application delivery networking market include Brocade Communications Systems, Inc., Cisco Systems, Inc., Citrix Systems, Inc., Radware Ltd. and A10 Networks. In the adjacent WAN Optimization Controller market, we compete with Blue Coat Systems, Inc., Cisco, Citrix, Juniper Networks, Inc. and Riverbed Technology, Inc. In the file virtualization market, we compete with EMC Corporation. We expect to continue to face additional competition as new participants enter our markets. As we continue to expand globally, we may see new competitors in different geographic regions. In addition, larger companies with significant resources, brand recognition, and sales channels may form alliances with or acquire competing application delivery networking solutions from other companies and emerge as significant competitors. Potential competitors may bundle their products or incorporate an Internet traffic management or security component into existing products in a manner that discourages users from purchasing our products. Any of these circumstances may limit our opportunities for growth and negatively impact our financial performance.

### ***The average selling price of our products may decrease and our costs may increase, which may negatively impact gross profits***

It is possible that the average selling prices of our products will decrease in the future in response to competitive pricing pressures, increased sales discounts, new product introductions by us or our competitors or other factors. Therefore, in order to maintain our gross profits, we must develop and introduce new products and product enhancements on a timely basis and continually reduce our product costs. Our failure to do so will cause our net revenue and gross profits to decline, which will harm our business and results of operations. In addition, we may experience substantial period-to-period fluctuations in future operating results due to the erosion of our average selling prices.

### ***It is difficult to predict our future operating results because we have an unpredictable sales cycle***

Our products have a lengthy sales cycle and the timing of our revenue is difficult to predict. Historically, our sales cycle has ranged from approximately two to three months and has tended to lengthen as we have increasingly focused our sales efforts on the enterprise market. Also, as our distribution strategy has evolved into more of a channel model, utilizing value-added resellers, distributors and systems integrators, the level of variability in the length of sales cycle across transactions has increased and made it more difficult to predict the timing of many of our sales transactions. Sales of our products require us to educate potential customers in their use and benefits. Sales of our products are subject to delays from the lengthy internal budgeting, approval and competitive evaluation processes that large corporations and governmental entities may require. For example, customers frequently begin by evaluating our products on a limited basis and devote time and resources to testing our products before they decide whether or not to purchase. Customers may also defer orders as a result of anticipated releases of new products or enhancements by our competitors or us. As a result, our products have an unpredictable sales cycle that contributes to the uncertainty of our future operating results.



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### ***Our business may be harmed if our contract manufacturers are not able to provide us with adequate supplies of our products or if a single source of hardware assembly is lost or impaired***

We outsource the manufacturing of our hardware platforms to third party contract manufacturers who assemble these hardware platforms to our specifications. We have experienced minor delays in shipments from contract manufacturers in the past. However, if we experience major delays in the future or other problems, such as inferior quality and insufficient quantity of product, any one or a combination of these factors may harm our business and results of operations. The inability of our contract manufacturers to provide us with adequate supplies of our products or the loss of one or more of our contract manufacturers may cause a delay in our ability to fulfill orders while we obtain a replacement manufacturer and may harm our business and results of operations. In particular, we currently subcontract manufacturing of our application delivery networking products to a single contract manufacturer with whom we do not have a long-term contract. If our arrangement with this single source of hardware assembly was terminated or otherwise impaired, and we were not able to engage another contract manufacturer in a timely manner, our business, financial condition and results of operation could be adversely affected.

If the demand for our products grows, we will need to increase our raw material and component purchases, contract manufacturing capacity and internal test and quality control functions. Any disruptions in product flow may limit our revenue, may harm our competitive position and may result in additional costs or cancellation of orders by our customers.

### ***Our business could suffer if there are any interruptions or delays in the supply of hardware components from our third-party sources***

We currently purchase several hardware components used in the assembly of our products from a number of single or limited sources. Lead times for these components vary significantly. The unavailability of suitable components, any interruption or delay in the supply of any of these hardware components or the inability to procure a similar component from alternate sources at acceptable prices within a reasonable time, may delay assembly and sales of our products and, hence, our revenues, and may harm our business and results of operations.

### ***We are subject to governmental export and import controls that could subject us to liability or impair our ability to compete in international markets***

Our products are subject to U.S. export controls and may be exported outside the U.S. only with the required level of export license or through an export license exception because we incorporate encryption technology into our products. In addition, various countries regulate the import of certain encryption technology and have enacted laws that could limit our ability to distribute our products or our customers' ability to implement our products in those countries. Changes in our products or changes in export and import regulations may create delays in the introduction of our products in international markets, prevent our customers with international operations from deploying our products throughout their global systems or, in some cases, prevent the export or import of our products to certain countries altogether. Any change in export or import regulations or related legislation, shift in approach to the enforcement or scope of existing regulations or change in the countries, persons or technologies targeted by such regulations, could result in decreased use of our products by, or in our decreased ability to export or sell our products to, existing or potential customers with international operations. Any decreased use of our products or limitation on our ability to export or sell our products would likely adversely affect our business, operating results and financial condition.

### ***Reliance on shipments at the end of the quarter could cause our revenue for the applicable period to fall below expected levels***

As a result of customer buying patterns and the efforts of our sales force and channel partners to meet or exceed their sales objectives, we have historically received a substantial portion of sales orders and generated a substantial portion of revenue during the last few weeks of each fiscal quarter. In addition, any significant interruption in our information technology systems, which manage critical functions such as order processing, revenue recognition, financial forecasts, inventory and supply chain management, and trade compliance reviews, could result in delayed order fulfillment and decreased revenue for that fiscal quarter. If expected revenue at the end of any fiscal quarter is delayed for any reason, including the failure of anticipated purchase orders to materialize, our third party contract manufacturers' inability to manufacture and ship products prior to fiscal quarter-end to fulfill purchase orders received near the end of the fiscal quarter, our failure to manage inventory to meet demand, our inability to release new products on schedule, any failure of our systems related to order review and processing, or any delays in shipments based on trade compliance requirements, our revenue for that quarter could fall below our expectations, resulting in a decline in the trading price of our common stock.

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### ***We may not be able to adequately protect our intellectual property, and our products may infringe on the intellectual property rights of third parties***

We rely on a combination of patent, copyright, trademark and trade secret laws, and restrictions on disclosure of confidential and proprietary information to protect our intellectual property rights. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy or otherwise obtain and use our products or technology. Monitoring unauthorized use of our products is difficult, and we cannot be certain that the steps we have taken will prevent misappropriation of our technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States.

Our industry is characterized by the existence of a large number of patents and frequent claims and related litigation regarding patent and other intellectual property rights. In the ordinary course of our business, we are involved in disputes and licensing discussions with others regarding their claimed proprietary rights and cannot provide assurance that we will always successfully defend ourselves against such claims. We expect that infringement claims may increase as the number of products and competitors in our market increases and overlaps occur. Also, as we have gained greater visibility, market exposure and competitive success, we face a higher risk of being the subject of intellectual property infringement claims. If we are found to infringe the proprietary rights of others, or if we otherwise settle such claims, we could be compelled to pay damages or royalties and either obtain a license to those intellectual property rights or alter our products so that they no longer infringe upon such proprietary rights. Any license could be very expensive to obtain or may not be available at all. Similarly, changing our products or processes to avoid infringing upon the rights of others may be costly or impractical. In addition, we have initiated, and may in the future initiate, claims or litigation against third parties for infringement of our proprietary rights, or to determine the scope and validity of our proprietary rights or those of our competitors. Any of these claims, whether claims that we are infringing the proprietary rights of others, or vice versa, with or without merit, may be time-consuming, result in costly litigation and diversion of technical and management personnel or require us to cease using infringing technology, develop non-infringing technology or enter into royalty or licensing agreements. Further, our license agreements typically require us to indemnify our customers, distributors and resellers for infringement actions related to our technology, which could cause us to become involved in infringement claims made against our customers, distributors or resellers. Any of the above-described circumstances relating to intellectual property rights disputes could result in our business and results of operations being harmed.

We incorporate open source software into our products. Although we monitor our use of open source closely, the terms of many open source licenses have not been interpreted by U.S. courts, and there is a risk that such licenses could be construed in a manner that could impose unanticipated conditions or restrictions on our ability to commercialize our products. We could also be subject to similar conditions or restrictions should there be any changes in the licensing terms of the open source software incorporated into our products. In either event, we could be required to seek licenses from third parties in order to continue offering our products, to re-engineer our products or to discontinue the sale of our products in the event re-engineering cannot be accomplished on a timely or successful basis, any of which could adversely affect our business, operating results and financial condition.

Many of our products include intellectual property licensed from third parties. In the future, it may be necessary to renew licenses for third party intellectual property or obtain new licenses for other technology. These third party licenses may not be available to us on acceptable terms, if at all. The inability to obtain certain licenses, or litigation regarding the interpretation or enforcement of license rights and related intellectual property issues, could have a material adverse effect on our business, operating results and financial condition. Furthermore, we license some third party intellectual property on a non-exclusive basis and this may limit our ability to protect our intellectual property rights in our products.

### ***We may not be able to sustain or develop new distribution relationships, and a reduction or delay in sales to significant distribution partners could hurt our business***

We sell our products and services through multiple distribution channels in the United States and internationally, including leading industry distributors, value-added resellers, systems integrators, service providers and other indirect channel partners. We have a limited number of agreements with companies in these channels, and we may not be able to increase our number of distribution relationships or maintain our existing relationships. Recruiting and retaining qualified channel partners and training them in our technologies requires significant time and resources. These channel partners may also market, sell and support products and services that are competitive with ours and may devote more resources to the marketing, sales and support of such competitive products. Our indirect sales channel structure could subject us to lawsuits, potential liability, and reputational harm if, for example, any of our channel partners misrepresent the functionality of our products or services to customers or violate laws or our corporate policies. If we are unable to establish or maintain our indirect sales channels, our business and results of operations will be harmed. In addition, two worldwide distributors of our products accounted for 30.9% of our total net revenue for fiscal year 2012. Two worldwide distributors of our products accounted for 28.8% of our total net revenue for fiscal year 2011. Three worldwide distributors of our products accounted for 42.0% of our total net revenue for the six months ended March 31, 2013. A substantial reduction or delay in sales of our products to these distribution partners, if not replaced by sales to other indirect channel partners and distributors, could harm our business, operating results and financial condition.



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### ***Undetected software or hardware errors or security vulnerabilities may harm our business and results of operations***

Our products may contain undetected errors or defects when first introduced or as new versions are released. We have experienced these errors or defects in the past in connection with new products and product upgrades. We expect that these errors or defects will be found from time to time in new or enhanced products after commencement of commercial shipments. These problems may cause us to incur significant warranty and repair costs, divert the attention of our engineering personnel from our product development efforts and cause significant customer relations problems. We may also be subject to liability claims for damages related to product errors or defects. While we carry insurance policies covering this type of liability, these policies may not provide sufficient protection should a claim be asserted. A material product liability claim may harm our business and results of operations.

Our products must successfully operate with products from other vendors. As a result, when problems occur in a network, it may be difficult to identify the source of the problem. The occurrence of software or hardware problems, whether caused by our products or another vendor's products, may result in the delay or loss of market acceptance of our products. The occurrence of any of these problems may harm our business and results of operations.

Our products are used to manage critical applications and data for customers and third parties may attempt to exploit security vulnerabilities in our products. As we continue to focus on the development and marketing of security solutions, we become a bigger target for malicious computer hackers who wish to exploit security vulnerabilities in our products. These problems may cause us to incur significant remediation costs, divert the attention of our engineering personnel from our product development efforts and cause significant customer relations problems. Adverse publicity related to security vulnerabilities or damage to a customer's operations due to exploitation of security vulnerability in our products may harm our business and results of operations.

Any errors, defects or vulnerabilities in our products could result in:

expenditures of significant financial and product development resources in efforts to analyze, correct, eliminate, or work-around errors and defects or to address and eliminate vulnerabilities;

loss of existing or potential customers or channel partners;

delayed or lost revenue;

delay or failure to attain market acceptance;

an increase in warranty claims compared with our historical experience, or an increased cost of servicing warranty claims, either of which would adversely affect our gross margins; and

litigation, regulatory inquiries, or investigations that may be costly and harm our reputation.

### ***We are dependent on various information technology systems, and failures of or interruptions to those systems could harm our business***

Many of our business processes depend upon our information technology (IT) systems, the systems and processes of third parties, and on interfaces with the systems of third parties. For example, our order entry system provides information to the systems of our contract manufacturers, which enables them to build and ship our products. If those systems fail or are interrupted, or if our ability to connect to or interact with one or more networks is interrupted, our processes may function at a diminished level or not at all. This would harm our ability to ship products, and our financial results may be harmed.

In addition, reconfiguring our IT systems or other business processes in response to changing business needs may be time-consuming and costly. To the extent this impacted our ability to react timely to specific market or business opportunities, our financial results may be harmed.

*Adverse general economic conditions or reduced information technology spending may adversely impact our business*

A substantial portion of our business depends on the demand for information technology by large enterprise customers and service providers, the overall economic health of our current and prospective customers and the continued growth and evolution of the Internet. International, national, regional and local economic conditions, such as recessionary economic cycles, protracted economic slowdown or further deterioration of the economy could adversely impact demand for our products. The purchase of our products is often discretionary and may involve a significant commitment of capital and other resources. Continued weak economic conditions or a reduction in information technology spending even if economic conditions improve would likely result in longer sales cycles and reduced product sales, each of which would adversely impact our business, results of operations and financial condition.



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### ***Our operating results are exposed to risks associated with international commerce***

As our international sales increase, our operating results become more exposed to international operating risks. These risks include risks related to recessionary economic cycles or protracted slowdowns in economies outside the United States, foreign currency exchange rates, managing foreign sales offices, regulatory, political or economic conditions in specific countries, military conflict or terrorist activities, changes in laws and tariffs, inadequate protection of intellectual property rights in foreign countries, foreign regulatory requirements and natural disasters. We must hire and train experienced personnel to staff and manage our foreign operations. To the extent that we experience difficulties in recruiting, training, managing, and retaining an international staff, and specifically staff related to sales management and sales personnel, we may experience difficulties in sales productivity in foreign markets. We also enter into strategic distributor and reseller relationships with companies in certain international markets where we do not have a local presence. If we are not able to maintain successful strategic distributor relationships internationally or recruit additional companies to enter into strategic distributor relationships, our future success in these international markets could be limited. Business practices in the international markets that we serve may differ from those in the United States and may require us in the future to include terms other than our standard terms in customer contracts, although to date we generally have not done so. To the extent that we may enter into customer contracts in the future that include non-standard terms related to payment, warranties, or performance obligations, our operating results may be adversely impacted. All of these factors could have a material adverse effect on our business. We intend to continue expanding into international markets. Sales outside of the Americas represented 42.4% and 41.2% of our net revenues for the fiscal years ended September 30, 2012 and 2011, respectively, and 43.7% for the six months ended March 31, 2013.

### ***Changes in governmental regulations could negatively affect our revenues***

Our products are subject to various regulations promulgated by the United States and various foreign governments including, but not limited to, environmental regulations and regulations implementing export license requirements and restrictions on the import or export of some technologies, especially encryption technology. Changes in governmental regulation and our inability or failure to obtain required approvals, permits or registrations could harm our international and domestic sales and adversely affect our revenues, business and operations.

### ***Changes in financial accounting standards may cause adverse unexpected revenue fluctuations and affect our reported results of operations***

A change in accounting policies can have a significant effect on our reported results and may even affect our reporting of transactions completed before the change is effective. New pronouncements and updates to existing pronouncements have occurred with frequency and may occur in the future. Changes to existing rules, or changes to the interpretations of existing rules, could lead to changes in our accounting practices, and such changes could adversely affect our reported financial results or the way we conduct our business.

### ***We may have exposure to greater than anticipated tax liabilities***

Our provision for income taxes is subject to volatility and could be adversely affected by nondeductible stock-based compensation, changes in the research and development tax credit laws, earnings being lower than anticipated in jurisdictions where we have lower statutory rates and being higher than anticipated in jurisdictions where we have higher statutory rates, transfer pricing adjustments, not meeting the terms and conditions of tax holidays or incentives, changes in the valuation of our deferred tax assets and liabilities, changes in actual results versus our estimates, or changes in tax laws, regulations, accounting principles or interpretations thereof. In addition, like other companies, we may be subject to examination of our income tax returns by the U.S. Internal Revenue Service and other tax authorities. While we regularly assess the likelihood of adverse outcomes from such examinations and the adequacy of our provision for income taxes, there can be no assurance that such provision is sufficient and that a determination by a tax authority will not have an adverse effect on our results of operations.

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### ***Acquisitions present many risks and we may not realize the financial and strategic goals that are contemplated at the time of the transaction***

With respect to our past acquisitions, as well as any other future acquisitions we may undertake, we may find that the acquired businesses, products or technologies do not further our business strategy as expected, that we paid more than what the assets are later worth or that economic conditions change, all of which may generate future impairment charges. Our acquisitions may be viewed negatively by customers, financial markets or investors. There may be difficulty integrating the operations and personnel of the acquired business, and we may have difficulty retaining the key personnel of the acquired business. We may have difficulty in integrating the acquired technologies or products with our existing product lines. Our ongoing business and management's attention may be disrupted or diverted by transition or integration issues and the complexity of managing geographically and culturally diverse locations. We may have difficulty maintaining uniform standards, controls, procedures and policies across locations. We may experience significant problems or liabilities associated with product quality, technology and other matters.

Our inability to successfully operate and integrate newly-acquired businesses appropriately, effectively and in a timely manner, or to retain key personnel of any acquired business, could have a material adverse effect on our ability to take advantage of further growth in demand for integrated traffic management and security solutions and other advances in technology, as well as on our revenues, gross margins and expenses.

### ***Our success depends on our key personnel and our ability to hire, retain and motivate qualified sales and marketing, operations, product development and professional services personnel***

Our success depends to a significant degree upon the continued contributions of our key management, product development, sales, marketing and finance personnel, many of whom may be difficult to replace. The complexity of our application delivery networking products and their integration into existing networks and ongoing support, as well as the sophistication of our sales and marketing effort, requires us to retain highly trained professional services, customer support and sales personnel. Competition for qualified professional services, customer support and sales personnel in our industry is intense because of the limited number of people available with the necessary technical skills and understanding of our products. Our ability to hire and retain these personnel may be adversely affected by volatility or reductions in the price of our common stock, since these employees are generally granted restricted stock units. The loss of services of any of our key personnel, the inability to retain and attract qualified personnel in the future or delays in hiring qualified personnel may harm our business and results of operations.

### ***We face litigation risks***

We are a party to lawsuits in the normal course of our business. Litigation in general, and intellectual property and securities litigation in particular, can be expensive, lengthy and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. Responding to lawsuits has been, and will likely continue to be, expensive and time-consuming for us. An unfavorable resolution of these lawsuits could adversely affect our business, results of operations or financial condition.

### ***Anti-takeover provisions could make it more difficult for a third party to acquire us***

Our Board of Directors has the authority to issue up to 10,000,000 shares of preferred stock and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by the shareholders. The rights of the holders of common stock may be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. The issuance of preferred stock may have the effect of delaying, deferring or preventing a change of control of our company without further action by our shareholders and may adversely affect the voting and other rights of the holders of common stock. Further, certain provisions of our bylaws, including a provision limiting the ability of shareholders to raise matters at a meeting of shareholders without giving advance notice, may have the effect of delaying or preventing changes in control or management of our company, which could have an adverse effect on the market price of our common stock. In addition, our articles of incorporation currently provide for a staggered board, which may make it more difficult for a third party to gain control of our Board of Directors. Similarly, state anti-takeover laws in the State of Washington related to corporate takeovers may prevent or delay a change of control of our company.

### ***Our business is subject to the risks of earthquakes, fire, power outages, floods, and other catastrophic events, and to interruption by man-made problems such as terrorism***

A significant natural disaster, such as an earthquake, fire, a flood, or significant power outage could have a material adverse impact on our business, operating results, and financial condition. We have an administrative and product development office and a third party contract manufacturer located in the San Francisco Bay Area, a region known for seismic activity. In addition, natural disasters could affect our supply chain, manufacturing vendors, or logistics providers' ability to provide materials and perform services such as manufacturing products or assisting with shipments on a timely basis. In the event our or our service providers' information technology systems or manufacturing or

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logistics abilities are hindered by any of the events discussed above, shipments could be delayed, resulting in missed financial targets, such as revenue and shipment targets, for a particular quarter. In addition, cyber-attacks, acts of terrorism, or other geo-political unrest could cause disruptions in our business or the business of our supply chain, manufacturers, logistics providers, partners, or end-customers or the economy as a whole. Any disruption in the business of our supply chain, manufacturers, logistics providers, partners or end-customers that impacts sales at the end of a fiscal quarter could have a

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significant adverse impact on our quarterly results. All of the aforementioned risks may be further increased if the disaster recovery plans for us and our suppliers prove to be inadequate. To the extent that any of the above should result in delays or cancellations of customer orders, or the delay in the manufacture, deployment or shipment of our products, our business, financial condition and operating results would be adversely affected.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

At March 31, 2013, the fair value of our AAA/A- (or equivalent) rated municipal ARS was approximately \$4.0 million. ARS are collateralized long-term debt instruments that provide liquidity through a Dutch auction process that resets the applicable interest rate at pre-determined intervals, typically every 7, 28 or 35 days. Based on our expected operating cash flows and our other sources of cash, we do not believe that any reduction in liquidity of our municipal ARS will have a material impact on our overall ability to meet our liquidity needs. We have no intent to sell, won't be required to sell, and believe we will hold these securities until recovery. We believe certain of these available-for-sale investments may remain illiquid for longer than twelve months and as a result, we have classified \$4.4 million (par value) of securities as long-term as of March 31, 2013.

Management believes there have been no other material changes to our quantitative and qualitative disclosures about market risk during the six month period ended March 31, 2013, compared to those discussed in our Annual Report on Form 10-K for the year ended September 30, 2012.

### **Item 4. Controls and Procedures**

Our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) are designed to ensure that required information is properly recorded, processed, summarized and reported within the required timeframe, as specified in the rules set forth by the SEC. Our disclosure controls and procedures are also designed to ensure that information required to be disclosed is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosures.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of March 31, 2013. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of March 31, 2013.

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) or 15d-15(f) of the Exchange Act) during the period covered by this quarterly report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **Item 1. Legal Proceedings**

We are not aware of any pending legal proceedings that, individually or in the aggregate, would have a material adverse effect on our business, operating results, or financial condition. We may in the future be party to litigation arising in the ordinary course of business, including claims that we allegedly infringe upon third-party intellectual property rights. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources.

### **Item 1A. Risk Factors**

Information regarding risk factors appears in Part I Item 2 of this Quarterly Report on Form 10-Q, Management's Discussion and Analysis of Financial Condition and Results of Operations Risk Factors that May Affect Future Results. This information includes previously disclosed material changes to the risk factors set forth in Part I Item 1A of the Form 10-K.

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

On April 24, 2013, we announced that our Board of Directors authorized an additional \$200 million for our common stock share repurchase program. This new authorization is incremental to the existing \$600 million program, initially approved in October 2010 and expanded in August 2011 and October 2011. Acquisitions for the share repurchase programs will be made from time to time in private transactions or open market purchases as permitted by securities laws and other legal requirements. The programs can be terminated at any time. As of May 3, 2013, we had repurchased and retired 10,300,034 shares at an average price of \$70.13 per share and we had \$277.2 million remaining to purchase shares as part of our repurchase programs.

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Shares repurchased and retired as of May 3, 2013 are as follows (in thousands, except shares and per share data):

		Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased per the Publicly Announced Plan	Approximate Dollar Value of Shares that May Yet be Purchased Under the Plan
October 1, 2011	October 31, 2011		\$		\$ 366,038
November 1, 2011	November 30, 2011	179,000	\$ 106.05	179,000	\$ 347,049
December 1, 2011	December 31, 2011	141,100	\$ 109.69	141,100	\$ 331,566
January 1, 2012	January 31, 2012	58,706	\$ 121.49	58,706	\$ 324,431
February 1, 2012	February 29, 2012	227,400	\$ 124.54	227,400	\$ 296,103
March 1, 2012	March 31, 2012	118,000	\$ 125.72	118,000	\$ 281,263
April 1, 2012	April 30, 2012		\$		\$ 281,263
May 1, 2012	May 31, 2012	332,000	\$ 121.79	332,000	\$ 240,820
June 1, 2012	June 30, 2012	93,088	\$ 102.64	93,088	\$ 231,263
July 1, 2012	July 31, 2012	43,500	\$ 91.65	43,500	\$ 227,275
August 1, 2012	August 31, 2012	237,831	\$ 98.70	237,831	\$ 203,793
September 1, 2012	September 30, 2012	232,418	\$ 96.91	232,418	\$ 181,263
October 1, 2012	October 31, 2012		\$		\$ 181,263
November 1, 2012	November 30, 2012	322,187	\$ 87.58	322,187	\$ 153,035
December 1, 2012	December 31, 2012	233,056	\$ 93.39	233,056	\$ 131,263
January 1, 2013	January 31, 2013	15,000	\$ 105.75	15,000	\$ 129,676
February 1, 2013	February 28, 2013	237,438	\$ 102.74	237,438	\$ 105,274
March 1, 2013	March 31, 2013	255,979	\$ 93.77	255,979	\$ 81,263
April 1, 2013	April 30, 2013		\$		\$ 281,263
May 1, 2013	May 3, 2013	54,000	\$ 75.13	54,000	\$ 277,204

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### **Item 6. Exhibits**

#### **Exhibit**

<b>Number</b>	<b>Exhibit Description</b>
10.40*	LineRate Systems, Inc. Third Amended and Restated 2009 Equity Incentive Plan
10.41*	LineRate Systems, Inc. Acquisition Equity Incentive Plan
31.1**	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2**	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1**	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS***	XBRL Instance Document
101.SCH***	XBRL Taxonomy Extension Schema Document
101.CAL***	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF***	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB***	XBRL Taxonomy Extension Label Linkbase Document
101.PRE***	XBRL Taxonomy Extension Presentation Linkbase Document

\* Incorporated by reference from Registration Statement on Form S-8, File No. 333-186765

\*\* Filed herewith.

\*\*\* XBRL (Extensible Business Reporting Language) information is furnished and not filed herewith, is not a part of a registration statement or Prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, and otherwise is not subject to liability under these 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 on this 9th day of May, 2013.

F5 NETWORKS, INC.

By: /s/ ANDY REINLAND  
Andy Reinland  
Executive Vice President,  
Chief Financial Officer  
(principal financial officer)

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Unrealized Losses  
U.S. Government and agency obligations  
\$  
1,106

\$  
(80  
)

\$  
—

\$  
—

\$  
1,106

\$  
(80  
)  
Municipal bonds:



Taxable  
3,344

(110  
)

2,964

(94  
)

6,308

(204  
)  
Tax exempt  
31,234

(1,282  
)

303

(17  
)

31,537

(1,299  
)  
Total municipal bonds  
34,578

(1,392  
)

3,267

(111  
)

37,845

(1,503  
)

Mortgage-backed or related securities:

Multifamily agency guaranteed  
3,293

(58  
)

—

—

3,293

(58  
)

\$  
38,977

\$  
(1,530  
)

\$  
3,267

\$  
(111  
)

\$  
42,244

\$  
(1,641  
)

There were no sales of securities—held-to-maturity during the nine months ended September 30, 2014 and 2013. At September 30, 2014, there were 27 securities—held-to-maturity with unrealized losses, compared to 36 securities at December 31, 2013. Management does not believe that any individual unrealized loss as of September 30, 2014 represents OTTI. The decline in fair market value of these securities was generally due to changes in interest rates and changes in market-desired spreads subsequent to their purchase. There were no securities—held-to-maturity on nonaccrual status at September 30, 2014 or 2013.

The amortized cost and estimated fair value of securities—held-to-maturity at September 30, 2014 and December 31, 2013, by contractual maturity, are shown below (in thousands). Expected maturities will differ from contractual maturities because some securities may be called or prepaid with or without call or prepayment penalties.

	September 30, 2014		December 31, 2013	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Maturing in one year or less	\$940	\$947	\$1,270	\$1,281
Maturing after one year through five years	15,400	15,679	10,834	11,206
Maturing after five years through ten years	26,090	26,440	17,948	17,908
Maturing after ten years through twenty years	75,613	80,421	59,643	60,791
Maturing after twenty years	15,026	15,267	12,818	12,424
	\$133,069	\$138,754	\$102,513	\$103,610

Pledged Securities: The following table presents, as of September 30, 2014, investment securities and interest-bearing deposits which were pledged to secure borrowings, public deposits or other obligations as permitted or required by law (in thousands):

	Carrying Value	Amortized Cost	Fair Value
Purpose or beneficiary:			
State and local governments public deposits	\$137,864	\$137,738	\$143,306
Interest rate swap counterparties	9,751	9,405	9,751
Retail repurchase agreements	100,350	100,115	100,350
Other	248	248	248
Total pledged securities and interest-bearing deposits	\$248,213	\$247,506	\$253,655

#### Note 6: FHLB STOCK

The Banks' investments in Federal Home Loan Bank of Seattle stock are carried at cost, which is its par value (\$100 per share) and which reasonably approximates its fair value. As members of the FHLB system, the Banks are required to maintain a minimum level of investment in FHLB stock based on specific percentages of their outstanding FHLB advances. At September 30, 2014 and December 31, 2013, respectively, the Company had recorded \$29.1 million and \$35.4 million in investments in FHLB stock. This stock is generally viewed as a long-term investment and it does not have a readily determinable fair value. Ownership of FHLB stock is restricted to the FHLB and member institutions and can only be purchased and redeemed at par. For the three months ended September 30, 2014 and 2013, the Banks received dividend income of \$8,000 and \$9,000, respectively, on FHLB stock. For the nine months ended September 30, 2014 and 2013, the Banks received dividend income of \$26,000 and \$9,000, respectively, on FHLB stock.

Management periodically evaluates FHLB stock for impairment. Management's determination of whether these investments are impaired is based on its assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as (1) the significance of any decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB, and (4) the liquidity position of the FHLB.

Previously, the Federal Housing Finance Agency (the FHFA), the FHLB of Seattle's primary regulator, determined that the FHLB of Seattle had a risk-based capital deficiency as of December 31, 2008, and required the FHLB to suspend future dividends and the repurchase and redemption of outstanding common stock. Subsequent improvement in the FHLB's operating performance and financial condition, however, led to a September 7, 2012 announcement by the FHLB that the FHFA now considers the FHLB of Seattle to be adequately capitalized. Dividends on, or repurchases of, the FHLB of Seattle stock continue to require the consent of the FHFA. Since the third quarter of 2012, the FHFA has approved the repurchase of portions of FHLB of Seattle stock in each subsequent quarter and since the third quarter of 2013 has approved the payment of cash dividends by the FHLB of Seattle in each subsequent quarter. The FHLB repurchased \$2.1 million of the Banks' stock during the quarter ending September 30, 2014. Even though the payment of dividends and stock repurchases have resumed, the Company will continue to monitor the financial condition of the FHLB as it relates to, among other things, the recoverability of Banner's investment. On September 25, 2014, the FHLB of Seattle entered into an Agreement and Plan of Merger with and into the FHLB of Des Moines. The Merger approval is subject to a number of conditions including, among other things, member approval for each FHLB as well as regulatory approval. Based on the above, the Company has determined there was no impairment on its FHLB stock investment as of September 30, 2014.

Note 7: LOANS RECEIVABLE AND THE ALLOWANCE FOR LOAN LOSSES

The Banks originate residential mortgage loans for both portfolio investment and sale in the secondary market. At the time of origination, mortgage loans are designated as held for sale or held for investment. Loans held for sale are stated at the lower of cost or estimated market value determined on an aggregate basis. Net unrealized losses on loans held for sale are recognized through a valuation allowance by charges to income. The Banks also originate construction, land and land development, commercial and multifamily real estate, commercial business, agricultural business and consumer loans for portfolio investment. Loans receivable not designated as held for sale are recorded at the principal amount outstanding, net of deferred fees and origination costs, and discounts and premiums. Premiums, discounts and deferred loan fees and origination costs are amortized to maturity using the level-yield methodology.

Interest is accrued as earned unless management doubts the collectability of the loan or the unpaid interest. Interest accruals are generally discontinued when loans become 90 days past due for scheduled interest payments. All previously accrued but uncollected interest is deducted from interest income upon transfer to nonaccrual status. Future collection of interest is included in interest income based upon an assessment of the likelihood that the loans will be repaid or recovered. A loan may be put on nonaccrual status sooner than this policy would dictate if, in management's judgment, the loan may be uncollectable. Such interest is then recognized as income only if it is ultimately collected.

Loans receivable, including loans held for sale, at September 30, 2014 and December 31, 2013 are summarized as follows (dollars in thousands):

	September 30, 2014		December 31, 2013		
	Amount	Percent of Total	Amount	Percent of Total	
Commercial real estate:					
Owner-occupied	\$546,333	14.4	% \$502,601	14.7	%
Investment properties	854,284	22.4	692,457	20.3	
Multifamily real estate	183,944	4.8	137,153	4.0	
Commercial construction	18,606	0.5	12,168	0.4	
Multifamily construction	48,606	1.3	52,081	1.5	
One- to four-family construction	214,141	5.6	200,864	5.8	
Land and land development:					
Residential	89,649	2.4	75,695	2.2	
Commercial	10,505	0.3	10,450	0.3	
Commercial business	728,088	19.1	682,169	20.0	
Agricultural business, including secured by farmland	240,048	6.3	228,291	6.7	
One- to four-family residential	527,271	13.8	529,494	15.5	
Consumer:					
Consumer secured by one- to four-family	215,385	5.7	173,188	5.1	
Consumer-other	129,835	3.4	121,834	3.5	
Total loans outstanding	3,806,695	100.0	% 3,418,445	100.0	%
Less allowance for loan losses	(74,331 )		(74,258 )		
Net loans	\$3,732,364		\$3,344,187		

Loan amounts are net of unearned loan fees in excess of unamortized costs of \$8.0 million as of September 30, 2014 and \$8.3 million as of December 31, 2013.

The Company's total loans by geographic concentration at September 30, 2014 were as follows (dollars in thousands):

	Washington	Oregon	Idaho	Other	Total	
Commercial real estate:						
Owner-occupied	\$389,967	\$85,032	\$53,891	\$17,443	\$546,333	
Investment properties	532,415	123,874	59,963	138,032	854,284	
Multifamily real estate	141,337	27,685	14,847	75	183,944	
Commercial construction	16,953	—	1,653	—	18,606	
Multifamily construction	41,462	7,144	—	—	48,606	
One- to four-family construction	128,882	82,656	2,603	—	214,141	
Land and land development:						
Residential	50,257	38,327	1,065	—	89,649	
Commercial	5,055	2,569	2,881	—	10,505	
Commercial business	392,334	121,078	80,262	134,414	728,088	
Agricultural business, including secured by farmland	123,910	63,146	52,992	—	240,048	
One- to four-family residential	329,751	173,384	23,371	765	527,271	
Consumer:						
Consumer secured by one- to four-family	130,312	69,121	15,313	639	215,385	
Consumer—other	83,379	39,818	6,241	397	129,835	
Total loans	\$2,366,014	\$833,834	\$315,082	\$291,765	\$3,806,695	
Percent of total loans	62.1	% 21.9	% 8.3	% 7.7	% 100.0	%



The geographic concentrations of the Company's land and land development loans by state at September 30, 2014 were as follows (dollars in thousands):

	Washington	Oregon	Idaho	Total	
Residential:					
Acquisition and development	\$21,759	\$17,976	\$922	\$40,657	
Improved land and lots	25,062	19,122	143	44,327	
Unimproved land	3,436	1,229	—	4,665	
Commercial:					
Improved land and lots	2,863	489	1,784	5,136	
Unimproved land	2,192	2,080	1,097	5,369	
Total land and land development loans	\$55,312	\$40,896	\$3,946	\$100,154	
Percent of land and land development loans	55.3	% 40.8	% 3.9	% 100.0	%

The Company originates both adjustable- and fixed-rate loans. The maturity and repricing composition of those loans, less undisbursed amounts and deferred fees and origination costs, at September 30, 2014 and December 31, 2013 were as follows (in thousands):

	September 30, 2014	December 31, 2013
Fixed-rate (term to maturity):		
Maturing in one year or less	\$ 106,939	\$ 122,313
Maturing after one year through three years	165,930	143,322
Maturing after three years through five years	196,794	187,279
Maturing after five years through ten years	235,143	209,869
Maturing after ten years	551,436	439,004
Total fixed-rate loans	1,256,242	1,101,787
Adjustable-rate (term to rate adjustment):		
Maturing or repricing in one year or less	1,502,536	1,390,579
Maturing or repricing after one year through three years	408,079	279,791
Maturing or repricing after three years through five years	553,810	541,529
Maturing or repricing after five years through ten years	84,758	99,503
Maturing or repricing after ten years	1,270	5,256
Total adjustable-rate loans	2,550,453	2,316,658
Total loans	\$3,806,695	\$3,418,445

The adjustable-rate loans have interest rate adjustment limitations and are generally indexed to various prime or London Inter-bank Offering Rate (LIBOR) rates, One to Five Year Constant Maturity Treasury Indices or FHLB advance rates. Future market factors may affect the correlation of the interest rate adjustment with the rates the Banks pay on the short-term deposits that were primarily utilized to fund these loans.

**Impaired Loans and the Allowance for Loan Losses.** A loan is considered impaired when, based on current information and circumstances, the Company determines it is probable that it will be unable to collect all amounts due according to the contractual terms of the loan agreement, including scheduled interest payments. Impaired loans are comprised of loans on nonaccrual, troubled debt restructurings (TDRs) that are performing under their restructured terms, and loans that are 90 days or more past due, but are still on accrual.

**Troubled Debt Restructures.** Some of the Company's loans are reported as TDRs. Loans are reported as TDRs when the bank grants one or more concessions to a borrower experiencing financial difficulties that it would not otherwise consider. Examples of such concessions include forgiveness of principal or accrued interest, extending the maturity date(s) or providing a lower interest rate than would be normally available for a transaction of similar risk. Our TDRs have generally not involved forgiveness of amounts due, but almost always include a modification of multiple factors;



the most common combination includes interest rate, payment amount and maturity date. As a result of these concessions, restructured loans are impaired as the Company will not collect all amounts due, both principal and interest, in accordance with the terms of the original loan agreement. Loans identified as TDRs are accounted for in accordance with the Company's impaired loan accounting policies.

The amount of impaired loans and the related allocated reserve for loan losses as of September 30, 2014 and December 31, 2013 were as follows (in thousands):

	September 30, 2014		December 31, 2013	
	Loan Amount	Allocated Reserves	Loan Amount	Allocated Reserves
Impaired loans:				
Nonaccrual loans				
Commercial real estate:				
Owner-occupied	\$2,396	\$33	\$2,466	\$31
Investment properties	305	57	3,821	89
Multifamily real estate	397	55	—	—
One- to four-family construction	—	—	269	—
Land and land development:				
Residential	1,285	173	924	6
Commercial business	1,037	60	724	104
Agricultural business, including secured by farmland	229	15	—	—
One- to four-family residential	8,615	83	12,532	250
Consumer:				
Consumer secured by one- to four-family	724	34	903	13
Consumer—other	414	1	269	1
Total nonaccrual loans	15,402	511	21,908	494
Loans 90 days or more past due and still accruing				
Commercial real estate:				
Owner-occupied	993	1	—	—
Commercial business	301	6	—	—
Agricultural business, including secured by farmland	—	—	105	8
One- to four-family residential	2,777	12	2,611	16
Consumer:				
Consumer secured by one- to four-family	—	—	13	—
Consumer—other	306	—	131	1
Total loans past due and still accruing	4,377	19	2,860	25
Troubled debt restructuring on accrual status:				
Commercial real estate:				
Owner-occupied	184	4	186	4
Investment properties	6,062	751	5,367	415
Multifamily real estate	791	91	5,744	1,139
One- to four-family construction	3,721	620	6,864	1,002
Land and land development:				
Residential	1,637	476	4,061	754
Commercial business	880	103	1,299	222
One- to four-family residential	16,677	1,074	23,302	1,355
Consumer:				
Consumer secured by one- to four-family	233	30	360	33
Consumer—other	202	6	245	34
Total troubled debt restructurings on accrual status	30,387	3,155	47,428	4,958

Total impaired loans	\$50,166	\$3,685	\$72,196	\$5,477
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As of September 30, 2014 and December 31, 2013, the Company had commitments to advance funds related to TDRs up to additional amounts of \$788,000 and \$225,000, respectively.

The following tables provide additional information on impaired loans with and without specific allowance reserves at or for the nine months ended September 30, 2014 and at or for the year ended December 31, 2013 (in thousands):

At or For the Nine Months Ended September 30, 2014

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Without a specific allowance reserve <sup>(1)</sup>					
Commercial real estate:					
Owner-occupied	\$1,565	\$1,614	\$34	\$1,579	\$38
Investment properties	305	850	57	325	—
Multifamily real estate	397	397	55	423	—
Commercial business	1,338	1,705	66	1,307	14
Agricultural business/farmland	229	229	15	102	—
One- to four-family residential	9,179	9,809	26	9,439	89
Consumer:					
Consumer secured by one- to four-family	628	641	12	642	—
Consumer—other	602	607	1	607	12
	14,243	15,852	266	14,424	153
With a specific allowance reserve <sup>(2)</sup>					
Commercial real estate:					
Owner-occupied	2,008	2,008	4	1,555	8
Investment properties	6,062	6,467	751	6,124	238
Multifamily real estate	791	791	91	797	34
One- to four family construction	3,721	3,721	620	3,501	120
Land and land development:					
Residential	2,922	4,078	649	2,937	67
Commercial business	880	880	103	918	38
One- to four-family residential	18,890	19,652	1,143	19,457	659
Consumer:					
Consumer secured by one- to four-family	329	329	52	383	13
Consumer—other	320	336	6	331	15
	35,923	38,262	3,419	36,003	1,192
Total					
Commercial real estate:					
Owner-occupied	3,573	3,622	38	3,134	46
Investment properties	6,367	7,317	808	6,449	238
Multifamily real estate	1,188	1,188	146	1,220	34
One- to four-family construction	3,721	3,721	620	3,501	120
Land and land development:					
Residential	2,922	4,078	649	2,937	67
Commercial business	2,218	2,585	169	2,225	52
Agricultural business/farmland	229	229	15	102	—
One- to four-family residential	28,069	29,461	1,169	28,896	748
Consumer:					
Consumer secured by one- to four-family	957	970	64	1,025	13
Consumer—other	922	943	7	938	27
	\$50,166	\$54,114	\$3,685	\$50,427	\$1,345

	At or For the Year Ended December 31, 2013				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Without a specific allowance reserve <sup>(1)</sup>					
Commercial real estate:					
Owner-occupied	\$534	\$584	\$31	\$569	\$—
Investment properties	429	974	89	624	—
Commercial business	724	1,040	104	896	—
Agricultural business/farmland	105	105	8	110	8
One- to four-family residential	8,611	9,229	42	8,889	31
Consumer:					
Consumer secured by one- to four-family	870	1,013	13	900	1
Consumer—other	276	285	2	287	8
	11,549	13,230	289	12,275	48
With a specific allowance reserve <sup>(2)</sup>					
Commercial real estate:					
Owner-occupied	2,118	2,118	4	2,192	12
Investment properties	8,759	10,395	415	8,353	241
Multifamily real estate	5,744	5,744	1,139	5,705	298
One- to four family construction	7,133	7,213	1,002	5,870	239
Land and land development:					
Residential	4,985	6,140	760	6,053	221
Commercial business	1,298	1,298	222	1,340	59
One- to four-family residential	29,834	31,440	1,579	31,668	1,032
Consumer:					
Consumer secured by one- to four-family	406	407	33	503	24
Consumer—other	370	386	34	390	21
	60,647	65,141	5,188	62,074	2,147
Total					
Commercial real estate					
Owner-occupied	2,652	2,702	35	2,761	12
Investment properties	9,188	11,369	504	8,977	241
Multifamily real estate	5,744	5,744	1,139	5,705	298
One- to four-family construction	7,133	7,213	1,002	5,870	239
Land and land development					
Residential	4,985	6,140	760	6,053	221
Commercial business	2,022	2,338	326	2,236	59
Agricultural business/farmland	105	105	8	110	8
One- to four-family residential	38,445	40,669	1,621	40,557	1,063
Consumer					
Consumer secured by one- to four-family	1,276	1,420	46	1,403	25
Consumer—other	646	671	36	677	29
	\$72,196	\$78,371	\$5,477	\$74,349	\$2,195

(1) Loans without a specific allowance reserve have not been individually evaluated for impairment, but have been included in pools of homogeneous loans for evaluation of related allowance reserves.

(2) Loans with a specific allowance reserve have been individually evaluated for impairment using either a discounted cash flow analysis or, for collateral dependent loans, current appraisals less costs to sell to establish realizable value. These analyses may identify a specific impairment amount needed or may conclude that no reserve is

needed. Any specific impairment that is identified is included in the category's Related Allowance column.

The following tables present TDRs at September 30, 2014 and December 31, 2013 (in thousands):

	September 30, 2014		
	Accrual Status	Nonaccrual Status	Total TDRs
Commercial real estate:			
Owner-occupied	\$184	\$110	\$294
Investment properties	6,062	38	6,100
Multifamily real estate	791	—	791
One- to four-family construction	3,721	—	3,721
Land and land development:			
Residential	1,637	535	2,172
Commercial business	880	103	983
One- to four-family residential	16,677	950	17,627
Consumer:			
Consumer secured by one- to four-family	233	119	352
Consumer—other	202	117	319
	\$30,387	\$1,972	\$32,359

	December 31, 2013		
	Accrual Status	Nonaccrual Status	Total TDRs
Commercial real estate:			
Owner-occupied	\$186	\$613	\$799
Investment properties	5,367	1,630	6,997
Multifamily real estate	5,744	—	5,744
One- to four-family construction	6,864	269	7,133
Land and land development:			
Residential	4,061	174	4,235
Commercial business	1,299	164	1,463
One- to four-family residential	23,302	2,474	25,776
Consumer:			
Consumer secured by one- to four-family	360	252	612
Consumer—other	245	123	368
	\$47,428	\$5,699	\$53,127

The following tables present new TDRs that occurred during the three and nine months ended September 30, 2014 and 2013 (dollars in thousands):

	Three Months Ended September 30, 2014			Nine Months Ended September 30, 2014		
	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment
Recorded Investment <sup>(1) (2)</sup>						
Commercial real estate						
Owner occupied	—	\$ —	\$ —	1	\$94	\$94
One- to four-family construction	1	388	388	5	1,369	1,369
Commercial business	—	—	—	1	100	100
One- to four-family residential	2	434	434	2	434	434
Consumer-other	—	—	—	1	9	9
	3	\$ 822	\$ 822	10	\$2,006	\$2,006
	Three Months Ended September 30, 2013			Nine Months Ended September 30, 2013		
	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment	Number of Contracts	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment
Recorded Investment <sup>(1) (2)</sup>						
Multifamily real estate	—	\$ —	\$ —	1	\$376	\$376
One- to four-family construction	3	773	773	11	3,008	3,008
Land and land development—residential	2	1,029	1,029	2	1,029	1,029
One- to four-family residential	—	—	—	10	2,923	2,923
	5	\$ 1,802	\$ 1,802	24	\$7,336	\$7,336

- (1) Since most loans were already considered classified and/or on nonaccrual status prior to restructuring, the modifications did not have a material effect on the Company's determination of the allowance for loan losses. The majority of these modifications do not fit into one separate type, such as rate, term, amount, interest-only or payment, but instead are a combination of multiple types of modifications; therefore, they are disclosed in aggregate.
- (2) payment, but instead are a combination of multiple types of modifications; therefore, they are disclosed in aggregate.

The following table presents TDRs which incurred a payment default within twelve months of the restructure date during the three and nine month periods ended September 30, 2014 and 2013 (in thousands). A default on a TDR results in either a transfer to nonaccrual status or a partial charge-off:

	Three Months Ended September 30		Nine Months Ended September 30	
	2014	2013	2014	2013
Commercial business	\$—	\$137	\$—	\$137
Total	\$—	\$137	\$—	\$137





**Credit Quality Indicators:** To appropriately and effectively manage the ongoing credit quality of the Company's loan portfolio, management has implemented a risk-rating or loan grading system for its loans. The system is a tool to evaluate portfolio asset quality throughout each applicable loan's life as an asset of the Company. Generally, loans and leases are risk rated on an aggregate borrower/relationship basis with individual loans sharing similar ratings. There are some instances when specific situations relating to individual loans will provide the basis for different risk ratings within the aggregate relationship. Loans are graded on a scale of 1 to 9. A description of the general characteristics of these categories is shown below:

**Overall Risk Rating Definitions:** Risk-ratings contain both qualitative and quantitative measurements and take into account the financial strength of a borrower and the structure of the loan or lease. Consequently, the definitions are to be applied in the context of each lending transaction and judgment must also be used to determine the appropriate risk rating, as it is not unusual for a loan or lease to exhibit characteristics of more than one risk-rating category. Consideration for the final rating is centered in the borrower's ability to repay, in a timely fashion, both principal and interest. There were no material changes in the risk-rating or loan grading system in the nine months ended September 30, 2014.

**Risk Rating 1: Exceptional**

A credit supported by exceptional financial strength, stability, and liquidity. The risk rating of 1 is reserved for the Company's top quality loans, generally reserved for investment grade credits underwritten to the standards of institutional credit providers.

**Risk Rating 2: Excellent**

A credit supported by excellent financial strength, stability and liquidity. The risk rating of 2 is reserved for very strong and highly stable customers with ready access to alternative financing sources.

**Risk Rating 3: Strong**

A credit supported by good overall financial strength and stability. Collateral margins are strong; cash flow is stable although susceptible to cyclical market changes.

**Risk Rating 4: Acceptable**

A credit supported by the borrower's adequate financial strength and stability. Assets and cash flow are reasonably sound and provide for orderly debt reduction. Access to alternative financing sources will be more difficult to obtain.

**Risk Rating 5: Watch**

A credit with the characteristics of an acceptable credit which requires, however, more than the normal level of supervision and warrants formal quarterly management reporting. Credits in this category are not yet criticized or classified, but due to adverse events or aspects of underwriting require closer than normal supervision. Generally, credits should be watch credits in most cases for six months or less as the impact of stress factors are analyzed.

**Risk Rating 6: Special Mention**

A credit with potential weaknesses that deserves management's close attention is risk rated a 6. If left uncorrected, these potential weaknesses will result in deterioration in the capacity to repay debt. A key distinction between Special Mention and Substandard is that in a Special Mention credit, there are identified weaknesses that pose potential risk(s) to the repayment sources, versus well defined weaknesses that pose risk(s) to the repayment sources. Assets in this category are expected to be in this category no more than 9-12 months as the potential weaknesses in the credit are resolved.

**Risk Rating 7: Substandard**

A credit with well defined weaknesses that jeopardize the ability to repay in full is risk rated a 7. These credits are inadequately protected by either the sound net worth and payment capacity of the borrower or the value of pledged

collateral. These are credits with a distinct possibility of loss. Loans headed for foreclosure and/or legal action due to deterioration are rated 7 or worse.

**Risk Rating 8: Doubtful**

A credit with an extremely high probability of loss is risk rated 8. These credits have all the same critical weaknesses that are found in a substandard loan; however, the weaknesses are elevated to the point that based upon current information, collection or liquidation in full is improbable. While some loss on doubtful credits is expected, pending events may strengthen a credit making the amount and timing of any loss indeterminable. In these situations taking the loss is inappropriate until it is clear that the pending event has failed to strengthen the credit and improve the capacity to repay debt.

**Risk Rating 9: Loss**

A credit that is considered to be currently uncollectible or of such little value that it is no longer a viable Bank asset is risk rated 9. Losses should be taken in the accounting period in which the credit is determined to be uncollectible. Taking a loss does not mean that a credit has absolutely no recovery or salvage value but, rather, it is not practical or desirable to defer writing off the credit, even though partial recovery may occur in the future.

The following table shows the Company's portfolio of risk-rated loans and non-risk-rated loans by grade or other characteristics as of September 30, 2014 and December 31, 2013 (in thousands):

	September 30, 2014							
	Commercial Real Estate	Multifamily Real Estate	Construction and Land	Commercial Business	Agricultural Business	One- to Four-Family Residential	Consumer	Total Loans
Risk-rated loans:								
Pass (Risk Ratings 1-5) <sup>(1)</sup>	\$1,366,811	\$182,727	\$364,770	\$684,572	\$234,787	\$514,857	\$342,524	\$3,691,048
Special mention	5,147	—	—	34,137	1,183	64	144	40,675
Substandard	28,394	1,217	16,737	9,372	4,078	12,350	2,541	74,689
Doubtful	265	—	—	7	—	—	11	283
Loss	—	—	—	—	—	—	—	—
Total loans	\$1,400,617	\$183,944	\$381,507	\$728,088	\$240,048	\$527,271	\$345,220	\$3,806,695
Performing loans	\$1,396,923	\$183,547	\$380,222	\$726,750	\$239,819	\$515,879	\$343,776	\$3,786,916
Non-performing loans <sup>(2)</sup>	3,694	397	1,285	1,338	229	11,392	1,444	19,779
Total loans	\$1,400,617	\$183,944	\$381,507	\$728,088	\$240,048	\$527,271	\$345,220	\$3,806,695
	December 31, 2013							
	Commercial Real Estate	Multifamily Real Estate	Construction and Land	Commercial Business	Agricultural Business	One- to Four-Family Residential	Consumer	Total Loans
Risk-rated loans:								
Pass (Risk Ratings 1-5) <sup>(1)</sup>	\$1,160,921	\$131,523	\$332,150	\$655,007	\$225,329	\$511,967	\$291,992	\$3,308,889
Special mention	6,614	—	350	10,484	561	—	106	18,115
Substandard	26,979	5,630	18,758	16,669	2,401	17,527	2,924	90,888
Doubtful	544	—	—	9	—	—	—	553
Loss	—	—	—	—	—	—	—	—
Total loans	\$1,195,058	\$137,153	\$351,258	\$682,169	\$228,291	\$529,494	\$295,022	\$3,418,445
Performing loans	\$1,188,771	\$137,153	\$350,065	\$681,445	\$228,187	\$514,351	\$293,705	\$3,393,677
Non-performing loans <sup>(2)</sup>	6,287	—	1,193	724	104	15,143	1,317	24,768
Total loans	\$1,195,058	\$137,153	\$351,258	\$682,169	\$228,291	\$529,494	\$295,022	\$3,418,445

The Pass category includes some performing loans that are part of homogenous pools which are not individually risk-rated. This includes all consumer loans, all one- to four-family residential loans and, as of September 30,

<sup>(1)</sup> 2014 and December 31, 2013, in the commercial business category, \$109 million and \$94 million, respectively, of credit-scored small business loans. As loans in these pools become non-performing, they are individually risk-rated.

<sup>(2)</sup> Non-performing loans include non-accrual loans and loans past due greater than 90 days and on accrual status.

The following tables provide additional detail on the age analysis of the Company's past due loans as of September 30, 2014 and December 31, 2013 (in thousands):

## September 30, 2014

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	Loans 90 Days or More Past Due and Accruing
Commercial real estate:							
Owner-occupied	\$187	\$1,620	\$1,258	\$3,065	\$543,268	\$546,333	\$993
Investment properties	—	—	267	267	854,017	854,284	—
Multifamily real estate	—	—	—	—	183,944	183,944	—
Commercial construction	—	—	—	—	18,606	18,606	—
Multifamily construction	—	—	—	—	48,606	48,606	—
One-to-four-family construction	—	—	—	—	214,141	214,141	—
Land and land development:							
Residential	—	—	750	750	88,899	89,649	—
Commercial	—	—	—	—	10,505	10,505	—
Commercial business	188	145	899	1,232	726,856	728,088	301
Agricultural business, including secured by farmland	14	552	229	795	239,253	240,048	—
One- to four-family residential	240	3,401	7,274	10,915	516,356	527,271	2,777
Consumer:							
Consumer secured by one- to four-family	368	572	176	1,116	214,269	215,385	—
Consumer—other	346	67	521	934	128,901	129,835	306
Total	\$1,343	\$6,357	\$11,374	\$19,074	\$3,787,621	\$3,806,695	\$4,377

December 31, 2013

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	Loans 90 Days or More Past Due and Accruing
Commercial real estate:							
Owner-occupied	\$883	\$550	\$813	\$2,246	\$500,355	\$502,601	\$—
Investment properties	—	—	—	—	692,457	692,457	—
Multifamily real estate	1,845	785	—	2,630	134,523	137,153	—
Commercial construction	—	—	—	—	12,168	12,168	—
Multifamily construction	—	—	—	—	52,081	52,081	—
One-to-four-family construction	9	7	4	20	200,844	200,864	—
Land and land development:							
Residential	—	—	251	251	75,444	75,695	—
Commercial	—	—	—	—	10,450	10,450	—
Commercial business	2,001	2	299	2,302	679,867	682,169	—
Agricultural business, including secured by farmland	—	—	—	—	228,291	228,291	105
One-to four-family residential	521	2,550	9,142	12,213	517,281	529,494	2,611
Consumer:							
Consumer secured by one- to four-family	723	93	918	1,734	171,454	173,188	13
Consumer—other	384	99	131	614	121,220	121,834	131
Total	\$6,366	\$4,086	\$11,558	\$22,010	\$3,396,435	\$3,418,445	\$2,860

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The following tables provide additional information on the allowance for loan losses and loan balances individually and collectively evaluated for impairment at or for the three and nine months ended September 30, 2014 and 2013 (in thousands):

	For the Three Months Ended September 30, 2014								
	Commercial Real Estate	Multifamily Real Estate	Construction and Land	Commercial Business	Agricultural Business	One- to Four-Family Residential	Consumer	Unallocated	Total
Allowance for loan losses:									
Beginning balance	\$ 18,884	\$ 5,765	\$ 17,837	\$ 12,014	\$ 2,824	\$ 9,270	\$ 748	\$ 6,968	\$ 74,310
Provision for loan losses	527	(853 )	2,858	490	(339 )	(38 )	603	(3,248 )	—
Recoveries	94	—	84	256	587	143	53	—	1,217
Charge-offs	—	(20 )	—	(83 )	(125 )	(239 )	(729 )	—	(1,196 )
Ending balance	\$ 19,505	\$ 4,892	\$ 20,779	\$ 12,677	\$ 2,947	\$ 9,136	\$ 675	\$ 3,720	\$ 74,331

	For the Nine Months Ended September 30, 2014								
	Commercial Real Estate	Multifamily Real Estate	Construction and Land	Commercial Business	Agricultural business	One- to Four-Family Residential	Consumer	Unallocated	Total
Allowance for loan losses:									
Beginning balance	\$ 16,759	\$ 5,306	\$ 17,640	\$ 11,773	\$ 2,841	\$ 11,486	\$ 1,335	\$ 7,118	\$ 74,258
Provision for loan losses	3,321	(394 )	2,558	1,150	(1,017 )	(2,253 )	33	(3,398 )	—
Recoveries	664	—	788	835	1,248	535	393	—	4,463
Charge-offs	(1,239 )	(20 )	(207 )	(1,081 )	(125 )	(632 )	(1,086 )	—	(4,390 )
Ending balance	\$ 19,505	\$ 4,892	\$ 20,779	\$ 12,677	\$ 2,947	\$ 9,136	\$ 675	\$ 3,720	\$ 74,331

	September 30, 2014								
	Commercial Real Estate	Multifamily Real Estate	Construction and Land	Commercial Business	Agricultural Business	One- to Four-Family Residential	Consumer	Unallocated	Total
Allowance individually evaluated for impairment	\$ 755	\$ 91	\$ 1,269	\$ 103	\$ —	\$ 1,143	\$ 58	\$ —	\$ 3,419
Allowance collectively evaluated for impairment	18,750	4,801	19,510	12,574	2,947	7,993	617	3,720	70,912
Total allowance for loan losses	\$ 19,505	\$ 4,892	\$ 20,779	\$ 12,677	\$ 2,947	\$ 9,136	\$ 675	\$ 3,720	\$ 74,331
Loan balances:									
Loans individually evaluated for impairment	\$ 8,070	\$ 791	\$ 6,643	\$ 880	\$ —	\$ 18,890	\$ 649	\$ —	\$ 35,923

Loans collectively evaluated for impairment	1,392,547	183,153	374,864	727,208	240,048	508,381	344,571	—	3,770,772
Total loans	\$1,400,617	\$183,944	\$381,507	\$728,088	\$240,048	\$527,271	\$345,220	\$—	\$3,806,695

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For the Three Months Ended September 30, 2013

	Commercial Real Estate	Multifamily Real Estate	Construction and Land	Commercial Business	Agricultural Business	One- to Four-Family Residential	Consumer	Unallocated	Total
Allowance for loan losses:									
Beginning balance	\$ 14,898	\$ 4,973	\$ 16,625	\$ 10,806	\$ 3,805	\$ 14,974	\$ 1,011	\$ 9,029	\$ 76,121
Provision for loan losses	1,239	310	(464 )	(223 )	(411 )	(1,599 )	43	1,105	—
Recoveries	331	—	507	339	265	19	68	—	1,529
Charge-offs	(850 )	—	—	(246 )	(248 )	(207 )	(174 )	—	(1,725 )
Ending balance	\$ 15,618	\$ 5,283	\$ 16,668	\$ 10,676	\$ 3,411	\$ 13,187	\$ 948	\$ 10,134	\$ 75,925

For the Nine Months Ended September 30, 2013

	Commercial Real Estate	Multifamily Real Estate	Construction and Land	Commercial Business	Agricultural business	One- to Four-Family Residential	Consumer	Unallocated	Total
Allowance for loan losses:									
Beginning balance	\$ 15,322	\$ 4,506	\$ 14,991	\$ 9,957	\$ 2,295	\$ 16,475	\$ 1,348	\$ 11,865	\$ 76,759
Provision for loan losses	(383 )	777	1,586	901	752	(2,166 )	264	(1,731 )	—
Recoveries	2,295	—	945	1,391	612	138	287	—	5,668
Charge-offs	(1,616 )	—	(854 )	(1,573 )	(248 )	(1,260 )	(951 )	—	(6,502 )
Ending balance	\$ 15,618	\$ 5,283	\$ 16,668	\$ 10,676	\$ 3,411	\$ 13,187	\$ 948	\$ 10,134	\$ 75,925

September 30, 2013

	Commercial Real Estate	Multifamily Real Estate	Construction and Land	Commercial Business	Agricultural Business	One- to Four-Family Residential	Consumer	Unallocated	Total
Allowance individually evaluated for impairment	\$ 459	\$ 1,256	\$ 2,182	\$ 202	\$ —	\$ 1,639	\$ 85	\$ —	\$ 5,823
Allowance collectively evaluated for impairment	15,159	4,027	14,486	10,474	3,411	11,548	863	10,134	70,102
Total allowance for loan losses	\$ 15,618	\$ 5,283	\$ 16,668	\$ 10,676	\$ 3,411	\$ 13,187	\$ 948	\$ 10,134	\$ 75,925
Loan balances:									
Loans individually evaluated for impairment	\$ 9,137	\$ 5,810	\$ 13,613	\$ 1,115	\$ —	\$ 28,711	\$ 1,139	\$ —	\$ 59,525
Loans collectively evaluated for impairment	1,112,961	127,960	319,999	634,543	223,187	514,552	282,709	—	3,215,911
Total loans	\$ 1,122,098	\$ 133,770	\$ 333,612	\$ 635,658	\$ 223,187	\$ 543,263	\$ 283,848	\$ —	\$ 3,275,436



## Note 8: REAL ESTATE OWNED, NET

The following table presents the changes in REO for the three and nine months ended September 30, 2014 and 2013 (in thousands):

	Three Months Ended September 30		Nine Months Ended September 30	
	2014	2013	2014	2013
Balance, beginning of the period	\$4,388	\$6,714	\$4,044	\$15,778
Additions from loan foreclosures	135	963	2,837	2,467
Additions from capitalized costs	—	297	35	344
Proceeds from dispositions of REO	(860)	(3,970)	(3,631)	(15,758)
Gain on sale of REO	265	1,005	680	2,477
Valuation adjustments in the period	—	(191)	(37)	(490)
Balance, end of the period	\$3,928	\$4,818	\$3,928	\$4,818

The following table shows REO by type and geographic location by state as of September 30, 2014 (in thousands):

	Washington	Oregon	Idaho	Total
Land development—residential	\$259	\$1,637	\$32	\$1,928
One- to four-family real estate	1,257	743	—	2,000
Balance, end of period	\$1,516	\$2,380	\$32	\$3,928

REO properties are recorded at the lower of the estimated fair value of the property, less expected selling costs, or the carrying value of the defaulted loan, establishing a new cost basis. Subsequently, REO properties are carried at the lower of the new cost basis or updated fair market values, based on updated appraisals of the underlying properties, as received. Valuation allowances on the carrying value of REO may be recognized based on updated appraisals or on management's authorization to reduce the selling price of a property.

## Note 9: INTANGIBLE ASSETS AND MORTGAGE SERVICING RIGHTS

Intangible Assets: At September 30, 2014, intangible assets consisted primarily of core deposit intangibles (CDI), which are amounts recorded in business combinations or deposit purchase transactions related to the value of transaction-related deposits and the value of the customer relationships associated with the deposits.

The Company amortizes CDI over their estimated useful lives and reviews them at least annually for events or circumstances that could impair their value. The CDI assets shown in the table below represent the value ascribed to the long-term deposit relationships acquired in three separate bank acquisitions during 2007, a single branch acquisition in the quarter ended September 30, 2013, and the Branch Acquisition in the quarter ended June 30, 2014. These intangible assets are being amortized using an accelerated method over estimated useful lives of three to eight years. The CDI assets are not estimated to have a significant residual value.

The following table summarizes the changes in the Company's core deposit intangibles for the nine months ended September 30, 2014 and the year ended December 31, 2013 (in thousands):

	CDI
Balance, December 31, 2012	\$4,230
Additions through acquisitions	160
Amortization	(1,941)
Balance, December 31, 2013	2,449
Additions through acquisitions	2,372
Amortization	(1,459)
Balance, September 30, 2014	\$3,362



The following table presents the estimated amortization expense with respect to intangibles for the periods indicated (in thousands):

	CDI
Remainder of 2014	\$531
2015	1,007
2016	353
2017	321
2018	296
Thereafter	854
	\$3,362

**Mortgage Servicing Rights:** Mortgage servicing rights are reported in other assets. Mortgage servicing rights are initially recorded at fair value and are amortized in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Mortgage servicing rights are subsequently evaluated for impairment based upon the fair value of the rights compared to the amortized cost (remaining unamortized initial fair value). If the fair value is less than the amortized cost, a valuation allowance is created through an impairment charge to servicing fee income. However, if the fair value is greater than the amortized cost, the amount above the amortized cost is not recognized in the carrying value. During the three and nine months ended September 30, 2014, the Company did not record an impairment charge. During the three and nine months ended September 30, 2013, the Company reversed \$400,000 and \$1.0 million, respectively, of valuation allowance for previously recorded impairment charges. Loans serviced for others totaled \$1.219 billion and \$1.116 billion at September 30, 2014 and December 31, 2013, respectively. Custodial accounts maintained in connection with this servicing totaled \$4.2 million and \$5.4 million at September 30, 2014 and December 31, 2013, respectively.

An analysis of our mortgage servicing rights, net of valuation allowances, for the three and nine months ended September 30, 2014 and 2013 is presented below (in thousands):

	Three Months Ended September 30		Nine Months Ended September 30	
	2014	2013	2014	2013
Balance, beginning of the period	\$8,481	\$7,036	\$8,086	\$6,244
Amounts capitalized	846	769	2,215	2,352
Amortization <sup>(1)</sup>	(543	) (520	) (1,517	) (1,911
Valuation adjustments in the period	—	400	—	1,000
Balance, end of the period <sup>(2)</sup>	\$8,784	\$7,685	\$8,784	\$7,685

<sup>(1)</sup> Amortization of mortgage servicing rights is recorded as a reduction of loan servicing income and any unamortized balance is fully written off if the loan repays in full.

<sup>(2)</sup> There was no valuation allowance as of September 30, 2014 and a \$300,000 valuation allowance as of September 30, 2013.

## Note 10: DEPOSITS AND RETAIL REPURCHASE AGREEMENTS

Deposits consisted of the following at September 30, 2014 and December 31, 2013 (dollars in thousands):

	September 30, 2014		December 31, 2013		
	Amount	Percent of Total	Amount	Percent of Total	
Non-interest-bearing accounts	\$1,304,720	32.7 %	\$1,115,346	30.8 %	
Interest-bearing checking	429,876	10.8	422,910	11.7	
Regular savings accounts	899,868	22.5	798,764	22.1	
Money market accounts	503,660	12.6	408,211	11.3	
Total transaction and saving accounts	3,138,124	78.6	2,745,231	75.9	
Certificates of deposit	852,994	21.4	872,695	24.1	
Total deposits	\$3,991,118	100.0 %	\$3,617,926	100.0 %	
Included in total deposits:					
Public fund transaction accounts	\$99,519	2.5 %	\$87,521	2.4 %	
Public fund interest-bearing certificates	48,508	1.2	51,465	1.4	
Total public deposits	\$148,027	3.7 %	\$138,986	3.8 %	
Total brokered deposits	\$41,249	1.0 %	\$4,291	0.1 %	

Certificate of deposit accounts by total balance at September 30, 2014 and December 31, 2013 were as follows (in thousands):

	September 30, 2014	December 31, 2013
Certificates of deposit less than \$100,000	\$405,788	\$386,745
Certificates of deposit \$100,000 through \$250,000	285,239	308,130
Certificates of deposit more than \$250,000	161,967	177,820
Total certificates of deposit	\$852,994	\$872,695

Scheduled maturities and repricing of certificate accounts at September 30, 2014 and December 31, 2013 were as follows (in thousands):

	September 30, 2014	December 31, 2013
Certificates which mature or reprice:		
Within one year or less	\$641,098	\$660,394
After one year through two years	121,166	117,789
After two years through three years	47,563	47,362
After three years through four years	20,309	26,443
After four years through five years	17,673	17,075
After five years	5,185	3,632
Total certificates of deposit	\$852,994	\$872,695

The following table presents the geographic concentration of deposits at September 30, 2014 (dollars in thousands):

	Washington	Oregon	Idaho	Total	
Total deposits	\$2,889,675	\$864,869	\$236,574	\$3,991,118	
Percent of total deposits	72.4	% 21.7	% 5.9	% 100.0	%

In addition to deposits, the banks also offer retail repurchase agreements which are customer funds that are primarily associated with sweep account arrangements tied to transaction deposit accounts. While the banks include these collateralized borrowings in other borrowings reported in our Consolidated Statements of Financial Condition, these accounts primarily represent customer utilization of our cash management services and related deposit accounts.



The following table presents retail repurchase agreement balances as of September 30, 2014 and December 31, 2013 (in thousands):

	September 30, 2014	December 31, 2013
Retail repurchase agreements	\$67,605	\$83,056

#### Note 11: FAIR VALUE ACCOUNTING AND MEASUREMENT

The Company measures and discloses certain assets and liabilities at fair value. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (that is, not a forced liquidation or distressed sale). GAAP (ASC 820, Fair Value Measurements) establishes a consistent framework for measuring fair value and disclosure requirements about fair value measurements. Among other things, the accounting standard requires the reporting entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's estimates for market assumptions. These two types of inputs create the following fair value hierarchy:

Level 1 – Quoted prices in active markets for identical instruments. An active market is a market in which transactions occur with sufficient frequency and volume to provide pricing information on an ongoing basis. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.

Level 2 – Observable inputs other than Level 1 including quoted prices in active markets for similar instruments, quoted prices in less active markets for identical or similar instruments, or other observable inputs that can be corroborated by observable market data.

Level 3 – Unobservable inputs supported by little or no market activity for financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation; also includes observable inputs from non-binding single dealer quotes not corroborated by observable market data.

The estimated fair value amounts of financial instruments have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize at a future date. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. In addition, reasonable comparability between financial institutions may not be likely due to the wide range of permitted valuation techniques and numerous estimates that must be made given the absence of active secondary markets for certain financial instruments. This lack of uniform valuation methodologies also introduces a greater degree of subjectivity to these estimated fair values. Transfers between levels of the fair value hierarchy are deemed to occur at the end of the reporting period.

#### Items Measured at Fair Value on a Recurring Basis:

Banner records trading account securities, securities available-for-sale, FHLB advances, junior subordinated debentures and certain derivative transactions at fair value on a recurring basis.

Investment securities primarily consist of U.S. Government and agency obligations, municipal bonds, corporate bonds, single issue trust preferred securities (TPS), pooled trust preferred collateralized debt obligation securities (TRUP CDO), mortgage-backed securities, asset-backed securities, equity securities and certain other financial instruments.



From mid-2008 through the current quarter, the lack of active markets and market participants for certain securities resulted in an increase in Level 3 measurements. In particular, the market for our TRUP CDO securities has been generally inactive during this period. This was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which TRUP CDOs trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market also has been inactive as almost no new TRUP CDOs have been issued since 2007. There are still very few market participants who are willing and/or able to transact for these securities. Thus, a low market price for a particular bond may only provide evidence of stress in the credit markets in general rather than being an indicator of credit problems with a particular issuer or of the fair value of the security. As of September 30, 2014, Banner owned \$20 million in par value of these securities.

Given these conditions in the debt markets and the absence of observable transactions in the secondary and new issue markets, management determined that for the TRUP CDOs at September 30, 2014 and December 31, 2013:

- The few observable transactions and market quotations that were available were not reliable for purposes of determining fair value,

- An income valuation approach technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs was equally or more representative of fair value than the market approach valuation technique, and

- The Company's TRUP CDOs should be classified exclusively within Level 3 of the fair value hierarchy because of the significant assumptions required to determine fair value at the measurement date.

The TRUP CDO valuations were derived using input from independent third parties who used proprietary cash flow models for analyzing collateralized debt obligations. Their approaches to determining fair value involve considering the credit quality of the collateral, assuming a level of defaults based on the probability of default of each underlying trust preferred security, creating expected cash flows for each TRUP CDO security and discounting that cash flow at an appropriate risk-adjusted rate plus a liquidity premium.

Where appropriate, management reviewed the valuation methodologies and assumptions used by the independent third party providers and determined that the fair value estimates were reasonable and utilized those estimates in the Company's reported financial statements. For one TRUP CDO, management became aware that a marketplace auction occurred one day after quarter-end that would redeem this security at par in the fourth quarter. That successful auction caused management to increase the fair value of this security to par and resulted in the recognition of a \$2.3 million fair value gain on this security in the quarter ended September 30, 2014. The aggregate result of the fair value analysis of all the Level 3 TRUP CDO measurements was a fair value gain of \$1.9 million in the quarter ended September 30, 2014 and a fair value gain of \$4.8 million in the nine months ended September 30, 2014.

At September 30, 2014, Banner also owned approximately \$19 million in amortized cost of single issuer TPS securities for which no direct market data or independent valuation source is available. Similar to the TRUP CDOs above, there were too few, if any, issuances of new TPS securities or sales of existing TPS securities to provide Level 1 or even Level 2 fair value measurements for these securities. Management, therefore, utilized a discounted cash-flow model to calculate the present value of each security's expected future cash flows to determine their respective fair values. Management took into consideration the limited market data that was available regarding similar securities and assessed the performance of the three individual issuers of TPS securities owned by the Company. In the current quarter, the Company again sought input from independent third parties to help it establish an appropriate set of parameters to identify a reasonable range of discount rates for use in its fair value model. Management concluded that market yields have been relatively stable in the quarter ended September 30, 2014 and that the indicated spreads and implied yields for non-investment grade securities as well as the yields associated with individual issuers in the third party analyst reports continue to support that a 500 basis point spread over the three-month LIBOR index, the same spread as used in the quarter ended June 30, 2014, was still a reasonable basis for determining an appropriate discount rate to estimate the fair value of these securities. These factors were then incorporated into the model at September 30, 2014, where a discount rate equal to three-month LIBOR plus 500 basis points was used to calculate the respective fair values of these securities. The result of this Level 3 fair value measurement was a fair value gain of \$35,000 in the quarter ended September 30, 2014 and a fair value gain of \$570,000 for the nine months ended September 30, 2014. The Company has and will continue to assess the appropriate fair value hierarchy for determination of fair values on TRUP CDO and TPS securities on a quarterly basis. For all other trading securities and securities available-for-sale we used matrix pricing models from investment reporting and valuation services. Management considers this to be a Level 2 input method.

Fair valuations for FHLB advances are estimated using fair market values provided by the lender, the FHLB of Seattle. The FHLB of Seattle prices advances by discounting the future contractual cash flows for individual advances using its current cost of funds curve to provide the discount rate. Management considers this to be a Level 2 input method.

• The fair valuations of junior subordinated debentures (TPS-related debt that the Company has issued) were also valued using discounted cash flows. These debentures carry interest rates that reset quarterly, using the three-month LIBOR index plus spreads of 1.38% to 3.35%. While the quarterly reset of the index on this debt would seemingly keep its fair value reasonably close to book value, the disparity in the fixed spreads above the index and the inability to determine realistic current market spreads, due to lack of new issuances and trades, resulted in having to rely more heavily on assumptions about what spread would be appropriate if market transactions were to take place. In periods prior to the third quarter of 2008, the discount rate used was based on recent issuances or quotes from brokers on the

date of valuation for comparable bank holding companies and was considered to be a Level 2 input method. However, as noted above in the discussions of TPS and TRUP CDOs, due to the unprecedented disruption of certain financial markets, management concluded that there were insufficient transactions or other indicators to continue to reflect these measurements as Level 2 inputs. Due to this reliance on assumptions and not on directly observable transactions, management believes fair value for these instruments should follow a Level 3 input methodology. Since the discount rate used in the fair value modeling is the most sensitive unobservable estimate in the calculation, the Company again utilized input from the same independent third party noted above to help it establish an appropriate set of parameters to identify a reasonable range of discount rates for use in its fair value model. In valuing the debentures at September 30, 2014, management evaluated the general market for credit spreads as noted above and for the discount rate used the period-ending three-month LIBOR plus 500 basis points. As noted above in the discussion about single-issuer TPS securities, since market spreads have been relatively stable in the recent period we used the same spread as used in the quarter ended June 30, 2014, resulting in a fair value loss on these instruments of \$311,000 for the quarter ended September 30, 2014. The fair value adjustment in the current period was attributed to the passage of time on the years to maturity in the discounted present value calculation used to estimate the fair value.

Derivative instruments include interest rate commitments related to one- to four-family loans and residential mortgage-backed securities and interest rate swaps. The fair value of 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 trends, where appropriate. The fair value of interest rate swaps is determined by using current market quotes on similar instruments provided by active broker/dealers in the swap market. Management considers these to be Level 2 input methods. The changes in the fair value of all of these derivative instruments are primarily attributable to changes in the level of market interest rates. The Company has elected to record the fair value of these derivative instruments on a net basis.

The following tables present financial assets and liabilities measured at fair value on a recurring basis and the level within the fair value hierarchy of the fair value measurements for those assets as of September 30, 2014 and December 31, 2013 (in thousands):

	September 30, 2014			
	Level 1	Level 2	Level 3	Total
Assets:				
Securities—available-for-sale				
U.S. Government and agency	\$—	\$43,293	\$—	\$43,293
Municipal bonds	—	49,679	—	49,679
Corporate bonds	—	5,049	—	5,049
Mortgage-backed or related securities	—	310,403	—	310,403
Asset-backed securities	—	25,321	—	25,321
	—	433,745	—	433,745
Securities—trading				
U.S. Government and agency	—	1,494	—	1,494
Municipal bonds	—	1,707	—	1,707
TPS and TRUP CDOs	—	—	29,013	29,013
Mortgage-backed or related securities	—	18,800	—	18,800
Equity securities and other	—	62	—	62
	—	22,063	29,013	51,076
Derivatives				
Interest rate lock commitments	—	226	—	226
Interest rate swaps	—	4,944	—	4,944
	\$—	\$460,978	\$29,013	\$489,991
Liabilities:				
Advances from FHLB at fair value	\$—	\$250	\$—	\$250
Junior subordinated debentures net of unamortized deferred issuance costs at fair value	—	—	77,624	77,624
Derivatives				
Interest rate sales forward commitments, net	—	33	—	33
Interest rate swaps	—	4,944	—	4,944
	\$—	\$5,227	\$77,624	\$82,851

	December 31, 2013			
	Level 1	Level 2	Level 3	Total
Assets:				
Securities—available-for-sale				
U.S. Government and agency	\$—	\$58,660	\$—	\$58,660
Municipal bonds	—	52,855	—	52,855
Corporate bonds	—	6,964	—	6,964
Mortgage-backed or related securities	—	326,610	—	326,610
Asset-backed securities	—	25,191	—	25,191
	—	470,280	—	470,280
Securities—trading				
U.S. Government and agency	—	1,481	—	1,481
Municipal bonds	—	5,023	—	5,023
TPS and TRUP CDOs	—	—	35,140	35,140
Mortgage-backed or related securities	—	20,760	—	20,760
Equity securities and other	—	68	—	68
	—	27,332	35,140	62,472
Derivatives				
Interest rate lock commitments	—	130	—	130
Interest rate swaps	—	4,946	—	4,946
	\$—	\$502,688	\$35,140	\$537,828
Liabilities:				
Advances from FHLB at fair value	\$—	\$27,250	\$—	\$27,250
Junior subordinated debentures net of unamortized deferred issuance costs at fair value	—	—	73,928	73,928
Derivatives				
Interest rate sales forward commitments, net	—	43	—	43
Interest rate swaps	—	4,946	—	4,946
	\$—	\$32,239	\$73,928	\$106,167

The following table provides a reconciliation of the assets and liabilities measured at fair value using significant unobservable inputs (Level 3) on a recurring basis during the three and nine months ended September 30, 2014 and 2013 (in thousands):

	Three Months Ended September 30, 2014 Level 3 Fair Value Inputs		Nine Months Ended September 30, 2014 Level 3 Fair Value Inputs	
	TPS and TRUP CDOs	Borrowings—Junior Subordinated Debentures	TPS and TRUP CDOs	Borrowings—Junior Subordinated Debentures
Beginning balance	\$38,529	\$ 77,313	\$35,140	\$73,928
Total gains or losses recognized				
Assets gains, including OTTI	1,969	—	5,389	—
Liabilities losses	—	311	—	3,696
Maturities and paydowns net of discount amortization	(11,485)	) —	(11,516)	) —
Ending balance at September 30, 2014	\$29,013	\$ 77,624	\$29,013	\$77,624
	Three Months Ended September 30, 2013 Level 3 Fair Value Inputs		Nine Months Ended September 30, 2013 Level 3 Fair Value Inputs	
	TPS and TRUP CDOs	Borrowings—Junior Subordinated Debentures	TPS and TRUP CDOs	Borrowings—Junior Subordinated Debentures
Beginning balance	\$35,105	\$ 73,471	\$35,741	\$73,063
Total gains or losses recognized				
Assets gains (losses), including OTTI	(10)	) —	(646)	) —
Liabilities losses	—	166	—	574
Ending balance at September 30, 2013	\$35,095	\$ 73,637	\$35,095	\$73,637

The Company has elected to continue to recognize the interest income and dividends from the securities reclassified to fair value as a component of interest income as was done in prior years when they were classified as available-for-sale. Interest expense related to the FHLB advances and junior subordinated debentures continues to be measured based on contractual interest rates and reported in interest expense. The change in fair market value of these financial instruments has been recorded as a component of other operating income.

#### Items Measured at Fair Value on a Non-recurring Basis:

Impaired loans are periodically evaluated to determine if valuation adjustments, or partial write-downs, should be recorded. The need for valuation adjustments arises when observable market prices or current appraised values of collateral indicate a shortfall in collateral value or discounted cash flows indicate a shortfall compared to current carrying values of the related loan. If the Company determines that the value of the impaired loan is less than the carrying value of the loan, the Company either establishes an impairment reserve as a specific component of the allowance for loan and lease losses (ALLL) or charges off the impaired amount. These valuation adjustments are considered non-recurring fair value adjustments. The remaining impaired loans are evaluated for reserve needs in homogenous pools within the Company's ALLL methodology. As of September 30, 2014, the Company reviewed all of its adversely classified loans totaling \$75 million and identified \$50 million which were considered impaired. Of those \$50 million in impaired loans, \$36 million were individually evaluated to determine if valuation adjustments, or partial write-downs, should be recorded, or if specific impairment reserves should be established. The \$36 million had

original carrying values of \$38 million which have been reduced by partial write-downs totaling \$2 million. In addition to these write-downs, in order to bring the impaired loan balances to fair value, Banner has also established \$3 million in specific reserves on these impaired loans. Impaired loans that were collectively evaluated for reserve purposes within homogenous pools totaled \$14 million and were found to require allowances totaling \$266,000. The valuation inputs for impaired loans are considered to be Level 3 inputs.

The Company records REO (acquired through a lending relationship) at fair value on a non-recurring basis. All REO properties are recorded at the lower of the estimated fair value of the properties, less expected selling costs, or the carrying amount of the defaulted loans. From time to time, non-recurring fair value adjustments to REO are recorded to reflect partial write-downs based on an observable market price or current appraised value of property. Banner considers any valuation inputs related to REO to be Level 3 inputs. The individual carrying values of these assets are reviewed for impairment at least annually and any additional impairment charges are expensed to operations. For the three months ended September 30, 2014, the Company recognized no impairment charges related to REO assets, compared to \$191,000 for the same quarter

one year earlier, and for the nine months ended September 30, 2014, the Company recognized \$37,000 in impairment charges compared to \$490,000 for the same period one year ago.

The following tables present financial assets measured at fair value on a non-recurring basis and the level within the fair value hierarchy of the fair value measurements for those assets as of September 30, 2014 and December 31, 2013 (in thousands):

At or For the Nine Months Ended September 30, 2014					Net Gains/(Losses) Recognized During the Period
	Level 1	Level 2	Level 3	Total	
Impaired loans	\$—	\$—	\$5,298	\$5,298	\$(2,828 )
REO	—	—	3,928	3,928	(458 )
At or For the Year Ended December 31, 2013					Net Gains/(Losses) Recognized During the Period
	Level 1	Level 2	Level 3	Total	
Impaired loans	\$—	\$—	\$10,627	\$10,627	\$(4,890 )
REO	—	—	4,044	4,044	(853 )

#### Assets and Liabilities Measured at Fair Value Using Significant Unobservable Inputs (Level 3):

The following table provides a description of the valuation technique, unobservable inputs, and qualitative information about the unobservable inputs for the Company's assets and liabilities classified as Level 3 and measured at fair value on a recurring and nonrecurring basis at September 30, 2014 and December 31, 2013:

Financial Instruments	Valuation Techniques	Unobservable Inputs	Weighted Average Rate	
			September 30, 2014	December 31, 2013
TPS securities	Discounted cash flows	Discount rate	5.24	% 5.50 %
TRUP CDOs	Discounted cash flows	Discount rate	3.99	3.85
Junior subordinated debentures	Discounted cash flows	Discount rate	5.24	5.50
Impaired loans	Discounted cash flows	Discount rate	Various	Various
REO	Collateral Valuations	Market values	n/a	n/a
	Appraisals	Market values	n/a	n/a

TPS and TRUP CDOs: Management believes that the credit risk-adjusted spread used to develop the discount rate utilized in the fair value measurement of TPS and TRUP CDOs is indicative of the risk premium a willing market participant would require under current market conditions for instruments with similar contractual rates and terms and conditions and issuers with similar credit risk profiles and with similar expected probability of default. Management attributes the change in fair value of these instruments, compared to their par value, primarily to perceived general market adjustments to the risk premiums for these types of assets subsequent to their issuance.



Junior subordinated debentures: Similar to the TPS and TRUP CDOs discussed above, management believes that the credit risk-adjusted spread utilized in the fair value measurement of the junior subordinated debentures is indicative of the risk premium a willing market participant would require under current market conditions for an issuer with Banner's credit risk profile. Management attributes the change in fair value of the junior subordinated debentures, compared to their par value, primarily to perceived general market adjustments to the risk premiums for these types of liabilities subsequent to their issuance. Future contractions in the risk adjusted spread relative to the spread currently utilized to measure the Company's junior subordinated debentures at fair value as of September 30, 2014, or the passage of time, will result in negative fair value adjustments. At September 30, 2014, the discount rate utilized was based on a credit spread of 500 basis points and three-month LIBOR of 24 basis points.

Impaired loans: Loans are considered impaired when, based on current information and events, management determines that it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors involved in determining impairment include, but are not limited to, the financial condition of the borrower, the value of the underlying collateral and the current status of the economy. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest

rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral dependent. If this practical expedient is used, the impaired loans are considered to be held at fair value. Subsequent changes in the value of impaired loans are included within the provision for loan losses in the same manner in which impairment initially was recognized or as a reduction in the provision that would otherwise be reported.

REO: Fair value adjustments on REO are based on updated real estate appraisals which are based on current market conditions. In many of our markets real estate sales are still slow and prices are negatively affected by an over-supply of properties for sale. These market conditions decrease the amount of comparable sales data and increase the reliance on estimates and assumptions about current and future market conditions and could negatively affect our operating results.

#### Fair Values of Financial Instruments:

The following table presents estimated fair values of the Company's financial instruments as of September 30, 2014 and December 31, 2013, whether or not measured at fair value in the consolidated Statements of Financial Condition. The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is necessary to interpret market data in the development of the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. The carrying value and estimated fair value of financial instruments are as follows (in thousands):

	September 30, 2014		December 31, 2013	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
<b>Assets:</b>				
Cash and due from banks	\$151,725	\$151,725	\$137,349	\$137,349
Securities—trading	51,076	51,076	62,472	62,472
Securities—available-for-sale	433,745	433,745	470,280	470,280
Securities—held-to-maturity	133,069	138,754	102,513	103,610
Loans receivable held for sale	6,949	7,044	2,734	2,751
Loans receivable	3,799,746	3,676,346	3,415,711	3,297,936
FHLB stock	29,106	29,106	35,390	35,390
Bank-owned life insurance	63,293	63,293	61,945	61,945
Mortgage servicing rights	8,784	12,585	8,086	11,529
Derivatives	5,170	5,170	5,076	5,076
<b>Liabilities:</b>				
Demand, interest checking and money market accounts	2,238,256	2,001,116	1,946,467	1,697,095
Regular savings	899,868	794,624	798,764	695,863
Certificates of deposit	852,994	846,973	872,695	867,904
FHLB advances at fair value	250	250	27,250	27,250
Junior subordinated debentures at fair value	77,624	77,624	73,928	73,928
Other borrowings	67,605	67,605	83,056	83,056
Derivatives	4,977	4,977	4,989	4,989

Fair value estimates, methods, assumptions and the level within the fair value hierarchy of the fair value measurements are set forth below for the Company's financial and off-balance-sheet instruments:

Cash and Due from Banks: The carrying amount of these items is a reasonable estimate of their fair value. These values are considered Level 1 measures.

Securities: The estimated fair values of investment securities and mortgaged-backed securities are priced using current active market quotes, if available, which are considered Level 1 measurements. For most of the portfolio, matrix pricing based on the securities' relationship to other benchmark quoted prices is used to establish the fair value. These measurements are considered Level 2. Due to the continued credit concerns in the capital markets and inactivity in the trust preferred markets that have limited the observability of market spreads for some of the Company's TPS and TRUP CDO securities (see earlier discussion above in determining the securities' fair market value), management has classified these securities as a Level 3 fair value measure.

Loans Receivable: Fair values are estimated first by stratifying the portfolios of loans with similar financial characteristics. Loans are segregated by type such as multifamily real estate, residential mortgage, nonresidential mortgage, commercial/agricultural, consumer and other. Each loan category is further segmented into fixed- and adjustable-rate interest terms and by performing and non-performing categories. A preliminary estimate of fair value is then calculated based on discounted cash flows using as a discount rate the current rate offered on similar products, plus an adjustment for liquidity to reflect the non-homogeneous nature of the loans. The preliminary estimate is then further reduced by the amount of the allowance for loan losses to arrive at a final estimate of fair value. Fair value for significant non-performing loans is also based on recent

appraisals or estimated cash flows discounted using rates commensurate with risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows and discount rates are judgmentally determined using available market information and specific borrower information. Management considers this to be a Level 2 measure.

FHLB Stock: The fair value is based upon the redemption value of the stock which equates to its carrying value. This fair value is considered a Level 3 measure.

Mortgage Servicing Rights: Fair values are estimated based on current pricing for sales of servicing for new loans adjusted up or down based on the serviced loan's interest rate versus current new loan rates. Management considers this to be a Level 3 measure.

Deposit Liabilities: The fair value of deposits with no stated maturity, such as savings and checking accounts, is estimated by applying decay rate assumptions to segregated portfolios of similar deposit types to generate cash flows which are then discounted using short-term market interest rates. The market value of certificates of deposit is based upon the discounted value of contractual cash flows. The discount rate is determined using the rates currently offered on comparable instruments. Fair value estimates for deposits are considered Level 3 measures.

FHLB Advances and Other Borrowings: Fair valuations for Banner's FHLB advances are estimated using fair market values provided by the lender, the FHLB of Seattle. The FHLB of Seattle prices advances by discounting the future contractual cash flows for individual advances using its current cost of funds curve to provide the discount rate. This is considered to be a Level 2 input method. Other borrowings are priced using discounted cash flows to the date of maturity based on using current rates at which such borrowings can currently be obtained. This fair value is considered to be a Level 3 measure.

Junior Subordinated Debentures: Due to continued credit concerns in the capital markets and inactivity in the trust preferred markets that have limited the observability of market spreads (see earlier discussion above in determining the junior subordinated debentures' fair market value), junior subordinated debentures have been classified as a Level 3 fair value measure. Management believes that the credit risk adjusted spread and resulting discount rate utilized is indicative of those that would be used by market participants.

Derivatives: Derivatives include interest rate swap agreements, interest rate lock commitments to originate loans held for sale and forward sales contracts to sell loans and securities related to mortgage banking activities. Fair values for these instruments, which generally change as a result of changes in the level of market interest rates, are estimated based on dealer quotes and secondary market sources. Management considers these to be Level 2 inputs.

Off-Balance Sheet Items: Off-balance sheet financial instruments include unfunded commitments to extend credit, including standby letters of credit, and commitments to purchase investment securities. The fair value of these instruments is not considered to be material. Other commitments to fund loans totaled \$1.235 billion and \$1.097 billion at September 30, 2014 and December 31, 2013, respectively, and have no carrying value at both dates, representing the cost of such commitments. There were no commitments to purchase securities at September 30, 2014 or at December 31, 2013.

Limitations: The fair value estimates presented herein are based on pertinent information available to management as of September 30, 2014 and December 31, 2013. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that date and, therefore, current estimates of fair value may differ significantly from the amounts presented herein.

Fair value estimates are based on existing on- and off-balance-sheet financial instruments without attempting to estimate the value of anticipated future business. The fair value has not been estimated for assets and liabilities that

are not considered financial instruments. Significant assets and liabilities that are not financial instruments include the deferred tax assets/liabilities; land, buildings and equipment; costs in excess of net assets acquired; and real estate held for sale.

Note 12: INCOME TAXES AND DEFERRED TAXES

The Company files a consolidated income tax return including all of its wholly-owned subsidiaries on a calendar year basis. Income taxes are accounted for using the asset and liability method. Under this method, a deferred tax asset or liability is determined based on the enacted tax rates which will be in effect when the differences between the financial statement carrying amounts and tax bases of existing assets and liabilities are expected to be reported in the Company's income tax returns. The effect on deferred taxes of a change in tax rates is recognized in income in the period of change. A valuation allowance is recognized as a reduction to deferred tax assets when management determines it is more likely than not that deferred tax assets will not be available to offset future income tax liabilities.

Accounting standards for income taxes prescribe a recognition threshold and measurement process for financial statement recognition and measurement of uncertain tax positions taken or expected to be taken in a tax return, and also provide guidance on the de-recognition of previously recorded benefits and their classification, as well as the proper recording of interest and penalties, accounting in interim periods, disclosures and transition. The Company periodically reviews its income tax positions based on tax laws and regulations and financial reporting considerations, and records adjustments as appropriate. This review takes into consideration the status of current taxing authorities' examinations of the Company's tax returns, recent positions taken by the taxing authorities on similar transactions, if any, and the overall tax environment.

As of September 30, 2014, the Company had an insignificant amount of unrecognized tax benefits for uncertain tax positions, none of which would materially affect the effective tax rate if recognized. The Company does not anticipate that the amount of unrecognized tax benefits will

significantly increase or decrease in the next twelve months. The Company's policy is to recognize interest and penalties on unrecognized tax benefits in the income tax expense. The Company files consolidated income tax returns in U.S. federal jurisdiction and in the Oregon and Idaho state jurisdictions. The tax years which remain subject to examination by the taxing authorities are the years ended December 31, 2013, 2012, 2011, and 2010. Tax years 2006 - 2009 are not open for assessment of additional tax, but remain open for adjustments to the amount of NOLs, credit, and other carryforwards utilized in open years or to be utilized in the future.

**Note 13: CALCULATION OF WEIGHTED AVERAGE SHARES OUTSTANDING FOR EARNINGS PER SHARE (EPS)**

The following table reconciles basic to diluted weighted shares outstanding used to calculate earnings per share data dollars and shares (in thousands, except per share data):

	Three Months Ended September 30		Nine Months Ended September 30	
	2014	2013	2014	2013
Net income	\$14,843	\$11,665	\$42,421	\$35,001
Basic weighted average shares outstanding	19,373	19,338	19,353	19,348
Plus unvested restricted stock	47	59	33	55
Diluted weighted shares outstanding	19,420	19,397	19,386	19,403
Earnings per common share				
Basic	\$0.77	\$0.60	\$2.19	\$1.81
Diluted	\$0.76	\$0.60	\$2.19	\$1.80

Options to purchase an additional 19,964 shares of common stock as of September 30, 2014 were not included in the computation of diluted earnings per share because their exercise price resulted in them being anti-dilutive. Also, as of September 30, 2014, the warrants originally issued to the U.S. Treasury in the fourth quarter of 2008 to purchase up to \$18.6 million (243,998 shares, post reverse-split) of common stock were not included in the computation of diluted EPS for the quarters ended September 30, 2014 and 2013 because the exercise price of the warrants was greater than the average market price of common shares. In June 2013, the Treasury sold the warrants in a public auction. That sale did not change the Company's capital position and did not have any impact on the financial accounting and reporting for these securities.

**Note 14: STOCK-BASED COMPENSATION PLANS**

The Company operates the following stock-based compensation plans as approved by the shareholders: the 1998 Stock Option Plan, and 2001 Stock Option Plan (collectively the SOPs), the 2012 Restricted Stock and Incentive Bonus Plan, and the 2014 Omnibus Incentive Plan. In addition, the Board approved in 2006 the Long Term Incentive Plan. The purpose of these plans is to promote the success and enhance the value of the Company by providing a means for attracting and retaining highly skilled employees, officers and directors of Banner Corporation and its affiliates and linking their personal interests with those of the Company's shareholders. Under these plans the Company currently has outstanding restricted stock grants, stock options and stock appreciation rights.

**Restricted Stock Grants:** Under the 2012 Restricted Stock and Incentive Bonus Plan, which was initially approved on April 24, 2012, the Company is authorized to issue up to 300,000 shares of its common stock to provide a means for attracting and retaining highly skilled officers of Banner Corporation and its affiliates. Shares granted under the Plan have a minimum vesting period of three years. The Plan will continue in effect for a term of ten years, after which no further awards may be granted. The 2012 Restricted Stock Plan was amended on April 23, 2013 to provide for the ability to grant (1) cash-denominated incentive-based awards payable in cash or common stock, including those that are eligible to qualify as qualified performance-based compensation for the purposes of Section 162(m) of the Code

and (2) restricted stock awards that qualify as qualified performance-based compensation for the purposes of Section 162(m) of the Code. Vesting requirements may include time-based conditions, performance-based conditions, or market-based conditions. As of September 30, 2014, the Company had granted 267,827 shares of restricted stock from the 2012 Restricted Stock and Incentive Bonus Plan, of which 87,139 shares had vested and 180,688 shares remain unvested. The expense associated with all restricted stock grants was \$710,000 and \$1.8 million, respectively, for the three and nine-month period ended September 30, 2014 and was \$482,000 and \$1.0 million, respectively, for the three and nine-month period ended September 30, 2013. Unrecognized compensation expense for these awards as of September 30, 2014 was \$4.9 million and will be amortized over the next 33 months.

**Stock Options.** Under the SOPs, Banner reserved 2,284,186 shares for issuance pursuant to the exercise of stock options to be granted to directors and employees. Authority to grant additional options under the 1998 Stock Option Plan terminated on July 24, 2008. Authority to grant additional options under the 2001 Stock Option Plan terminated on April 20, 2011. The exercise price of the stock options is set at 100% of the fair market value of the stock price on the date of grant. Options granted vest at a rate of 20% per year from the date of grant and any unexercised incentive stock options will expire ten years after date of grant or 90 days after employment or service ends.

During the nine months ended September 30, 2014 and 2013, the Company did not grant any stock options. Additionally, there were no significant modifications made to any stock option grants during the period. The fair values of stock options granted are amortized as compensation expense on a straight-line basis over the vesting period of the grant.

There were no stock-based compensation costs related to the SOPs for the quarters ended September 30, 2014 or September 30, 2013. The SOPs' stock option grant compensation costs are generally based on the fair value calculated from the Black-Scholes option pricing on the date of the grant award. The Black-Scholes model assumes an expected stock price volatility based on the historical volatility at the date of the grant and an expected term based on the remaining contractual life of the vesting period. The Company bases the estimate of risk-free interest rate on the U.S. Treasury Constant Maturities Indices in effect at the time of the grant. The dividend yield is based on the current quarterly dividend in effect at the time of the grant.

During the three and nine months ended September 30, 2014 and 2013, there were no exercises of stock options. Cash was not used to settle any equity instruments previously granted. The Company issues shares from authorized but unissued shares upon the exercise of stock options. The Company does not currently expect to repurchase shares from any source to satisfy such obligations under the SOPs.

**Banner Corporation Long-Term Incentive Plan:** In June 2006, the Board of Directors adopted the Banner Corporation Long-Term Incentive Plan effective July 1, 2006. The Plan is an account-based type of benefit, the value of which is directly related to changes in the value of Company common stock, dividends declared on Company common stock and changes in Banner Bank's average earnings rate, and is considered a stock appreciation right (SAR). Each SAR entitles the holder to receive cash upon vesting, equal to the excess of the fair market value of a share of the Company's common stock on the date of maturity of the SAR over the fair market value of such share on the date granted plus, for some grants, the dividends declared on the stock from the date of grant to the date of vesting. The primary objective of the Plan is to create a retention incentive by allowing officers who remain with the Company or the Banks for a sufficient period of time to share in the increases in the value of Company stock. The Company re-measures the fair value of SARs each reporting period until the award is settled and recognizes changes in fair value and vesting in compensation expense. The Company recognized compensation expense of \$16,000 for the three months ended September 30, 2014 and a net reversal of compensation expense of \$122,000 for the nine months ended September 30, 2014 due to variations in market value of the underlying stock, compared to compensation expense of \$286,000 for the three months ended September 30, 2013 and a compensation expense of \$526,000 for the nine months ended September 30, 2013. At September 30, 2014, the aggregate liability related to SARs was \$867,000 and was included in deferred compensation.

**Banner Corporation 2014 Omnibus Incentive Plan:** The 2014 Plan was approved by shareholders on April 22, 2014. The 2014 Plan provides for the grant of incentive stock options, non-qualified stock options, stock appreciation rights, restricted stock, restricted stock units, performance shares, performance units, other stock-based awards and other cash awards, and provides for vesting requirements which may include time-based or performance-based conditions. The Company has reserved 900,000 shares of its common stock for issuance under the 2014 Plan in connection with exercise of awards. As of September 30, 2014, 9,352 shares had been granted to directors under the 2014 Omnibus Plan.

#### Note 15: COMMITMENTS AND CONTINGENCIES

**Lease Commitments** — The Company leases 65 sites under non-cancelable operating leases. The leases contain various provisions for increases in rental rates, based either on changes in the published Consumer Price Index or a predetermined escalation schedule. Substantially all of the leases provide the Company with the option to extend the lease term one or more times following expiration of the initial term.

**Financial Instruments with Off-Balance-Sheet Risk** — The Company has financial instruments with off-balance-sheet risk generated in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit, commitments related to standby letters of credit, commitments to originate loans, commitments to sell loans, commitments to buy and sell securities. These instruments involve, to



varying degrees, elements of credit and interest rate risk similar to the risk involved in on-balance sheet items recognized in our Consolidated Statements of Financial Condition.

Our exposure to credit loss in the event of nonperformance by the other party to the financial instrument from commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. We use the same credit policies in making commitments and conditional obligations as for on-balance-sheet instruments.

Outstanding commitments for which no asset or liability for the notional amount has been recorded consisted of the following at the dates indicated (in thousands):

	Contract or Notional Amount	
	September 30, 2014	December 31, 2013
Commitments to extend credit	\$1,197,737	\$1,073,897
Standby letters of credit and financial guarantees	10,004	6,990
Commitments to originate loans	27,272	15,776
Derivatives also included in Note 16:		
Commitments to originate loans held for sale	31,071	21,434
Commitments to sell loans secured by one- to four-family residential properties	13,697	9,378
Commitments to sell securities related to mortgage banking activities	22,468	15,200

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. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Many of the commitments may expire without being drawn upon; therefore, the total commitment amounts do not necessarily represent future cash requirements. Each customer's creditworthiness is evaluated on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the customer. The type of collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, and income producing commercial properties.

Standby letters of credit are conditional commitments issued to guarantee a customer's performance or payment to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

Interest rates on residential one- to four-family mortgage loan applications are typically rate locked (committed) to customers during the application stage for periods ranging from 30 to 60 days, the most typical period being 45 days. Traditionally these loan applications with rate lock commitments had the pricing for the sale of these loans locked with various qualified investors under a best-efforts delivery program at or near the time the interest rate is locked with the customer. The Company then attempts to deliver these loans before their rate locks expired. This arrangement generally required delivery of the loans prior to the expiration of the rate lock. Delays in funding the loans required a lock extension. The cost of a lock extension at times was borne by the customer and at times by the Bank. These lock extension costs have not had a material impact to our operations. In 2012, the Company also began entering into forward commitments at specific prices and settlement dates to deliver either: (1) residential mortgage loans for purchase by secondary market investors (i.e., Freddie Mac or Fannie Mae), or (2) mortgage-backed securities to broker/dealers. The purpose of these forward commitments is to offset the movement in interest rates between the execution of its residential mortgage rate lock commitments with borrowers and the sale of those loans to the secondary market investor. There were no counterparty default losses on forward contracts in the nine months ended September 30, 2014 or September 30, 2013. Market risk with respect to forward contracts arises principally from changes in the value of contractual positions due to changes in interest rates. We limit our exposure to market risk by monitoring differences between commitments to customers and forward contracts with market investors and securities broker/dealers. In the event we have forward delivery contract commitments in excess of available mortgage loans, the transaction is completed by either paying or receiving a fee to or from the investor or broker/dealer equal to the increase or decrease in the market value of the forward contract.

**Legal Proceedings** — In the normal course of business, the Company and/or its subsidiaries have various legal proceedings and other contingent matters outstanding. These proceedings and the associated legal claims are often contested and the outcome of individual matters is not always predictable. The claims and counter-claims typically arise during the course of collection efforts on problem loans or with respect to action to enforce liens on properties in which the Company holds a security interest. Based on information known to management at this time, the Company is not a party to any legal proceedings that management believes would have a material adverse effect on the Company's results of operations or consolidated financial position at September 30, 2014.

#### NOTE 16: DERIVATIVES AND HEDGING

The Company, through its Banner Bank subsidiary, is party to various derivative instruments that are used for asset and liability management and customer financing needs. Derivative instruments are contracts between two or more parties that have a notional amount and an underlying variable, require no net investment and allow for the net settlement of positions. The notional amount serves as the basis for the payment provision of the contract and takes the form of units, such as shares or dollars. The underlying variable represents a specified interest rate, index, or other component. The interaction between the notional amount and the underlying variable determines the number of units to be exchanged between the parties and influences the market value of the derivative contract. The Company obtains dealer quotations to value its derivative contracts.

The Company's predominant derivative and hedging activities involve interest rate swaps related to certain term loans and forward sales contracts associated with mortgage banking activities. Generally, these instruments help the Company manage exposure to market risk and meet customer financing needs. Market risk represents the possibility that economic value or net interest income will be adversely affected by fluctuations in external factors such as market-driven interest rates and prices or other economic factors.

#### Derivatives Designated in Hedge Relationships

The Company's fixed rate loans result in exposure to losses in value or net interest income as interest rates change. The risk management objective for hedging fixed rate loans is to effectively convert the fixed rate received to a floating rate. The Company has hedged exposure to changes in the fair value of certain fixed rate loans through the use of interest rate swaps. For a qualifying fair value hedge, changes in the value of the derivatives are recognized in current period earnings along with the corresponding changes in the fair value of the designated hedged item attributable to the risk being hedged.

In a program brought to Banner Bank through its merger with F&M Bank in 2007, customers received fixed interest rate commercial loans and the Bank subsequently hedged that fixed rate loan by entering into an interest rate swap with a dealer counterparty. The Bank receives fixed rate payments from the customers on the loans and makes similar fixed rate payments to the dealer counterparty on the swaps in exchange for variable rate payments based on the one-month LIBOR index. Some of these interest rate swaps are designated as fair value hedges. Through application of the "short cut method of accounting," there is an assumption that the hedges are effective. The Bank discontinued originating interest rate swaps under this program in 2008.

As of September 30, 2014 and December 31, 2013, the notional values or contractual amounts and fair values of the Company's derivatives designated in hedge relationships were as follows (in thousands):

	Asset Derivatives				Liability Derivatives			
	September 30, 2014	December 31, 2013	September 30, 2014	December 31, 2013	September 30, 2014	December 31, 2013	September 30, 2014	December 31, 2013
	Notional/ Contract Amount	Fair Value <sup>(1)</sup>	Notional/ Contract Amount	Fair Value <sup>(1)</sup>	Notional/ Contract Amount	Fair Value <sup>(2)</sup>	Notional/ Contract Amount	Fair Value <sup>(2)</sup>
Interest rate swaps	\$7,175	\$1,161	\$7,420	\$1,295	\$7,175	\$1,161	\$7,420	\$1,295

(1) Included in Loans receivable on the Consolidated Statements of Financial Condition.

(2) Included in Other liabilities on the Consolidated Statements of Financial Condition.

#### Derivatives Not Designated in Hedge Relationships

**Interest Rate Swaps.** Banner Bank has been using an interest rate swap program for commercial loan customers, termed the Back-to-Back Program, since 2010. In the Back-to-Back Program, the Bank provides the client with a variable rate loan and enters into an interest rate swap in which the client receives a variable rate payment in exchange for a fixed rate payment. The Bank offsets its risk exposure by entering into an offsetting interest rate swap with a dealer counterparty for the same notional amount and length of term as the client interest rate swap providing the dealer counterparty with a fixed rate payment in exchange for a variable rate payment. There are also a few interest rate swaps from prior to 2009 that were not designated in hedge relationships that are included in these totals. These swaps do not qualify as designated hedges; therefore, each swap is accounted for as a free standing derivative.

**Mortgage Banking.** In the normal course of business, the Company sells originated mortgage loans into the secondary mortgage loan markets. During the period of loan origination and prior to the sale of the loans in the secondary market, the Company has exposure to movements in interest rates associated with written rate lock commitments with potential borrowers to originate loans that are intended to be sold and for closed loans that are awaiting sale and delivery into the secondary market.

Written loan commitments that relate to the origination of mortgage loans that will be held for resale are considered free-standing derivatives and do not qualify for hedge accounting. Written loan commitments generally have a term of up to 60 days before the closing of the loan. The loan commitment does not bind the potential borrower to enter into the loan, nor does it guarantee that the Company will approve the potential borrower for the loan. Therefore, when determining fair value, the Company makes estimates of expected "fallout" (loan commitments not expected to close), using models which consider cumulative historical fallout rates, current market interest rates and other factors.

Written loan commitments in which the borrower has locked in an interest rate results in market risk to the Company to the extent market interest rates change from the rate quoted to the borrower. The Company economically hedges the risk of changing interest rates associated with its interest rate lock commitments by entering into forward sales contracts.

Mortgage loans which are held for sale are subject to changes in fair value due to fluctuations in interest rates from the loan's closing date through the date of sale of the loans into the secondary market. Typically, the fair value of these loans declines when interest rates increase and rises when interest rates decrease. To mitigate this risk, the Company enters into forward sales contracts on a significant portion of these loans to provide an economic hedge against those changes in fair value. Mortgage loans held for sale and the forward sales contracts are recorded at fair value with ineffective changes in value recorded in current earnings as loan sales and servicing income.



As of September 30, 2014 and December 31, 2013, the notional values or contractual amounts and fair values of the Company's derivatives not designated in hedge relationships were as follows (in thousands):

	Asset Derivatives				Liability Derivatives			
	September 30, 2014		December 31, 2013		September 30, 2014		December 31, 2013	
	Notional/ Contract Amount	Fair Value <sup>(1)</sup>	Notional/ Contract Amount	Fair Value <sup>(1)</sup>	Notional/ Contract Amount	Fair Value <sup>(2)</sup>	Notional/ Contract Amount	Fair Value <sup>(2)</sup>
Interest rate swaps	\$136,434	\$3,782	\$135,122	\$3,651	\$136,434	\$3,782	\$135,122	\$3,651
Mortgage loan commitments	20,477	205	14,107	57	10,593	21	7,326	43
Forward sales contracts	10,593	21	22,526	73	22,468	12	—	—
	\$167,504	\$4,008	\$171,755	\$3,781	\$169,495	\$3,815	\$142,448	\$3,694

- Included in Other assets on the Consolidated Statements of Financial Condition, with the exception of those
- (1) interest rate swaps from prior to 2009 that were not designated in hedge relationships (with a fair value of \$603,000 at September 30, 2014 and \$791,000 at December 31, 2013), which are included in Loans receivable.
- (2) Included in Other liabilities on the Consolidated Statements of Financial Condition.

Gains (losses) recognized in income on non-designated hedging instruments for the three and nine months ended September 30, 2014 and 2013 were as follows (in thousands):

	Location on Income Statement	Three Months Ended September 30		Nine Months Ended September 30	
		2014	2013	2014	2013
Mortgage loan commitments	Mortgage banking operations	\$(243)	) \$651	\$148	\$(165)
Forward sales contracts	Mortgage banking operations	224	(952)	(42)	(130)
		\$(19)	) \$(301)	) \$106	\$(295)

The Company is exposed to credit-related losses in the event of nonperformance by the counterparty to these agreements. Credit risk of the financial contract is controlled through the credit approval, limits, and monitoring procedures and management does not expect the counterparties to fail their obligations.

In connection with the interest rate swaps between Banner Bank and the dealer counterparties, the agreements contain a provision where if Banner Bank fails to maintain its status as a well/adequately capitalized institution, then the counterparty could terminate the derivative positions and Banner Bank would be required to settle its obligations. Similarly, Banner Bank could be required to settle its obligations under certain of its agreements if specific regulatory events occur, such as a publicly issued prompt corrective action directive, cease and desist order, or a capital maintenance agreement that required Banner Bank to maintain a specific capital level. If Banner Bank had breached any of these provisions at September 30, 2014 or December 31, 2013, it could have been required to settle its obligations under the agreements at the termination value. As of September 30, 2014 and December 31, 2013, the termination value of derivatives in a net liability position related to these agreements was \$4.6 million and \$2.7 million, respectively. The Company generally posts collateral against derivative liabilities in the form of government agency-issued bonds, mortgage-backed securities, or commercial mortgage-backed securities. Collateral posted against derivative liabilities was \$9.8 million and \$8.9 million as of September 30, 2014 and December 31, 2013, respectively.

Derivative assets and liabilities are recorded at fair value on the balance sheet and do not take into account the effects of master netting agreements. Master netting agreements allow the Company to settle all derivative contracts held with a single counterparty on a net basis and to offset net derivative positions with related collateral where applicable.

The following table illustrates the potential effect of the Company's derivative master netting arrangements, by type of financial instrument, on the Company's Statements of Financial Condition as of September 30, 2014 and December 31, 2013 (in thousands):

September 30, 2014

				Gross Amounts of Financial Instruments Not Offset in the Statement of Financial Condition			
	Gross Amounts Recognized	Amounts offset in the Statement of Financial Condition	Net Amounts in the Statement of Financial Condition	Netting Adjustment Per Applicable Master Netting Agreements	Fair Value of Financial Collateral in the Statement of Financial Condition		Net Amount
Derivative assets							
Interest rate swaps	\$4,944	\$—	\$4,944	\$(212	) \$—		\$4,732
	\$4,944	\$—	\$4,944	\$(212	) \$—		\$4,732
Derivative liabilities							
Interest rate swaps	\$4,944	\$—	\$4,944	\$(212	) \$(4,520	)	\$212
	\$4,944	\$—	\$4,944	\$(212	) \$(4,520	)	\$212

December 31, 2013

				Gross Amounts of Financial Instruments Not Offset in the Statement of Financial Condition			
	Gross Amounts Recognized	Amounts offset in the Statement of Financial Condition	Net Amounts in the Statement of Financial Condition	Netting Adjustment Per Applicable Master Netting Agreements	Fair Value of Financial Collateral in the Statement of Financial Condition		Net Amount
Derivative assets							
Interest rate swaps	\$4,946	\$—	\$4,946	\$(554	) \$—		\$4,392
	\$4,946	\$—	\$4,946	\$(554	) \$—		\$4,392
Derivative liabilities							
Interest rate swaps	\$4,946	\$—	\$4,946	\$(554	) \$(2,657	)	\$1,735
	\$4,946	\$—	\$4,946	\$(554	) \$(2,657	)	\$1,735



## ITEM 2 – Management’s Discussion and Analysis of Financial Condition and Results of Operations

### Executive Overview

We are a bank holding company incorporated in the State of Washington which owns two subsidiary banks, Banner Bank and Islanders Bank. Banner Bank is a Washington-chartered commercial bank that conducts business from its main office in Walla Walla, Washington and, as of September 30, 2014, its 90 branch offices and ten loan production offices located in Washington, Oregon and Idaho. Islanders Bank is also a Washington-chartered commercial bank and conducts its business from three locations in San Juan County, Washington. Banner Corporation is subject to regulation by the Board of Governors of the Federal Reserve System (the Federal Reserve Board). Banner Bank and Islanders Bank (the Banks) are subject to regulation by the Washington State Department of Financial Institutions, Division of Banks and the Federal Deposit Insurance Corporation (the FDIC). As of September 30, 2014, we had total consolidated assets of \$4.8 billion, total loans of \$3.8 billion, total deposits of \$4.0 billion and total stockholders’ equity of \$574 million.

Banner Bank is a regional bank which offers a wide variety of commercial banking services and financial products to individuals, businesses and public sector entities in its primary market areas. Islanders Bank is a community bank which offers similar banking services to individuals, businesses and public entities located in the San Juan Islands. The Banks’ primary business is that of traditional banking institutions, accepting deposits and originating loans in locations surrounding their offices in portions of Washington, Oregon and Idaho. Banner Bank is also an active participant in the secondary market, engaging in mortgage banking operations largely through the origination and sale of one- to four-family residential loans. Lending activities include commercial business and commercial real estate loans, agriculture business loans, construction and land development loans, one- to four-family residential loans and consumer loans.

Banner Corporation's successful execution of its strategic plan and operating initiatives continued in the third quarter of 2014, as evidenced by our solid operating results and profitability. Highlights for the quarter included additional loan growth, significantly increased core deposits (transaction and savings accounts), additional client acquisition, further improvement in our asset quality and strong revenues from core operations. For the third quarter we had a significant increase in net interest income, as well as a meaningful increase in deposit fees and service charges and a further rebound in revenue from mortgage banking. The current year-to-date period was also highlighted by the acquisition of six branches in southwestern Oregon (the Branch Acquisition). In connection with the Branch Acquisition, as of June 20, 2014, the Company acquired approximately \$212 million in deposits, \$88 million in loans and 10,500 new customer relationships. In addition, the Company recognized a \$9.1 million bargain purchase gain related to the Branch Acquisition, which net of related expenses added \$0.25 per diluted share to the year-to-date earnings.

In spite of persistently weak economic conditions and exceptionally low interest rates which have created an unusually challenging banking environment for an extended period, the Company experienced marked improvement and consistent profitability in 2012 and 2013 which has continued through the third quarter of 2014. For the quarter ended September 30, 2014, our net income was \$14.8 million, or \$0.76 per diluted share, compared to a net income of \$11.7 million, or \$0.60 per diluted share, for the quarter ended September 30, 2013. For the nine months ended September 30, 2014, our net income was \$42.4 million, or \$2.19 per diluted share, compared to net income of \$35.0 million, or \$1.80 per diluted share for the same period a year earlier. Although there continue to be indications that economic conditions are improving, the pace of expansion has been modest and uneven and ongoing uncertainty in the economy will likely continue to be challenging going forward. As a result, our future operating results and financial performance will be significantly affected by the course of economic activity. However, over the past four years we have significantly added to our client relationships and account base, as well as substantially improved our risk profile by aggressively managing and reducing our problem assets, which has resulted in stronger and sustainable revenues and lower credit costs, and which we believe has positioned the Company well to meet this challenging

environment with continued success.

Our operating results depend primarily on our net interest income, which is the difference between interest income on interest-earning assets, consisting of loans and investment securities, and interest expense on interest-bearing liabilities, composed primarily of customer deposits and borrowings. Net interest income is primarily a function of our interest rate spread, which is the difference between the yield earned on interest-earning assets and the rate paid on interest-bearing liabilities, as well as a function of the average balances of interest-earning assets and interest-bearing liabilities. Our net interest income before provision for loan losses increased \$5.2 million, or 12%, to \$47.1 million for the quarter ended September 30, 2014, compared to \$41.9 million for the same quarter one year earlier. This increase in net interest income reflects the significant growth in earning assets and occurred despite the decrease in interest rate spread as a result of declining yields on earning assets, which were only partially offset by continuing reductions in deposit and other funding costs. Our interest rate spread decreased to 4.06% in the current quarter from 4.07% in the quarter ended September 30, 2013 while our net interest margin decreased to 4.07% in the current quarter compared to 4.09% in the same quarter a year earlier.

Our net income also is affected by the level of our other operating income, including deposit fees and service charges, loan origination and servicing fees, and gains and losses on the sale of loans and securities, as well as credit costs and our non-interest operating expenses and income tax provisions. In addition, our net income is affected by the net change in the valuation of certain financial instruments carried at fair value and in certain periods by other-than-temporary impairment (OTTI) charges or recoveries and acquisition-related bargain purchase gains and costs. In the nine months ended September 30, 2014, net income was significantly augmented by the \$9.1 million bargain purchase gain (\$5.8 million net of income tax) realized from the Branch Acquisition. (See Notes 4 and 11 of the Selected Notes to the Consolidated Financial Statements.)

As a result of adequate reserves already in place representing 1.95% of total loans outstanding at September 30, 2014, we did not record a provision for loan losses in the three months ended September 30, 2014. Our reserves at June 30, 2014 and September 30, 2013 were 1.97% and 2.32%, respectively, of total loans outstanding and, similar to the current quarter, no provisions for loan losses were recorded in the quarters

ended June 30, 2014 or September 30, 2013. The allowance for loan losses at September 30, 2014 was \$74.3 million, representing 376% of non-performing loans. Non-performing loans increased slightly to \$19.8 million at September 30, 2014, compared to \$19.7 million three months earlier, but decreased 20% when compared to \$24.9 million a year earlier. (See Note 7, Loans Receivable and the Allowance for Loan Losses, as well as “Asset Quality” below in this Form 10-Q.)

Our total other operating income, which includes the gain on sale of securities and changes in the value of financial instruments carried at fair value, was \$13.4 million for the quarter ended September 30, 2014, compared to \$10.1 million for the quarter ended September 30, 2013. For the quarter ended September 30, 2014, we recorded a net fair value gain of \$1.5 million in fair value adjustments and \$6,000 in gains on the sale of securities. In comparison, for the quarter ended September 30, 2013, we recorded a net fair value loss of \$352,000, partially offset by \$2,000 in gains on the sale of securities. Other operating income excluding the gain on sale of securities and changes in the fair value of financial instruments, which we believe is more indicative of our core operations, increased 13% to \$11.9 million for the quarter ended September 30, 2014, compared to \$10.5 million for the same quarter a year earlier, as a result of meaningfully increased deposit fees and service charges fueled by growth in non-interest-bearing deposit accounts and increased revenues from our mortgage banking operations.

Our total revenues (net interest income before the provision for loan losses plus total other operating income) for the third quarter of 2014 increased \$8.4 million to \$60.4 million, compared to \$52.0 million for the same period a year earlier, as a result of increased net interest income and deposit fees and service charges, positive changes in fair value adjustments, as well as increased mortgage banking revenues and gain on sale of securities. Our total revenues, excluding changes in the fair value of financial instruments and gain on sale of securities, which we believe are more indicative of our core operations, also were strong at \$59.0 million for the quarter ended September 30, 2014, a \$6.6 million, or 13% increase, compared to \$52.4 million for the same period a year earlier.

Our other operating expenses increased in the third quarter of 2014 compared to a year earlier largely as a result of increased salary and employee benefits, advertising and marketing expenses, payment and card processing expenses, occupancy and equipment expenses and data processing expenses, which were partially offset by decreased professional services expenses and gains on sales of REO properties as well as an increase in the credit for capitalized loan origination costs and a net credit to acquisition-related costs as a result of modest over-accruals of certain of those costs in the preceding quarter. Other operating expenses were \$38.5 million for the quarter ended September 30, 2014, compared to \$34.5 million for the same quarter a year earlier.

Other operating income, revenues and other earnings information excluding fair value adjustments, OTTI losses or recoveries, and gains or losses on sale of securities and, in certain periods, acquisition-related bargain purchase gains and costs are non-GAAP financial measures. Management has presented these and other non-GAAP financial measures in this discussion and analysis because it believes that they provide useful and comparative information to assess trends in our core operations. However, these non-GAAP financial measures are supplemental and are not a substitute for any analysis based on GAAP. Where applicable, we have also presented comparable earnings information using GAAP financial measures. For a reconciliation of these non-GAAP financial measures, see the tables below. Because not all companies use the same calculations, our presentation may not be comparable to other similarly titled measures as calculated by other companies. See “Comparison of Results of Operations for the Three and Nine Months Ended September 30, 2014 and 2013” for more detailed information about our financial performance.

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The following tables set forth reconciliations of non-GAAP financial measures discussed in this report (in thousands):

	For the Three Months Ended September 30 2014		For the Nine Months Ended September 30 2014	
	2014	2013	2014	2013
Total other operating income (GAAP)	\$13,350	\$10,142	\$42,342	\$30,763
Exclude net gain on sale of securities	(6	) (2	) (41	) (1,020
Exclude other-than-temporary impairment (recovery) loss	—	—	—	(409
Exclude change in valuation of financial instruments carried at fair value	(1,452	) 352	(1,662	) 1,954
Exclude acquisition bargain purchase gain	—	—	(9,079	) —
Total other operating income from core operations (non-GAAP)	\$11,892	\$10,492	\$31,560	\$31,288
Net interest income before provision for loan losses	\$47,064	\$41,893	\$133,211	\$125,109
Total other operating income	13,350	10,142	42,342	30,763
Total GAAP revenue	60,414	52,035	175,553	155,872
Exclude net gain on sale of securities	(6	) (2	) (41	) (1,020
Exclude other-than-temporary impairment (recovery) loss	—	—	—	(409
Exclude change in valuation of financial instruments carried at fair value	(1,452	) 352	(1,662	) 1,954
Exclude acquisition bargain purchase gain	—	—	(9,079	) —
Revenue from core operations (non-GAAP)	\$58,956	\$52,385	\$164,771	\$156,397
Income before provision for taxes (GAAP)	\$21,919	\$17,545	\$63,041	\$51,826
Exclude net gain on sale of securities	(6	) (2	) (41	) (1,020
Exclude other-than-temporary impairment (recovery) loss	—	—	—	(409
Exclude change in valuation of financial instruments carried at fair value	(1,452	) 352	(1,662	) 1,954
Exclude acquisition bargain purchase gain	—	—	(9,079	) —
Income from core operations before provision for taxes (non-GAAP)	\$20,461	\$17,895	\$52,259	\$52,351
Net income (GAAP)	\$14,843	\$11,665	\$42,421	\$35,001
Exclude net gain on sale of securities	(6	) (2	) (41	) (1,020
Exclude other-than-temporary impairment (recovery) loss	—	—	—	(409
Exclude change in valuation of financial instruments carried at fair value	(1,452	) 352	(1,662	) 1,954
Exclude acquisition bargain purchase gain	—	—	(9,079	) —
Exclude related tax expense (benefit)	525	(126	) 3,882	(189
Total earnings from core operations (non-GAAP)	\$13,910	\$11,889	\$35,521	\$35,337
Acquisition bargain purchase gain	\$—	\$—	\$9,079	\$—
Acquisition-related costs	494	—	(1,530	) —
Related tax expense	(178	) —	(2,718	) —
Total net effect of acquisition on earnings	\$316	\$—	\$4,831	\$—
Diluted weighted shares outstanding	19,419,344	19,397,329	19,385,933	19,402,659
Total net effect of acquisition on diluted earnings per share	\$0.02	\$—	\$0.25	\$—



The ratio of tangible common stockholders' equity to tangible assets is also a non-GAAP financial measure. We calculate tangible common equity by excluding other intangible assets from stockholders' equity. We calculate tangible assets by excluding the balance of other intangible assets from total assets. We believe that this is consistent with the treatment by our bank regulatory agencies, which exclude goodwill and other intangible assets from the calculation of risk-based capital ratios. Management believes that this non-GAAP financial measure provides information to investors that is useful in understanding the basis of our capital position (dollars in thousands).

	September 30, 2014	December 31, 2013	September 30, 2013	
Stockholders' equity (GAAP)	\$574,058	\$538,972	\$529,992	
Exclude other intangible assets, net	3,362	2,449	2,937	
Tangible common stockholders' equity (non-GAAP)	\$570,696	\$536,523	\$527,055	
Total assets (GAAP)	\$4,759,389	\$4,388,898	\$4,283,285	
Exclude other intangible assets, net	3,362	2,449	2,937	
Total tangible assets (non-GAAP)	\$4,756,027	\$4,386,449	\$4,280,348	
Tangible common stockholders' equity to tangible assets (non-GAAP)	12.00	% 12.23	% 12.31	%

Loans are our most significant and generally highest yielding earning assets. We attempt to maintain a portfolio of loans in a range of 90% to 95% of total deposits to enhance our revenues, while adhering to sound underwriting practices and appropriate diversification guidelines in order to maintain a moderate risk profile. We had modest loan growth in the current quarter and at September 30, 2014 our net loan portfolio totaled \$3.732 billion compared to \$3.344 billion at December 31, 2013 and \$3.200 billion at September 30, 2013.

We offer a wide range of loan products to meet the demands of our customers. Our lending activities are primarily directed toward the origination of real estate and commercial loans. Commercial real estate loans for both owner-occupied and investment properties, including construction and development loans for these types of properties, totaled \$1.430 billion, or approximately 38% of our loan portfolio at September 30, 2014. In addition, multifamily residential real estate loans, including construction and development loans for these types of properties, totaled \$233 million and comprise approximately 6% of our loan portfolio. While our level of activity and investment in commercial and multifamily real estate loans has been relatively stable for many years, we have experienced an increase in new originations in recent periods resulting in growth in these loan balances. Commercial real estate loans increased by \$212 million during the first nine months of 2014 and multifamily loans increased by \$43 million. We also originate residential construction, land and land development loans and, although our portfolio balances are well below the peak levels before the financial crisis, beginning in 2011 and continuing since then we have experienced increased demand for one- to four-family construction loans. Outstanding residential construction, land and land development balances increased \$27 million, or 10%, to \$304 million at September 30, 2014 compared to \$276 million at December 31, 2013 and increased \$34 million, or 13%, compared to \$270 million at September 30, 2013. Still, residential construction, land and land development loans represented only approximately 8% of our total loan portfolio at September 30, 2014. Our commercial business lending is directed toward meeting the credit and related deposit needs of various small- to medium-sized business and agribusiness borrowers operating in our primary market areas. Reflecting the slowly recovering economy, demand for these types of commercial business loans has been modest although our production levels have increased in recent periods. In recent years, our commercial business lending has also included participation in certain national syndicated loans, including shared national credits, which totaled \$118 million at September 30, 2014. Commercial and agricultural business loans increased \$58 million, or 6%, to \$968 million at September 30, 2014, compared to \$910 million at December 31, 2013, and have increased \$109 million, or 13%, compared to \$859 million at September 30, 2013. Commercial and agricultural business loans represented approximately 25% of our portfolio at September 30, 2014.

Our residential mortgage loan originations have been relatively strong in recent years, as exceptionally low interest rates have supported demand for loans to refinance existing debt as well as loans to finance home purchases.

Refinancing activity was particularly significant in 2012 and in the first six months of 2013, leading to meaningful increases in residential mortgage originations during those periods; however, the rise in mortgage interest rates that began in the second quarter of 2013 slowed origination activity and has resulted in much lower refinancing activity in recent periods. At September 30, 2014, our outstanding balances for residential mortgages decreased \$2 million to \$527 million, compared to \$529 million at December 31, 2013, and have decreased \$16 million compared to \$543 million at September 30, 2013. One- to four-family residential real estate loans represented nearly 14% of our loan portfolio at September 30, 2014. Most of the one- to four-family loans that we originate are sold in the secondary markets with net gains on sales and loan servicing fees reflected in our revenues from mortgage banking.

Our consumer loan activity is primarily directed at meeting demand from our existing deposit customers. We have increased our emphasis on consumer lending in recent years, and while demand for consumer loans has been modest during this period of economic weakness as we believe many consumers have been focused on reducing their personal debt, we are starting to see some meaningful growth in 2014. At September 30, 2014, consumer loans, including consumer loans secured by one- to four-family residences, increased \$50 million to \$345 million, compared to \$295 million at December 31, 2013, and have increased \$61 million compared to \$284 million at September 30, 2013, with most of the increase arising from increased usage of home equity lines of credit.

Deposits, customer retail repurchase agreements and loan repayments are the major sources of our funds for lending and other investment purposes. We compete with other financial institutions and financial intermediaries in attracting deposits and we generally attract deposits within our primary market areas. Much of the focus of our branch expansion over many years, including the Branch Acquisition, and our current

marketing efforts have been directed toward attracting additional deposit customer relationships and balances. This effort has been particularly directed towards increasing transaction and savings accounts and for the past four years we have been very successful in increasing these core deposit balances. The long-term success of our deposit gathering activities is reflected not only in the growth of deposit balances, but also in increases in the level of deposit fees, service charges and other payment processing revenues compared to periods prior to that expansion.

Total deposits were \$3.991 billion at September 30, 2014, compared to \$3.919 billion three months earlier and \$3.535 billion a year ago. Non-interest-bearing account balances increased 8% to \$1.305 billion at September 30, 2014, compared to \$1.210 billion at June 30, 2014, and increased 24% compared to \$1.052 billion a year ago largely as a result of our successful client acquisition strategies and the Branch Acquisition. Interest-bearing transaction and savings accounts increased 3% to \$1.833 billion at September 30, 2014, compared to \$1.772 billion at June 30, 2014 and increased 16% compared to \$1.583 billion a year ago, while certificates of deposit decreased 9% to \$853 million at September 30, 2014, compared to \$937 million at June 30, 2014 and decreased 5% compared to \$900 million a year earlier. Core deposits represented 79% of total deposits at September 30, 2014, compared to 75% of total deposits a year earlier.

Management's Discussion and Analysis of Results of Operations is intended to assist in understanding our financial condition and results of operations. The information contained in this section should be read in conjunction with the Consolidated Financial Statements and accompanying Selected Notes to the Consolidated Financial Statements contained in Item 1 of this Form 10-Q.

#### Summary of Critical Accounting Policies

Our significant accounting policies are described in Note 1 of the Notes to the Consolidated Financial Statements for the year ended December 31, 2013 included in the 2013 Form 10-K. Various elements of our accounting policies, by their nature, are inherently subject to estimation techniques, valuation assumptions and other subjective assessments. In particular, management has identified several accounting policies that, due to the judgments, estimates and assumptions inherent in those policies, are critical to an understanding of our financial statements. These policies relate to (i) the methodology for the recognition of interest income, (ii) determination of the provision and allowance for loan and lease losses, (iii) the valuation of financial assets and liabilities recorded at fair value, including OTTI losses, (iv) the valuation of intangibles, such as core deposit intangibles and mortgage servicing rights, (v) the valuation of real estate held for sale and (vi) the valuation of or recognition of deferred tax assets and liabilities. These policies and judgments, estimates and assumptions are described in greater detail below. Management believes that the judgments, estimates and assumptions used in the preparation of the financial statements are appropriate based on the factual circumstances at the time. However, given the sensitivity of the financial statements to these critical accounting policies, the use of other judgments, estimates and assumptions could result in material differences in our results of operations or financial condition. Further, subsequent changes in economic or market conditions could have a material impact on these estimates and our financial condition and operating results in future periods. There have been no significant changes in our application of accounting policies during the first nine months of 2014.

**Interest Income:** (Note 1) Interest on loans and securities is accrued as earned unless management doubts the collectability of the asset or the unpaid interest. Interest accruals on loans are generally discontinued when loans become 90 days past due for payment of interest and the loans are then placed on nonaccrual status. All previously accrued but uncollected interest is deducted from interest income upon transfer to nonaccrual status. For any future payments collected, interest income is recognized only upon management's assessment that there is a strong likelihood that the full amount of a loan will be repaid or recovered. A loan may be put on nonaccrual status sooner than this policy would dictate if, in management's judgment, the amounts owed, principal or interest, may be uncollectable. While less common, similar interest reversal and nonaccrual treatment is applied to investment securities if their ultimate collectability becomes questionable.



Provision and Allowance for Loan Losses: (Note 7) The provision for loan losses reflects the amount required to maintain the allowance for losses at an appropriate level based upon management's evaluation of the adequacy of general and specific loss reserves. We maintain an allowance for loan losses consistent in all material respects with the GAAP guidelines outlined in ASC 450, Contingencies. We have established systematic methodologies for the determination of the adequacy of our allowance for loan losses. The methodologies are set forth in a formal policy and take into consideration the need for an overall general valuation allowance as well as specific allowances that are tied to individual problem loans. We increase our allowance for loan losses by charging provisions for probable loan losses against our income and value impaired loans consistent with the accounting guidelines outlined in ASC 310, Receivables.

The allowance for losses on loans is maintained at a level sufficient to provide for probable losses based on evaluating known and inherent risks in the loan portfolio and upon our continuing analysis of the factors underlying the quality of the loan portfolio. These factors include, among others, changes in the size and composition of the loan portfolio, delinquency rates, actual loan loss experience, current and anticipated economic conditions, detailed analysis of individual loans for which full collectability may not be assured, and determination of the existence and realizable value of the collateral and guarantees securing the loans. Realized losses related to specific assets are applied as a reduction of the carrying value of the assets and charged immediately against the allowance for loan loss reserve. Recoveries on previously charged off loans are credited to the allowance. The reserve is based upon factors and trends identified by us at the time financial statements are prepared. Although we use the best information available, future adjustments to the allowance may be necessary due to economic, operating, regulatory and other conditions beyond our control. The adequacy of general and specific reserves is based on our continuing evaluation of the pertinent factors underlying the quality of the loan portfolio as well as individual review of certain large balance loans. Loans are considered impaired when, based on current information and events, we determine that it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. Factors involved in determining impairment include, but are not limited to, the financial condition of the borrower, the value of the underlying collateral and the current status of the economy. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of collateral if the loan is collateral dependent. Subsequent changes in the value of impaired loans are included within the provision for loan losses in the same manner in which impairment initially was recognized or as a reduction in the provision that would otherwise be reported.

Large groups of smaller-balance homogeneous loans are collectively evaluated for impairment. Loans that are collectively evaluated for impairment include residential real estate and consumer loans and, as appropriate, smaller balance non-homogeneous loans. Larger balance non-homogeneous residential construction and land, commercial real estate, commercial business loans and unsecured loans are individually evaluated for impairment.

Our methodology for assessing the appropriateness of the allowance consists of several key elements, which include specific allowances, an allocated formula allowance and an unallocated allowance. Losses on specific loans are provided for when the losses are probable and estimable. General loan loss reserves are established to provide for inherent loan portfolio risks not specifically provided for on an individual loan basis. The level of general loan loss reserves is based on analysis of potential exposures existing in our loan portfolio including evaluation of historical trends, current market conditions and other relevant factors identified by us at the time the financial statements are prepared. The formula allowance is calculated by applying loss factors to outstanding loans, excluding those loans that are subject to individual analysis for specific allowances. Loss factors are based on our historical loss experience adjusted for significant environmental considerations, including the experience of other banking organizations, which in our judgment affect the collectability of the portfolio as of the evaluation date. The unallocated allowance is based upon our evaluation of various factors that are not directly measured in the determination of the formula and specific allowances. This methodology may result in losses or recoveries differing significantly from those provided in the Consolidated Financial Statements.

While we believe the estimates and assumptions used in our determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact our financial condition and results of operations. In addition, the determination of the amount of the Banks' allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the adjustment of reserves based upon their judgment of information available to them at the time of their examination.

**Fair Value Accounting and Measurement:** (Note 11) We use fair value measurements to record fair value adjustments to certain financial assets and liabilities and to determine fair value disclosures. We include in the Notes to the Consolidated Financial Statements 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 11 in the Selected Notes to the Consolidated Financial Statements in this report on Form 10-Q.

**Other Intangible Assets:** (Note 9) Other intangible assets consists primarily of core deposit intangibles (CDI), which are amounts recorded in business combinations or deposit purchase transactions related to the value of transaction-related deposits and the value of the customer relationships associated with the deposits. Core deposit intangibles are being amortized on an accelerated basis over a weighted average estimated useful life of eight years. These assets are reviewed at least annually for events or circumstances that could impact their recoverability. These events could include loss of the underlying core deposits, increased competition or adverse changes in the economy. To the extent other identifiable intangible assets are deemed unrecoverable, impairment losses are recorded in other non-interest expense to reduce the carrying amount of the assets.

**Mortgage Servicing Rights:** (Note 9) 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 non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

**Real Estate Held for Sale:** (Note 8) Property acquired by foreclosure or deed in lieu of foreclosure is recorded at the lower of the estimated fair value of the property, less expected selling costs, or the carrying value of the defaulted loan. Development and improvement costs relating to the property may be capitalized, while other holding costs are expensed. 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 the Bank will ultimately recover from real estate held for sale may differ substantially from the carrying value of the assets because of market factors beyond the Banks' control or because of changes in the Banks' strategies for recovering the investment.

**Income Taxes and Deferred Taxes:** (Note 12) The Company and its wholly-owned subsidiaries file consolidated U.S. federal income tax returns, as well as state income tax returns in Oregon and Idaho. Income taxes are accounted for using the asset and liability method. Under this method a deferred tax asset or liability is determined based on the enacted tax rates which are expected to be in effect when the differences between the financial statement carrying amounts and tax basis of existing assets and liabilities are expected to be reported in the Company's income tax returns. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. Under GAAP (ASC 740), a valuation allowance is required to be recognized if it is "more likely than not" that all or a portion of our deferred tax assets will not be realized.

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

General. Total assets increased \$370 million, or 8%, to \$4.759 billion at September 30, 2014, from \$4.389 billion at December 31, 2013. Net loans receivable (gross loans less deferred fees and discounts, and allowance for loan losses) increased \$388 million, or 12%, to \$3.732 billion at September 30, 2014, from \$3.344 billion at December 31, 2013. A portion of these increases resulted from the Branch Acquisition in which we acquired \$88 million in loans and \$212 million in deposits when the purchase transaction closed on June 20, 2014.

The increase in net loans included increases of \$206 million in commercial real estate loans, \$50 million in consumer loans, \$47 million in multifamily loans, \$46 million in commercial business loans, \$14 million in land and land development loans, \$13 million in one- to four-family construction loans, \$12 million in agricultural business loans, and \$6 million in commercial construction loans, partially offset by decreases of \$3 million in multifamily construction loans and \$2 million in one- to four-family residential loans. The increase in commercial real estate loans included \$162 million for investment properties and \$44 million for owner-occupied properties. The increase in commercial business loans is an encouraging sign of improving economic activity as well as additional successful sales results for our lending officers. The increase in agricultural business loans represents a normal seasonal increase for the third quarter.

The aggregate balance of interest-earning deposits and securities decreased \$2 million from December 31, 2013 to \$701 million at September 30, 2014. Our total investment in securities decreased \$17 million to \$618 million at September 30, 2014, while interest-earning deposits increased \$15 million during the nine months to \$83 million. Securities purchases during the nine-month period have been modest and were primarily mortgage-backed securities and intermediate-term taxable and tax-exempt municipal securities. Securities sales have also been modest and were primarily sales of mortgage-backed securities. The average effective duration of Banner's securities portfolio was approximately 3.2 years at September 30, 2014. Net fair value adjustments to the portfolio of securities held for trading, which are included in net income, were \$5.4 million in the nine months ended September 30, 2014. In addition, fair value adjustments for securities designated as available-for-sale reflected an increase of \$3.2 million for the nine months ended September 30, 2014, which was included net of the associated tax expense of \$1.2 million as a component of other comprehensive income and largely occurred as a result of modestly decreased market interest rates. (See Note 11 of the Selected Notes to the Consolidated Financial Statements in this Form 10-Q.)

REO decreased \$116,000, to \$3.9 million at September 30, 2014, compared to \$4.0 million at December 31, 2013. The September 30, 2014 total included \$1.9 million in residential construction, land or land development projects and \$2.0 million in single-family homes. During the three months ended September 30, 2014, we transferred \$135,000 of loans into REO, disposed of \$860,000 of REO properties recognizing \$265,000 in gains related to those sales, and did not have any valuation adjustments. During the nine months ended September 30, 2014, we transferred \$2.8 million of loans into REO, disposed of \$3.6 million of REO properties recognizing \$680,000 in gains related to those sales, and charged-off \$37,000 in valuation adjustments (see Note 8 of the Selected Notes to the Consolidated Financial Statements in the Form 10-Q and "Asset Quality" discussion below).

Deposits increased \$373 million, or 10%, to \$3.991 billion at September 30, 2014 from \$3.618 billion at December 31, 2013, largely as a result of the Branch Acquisition in the second quarter, as well as a \$37 million increase in brokered deposits utilized to meet short-term funding needs caused by the strong loan growth. Following normal seasonal patterns, our deposits at locations other than the recently acquired branches increased significantly in the third quarter, after being nearly unchanged for the first half of the year. Non-interest-bearing deposits increased by \$189 million, or 17%, to \$1.305 billion at September 30, 2014, compared to \$1.115 billion at December 31, 2013, and have increased by 24% compared to a year earlier. Interest-bearing transaction and savings accounts increased by \$204 million, or 12%, to \$1.833 billion at September 30, 2014 from \$1.630 billion at December 31, 2013 and have increased by 16% compared to a year earlier. Certificates of deposit decreased \$20 million, or 2%, to \$853 million at September 30, 2014 from \$873 million at December 31, 2013, and have decreased by 5% compared to a year earlier.

Core deposits increased to 79% of total deposits at the end of the third quarter, compared to 75% of total deposits a year earlier. The Branch Acquisition resulted in a \$217 million increase in deposits, including \$78 million in non-interest bearing deposits, \$105 million in interest-bearing transaction and savings accounts, and \$34 million in certificates of deposit as of September 30, 2014.

FHLB advances decreased \$27 million, or 99%, to \$250,000 at September 30, 2014 from \$27 million at December 31, 2013 as we used our excess liquidity to repay maturing FHLB advances. Other borrowings, consisting of retail repurchase agreements primarily related to customer cash management accounts, decreased \$15 million, or 19%, to \$68 million at September 30, 2014, compared to \$83 million at December 31, 2013. No additional junior subordinated debentures were issued or matured during the quarter and the estimated fair value of these instruments increased \$4 million to \$78 million at September 30, 2014 from \$74 million at December 31, 2013. For more information, see Notes 10 and 11 of the Selected Notes to the Consolidated Financial Statements.

Total stockholders' equity increased \$35 million, or 7%, to \$574 million at September 30, 2014 compared to \$539 million at December 31, 2013. The increase in equity primarily reflects the year-to-date net income reduced by payment of dividends to common stockholders. In addition, there was an improvement of \$2.0 million in accumulated other comprehensive income representing a decline in the unrealized loss, net of tax, on securities available-for-sale. Tangible common stockholders' equity, which excludes intangible assets, also increased \$34 million to \$571 million, or 12.00% of tangible assets at September 30, 2014, compared to \$537 million, or 12.23% of tangible assets at December 31, 2013. In the nine months ended September 30, 2014, we did not have any repurchases of our common stock as part of the publicly announced repurchase plan, but 14,422 shares were surrendered by employees to satisfy tax withholding obligations upon the vesting of restricted stock grants. Additionally, there were 47,890 shares redeemed and canceled that related to the termination of the ESOP.

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

For the quarter ended September 30, 2014, net income was \$14.8 million, or \$0.76 per diluted share. This compares to net income of \$11.7 million, or \$0.60 per diluted share, for the quarter ended September 30, 2013. For the nine months ended September 30, 2014, net income was \$42.4 million, or \$2.19 per diluted share. This compares to net income of \$35.0 million, or \$1.80 per diluted share, for the nine months ended September 30, 2013. As expected, our current quarter and nine month operating results continued to be influenced by very low interest rates which produced downward pressure on asset yields. Nonetheless, significant growth in earning assets, as well as changes in the asset mix and further reductions in funding costs combined to offset this yield pressure. In addition, credit costs remained low and deposit fees and other payment processing revenues increased compared to a year earlier reflecting further growth in client relationships. We also experienced a further rebound in mortgage banking revenues, which increased 9% to \$2.8 million in the current quarter ended September 30, 2014. While stronger in the current quarter than a year earlier, revenues from mortgage banking decreased 19% in the nine months ended September 30, 2014 compared to the same period a year ago as refinance activity was particularly robust early in 2013. In the nine months ended September 30, 2014, net income was also significantly augmented by the \$9.1 million bargain purchase gain (\$5.8 million net of income tax) realized from the Branch Acquisition. As a result, net income for the current quarter and nine months ended September 30, 2014 remains solid, represents further progress in 2014 and produced an annualized return on average assets of 1.23% for the quarter and 1.24% for the nine months ended September 30, 2014, a significant improvement from 1.09% and 1.10% for the same periods a year ago.

**Net Interest Income.** Net interest income before provision for loan losses increased by \$5.2 million, or 12%, to \$47.1 million for the quarter ended September 30, 2014, compared to \$41.9 million for the same quarter one year earlier, as a decrease in the net interest margin was more than offset by an increase in the average balance of interest-earning assets. The net interest margin of 4.07% for the quarter ended September 30, 2014 was two basis points lower than for the same quarter in the prior year. The decrease in the net interest margin compared to a year earlier reflects the impact of persistently low market interest rates on earning asset yields, which was only partially offset by changes in the earning asset mix and reductions in deposit and other funding costs. Nonaccrual loans reduced the margin by two basis points in the third quarter of 2014, while net collections on nonaccrual loans added one basis point to the margin in the third quarter of 2013. In addition, the decrease in the average balance of real estate owned for the quarter ended September 30, 2014 compared to the quarter ended September 30, 2013 reduced the adverse effect of this non-interest-earning asset on the net interest margin.

The net interest spread decreased to 4.06% for the quarter ended September 30, 2014 compared to 4.07% for the same quarter a year earlier. Reflecting generally lower market interest rates as well as changes in asset mix, the yield on interest-earning assets for the quarter ended September 30, 2014 was 4.31%, a decrease of nine basis points compared to the same quarter a year earlier. While declining less than asset yields, funding costs were also significantly lower, especially deposit costs which decreased seven basis points to 0.19% from 0.26% a year earlier, leading to a decrease of eight basis points for all funding liabilities to 0.25% for the quarter ended September 30, 2014.

Net interest income before provision for loan losses increased by \$8.1 million, or 6%, to \$133.2 million for the nine months ended September 30, 2014 compared to \$125.1 million for the same period one year earlier, as a result of an increase in average interest-earning assets and despite an eight basis point decrease in the net interest margin. The net interest margin decreased to 4.07% for the nine months ended September 30, 2014 compared to 4.15% for the same period in the prior year and, similar to the results for the current quarter, this decrease was a result of the effect of lower asset yields and occurred despite lower funding costs and fewer non-performing assets. Nonaccruing loans reduced the margin by two basis points during the nine months ended September 30, 2014. The adverse effect on interest income from nonaccruing loans during the same nine month period in the prior year was fully offset by the collection of interest on previously nonaccruing loans.

Interest Income. Interest income for the quarter ended September 30, 2014 was \$49.8 million, compared to \$45.0 million for the same quarter in the prior year, an increase of \$4.8 million, or 10%. The increase in interest income occurred as a result of an increase in the average balances of interest-earning assets, which was partially offset by a decline in the yield. The average balance of interest-earning assets was \$4.585 billion for the quarter ended September 30, 2014, an increase of \$524 million, or 13%, compared to \$4.061 billion one year earlier. The yield on average interest-earning assets decreased to 4.31% for the quarter ended September 30, 2014, compared to 4.40% for the same quarter one year earlier. The decrease in the yield on earning assets reflects the continuing erosion of yields as loans mature or prepay and are replaced by lower yielding assets in the current low interest rate environment. Average loans receivable for the quarter ended September 30, 2014 increased \$542 million, or 16%, to \$3.834 billion, compared to \$3.292 billion for the same quarter in the prior year. Interest income on loans increased by \$4.5 million, or 11%, to \$46.5 million for the current quarter from \$42.0 million for the quarter ended September 30, 2013, reflecting the impact of the \$542 million increase in average loan balances, partially offset by a 25 basis point decrease in the average yield on loans. The average yield on loans was 4.81% for the quarter ended September 30, 2014, compared to 5.06% for the same quarter one year earlier.

Interest income for the nine months ended September 30, 2014 was \$141.4 million, compared to \$135.1 million for the same period in the prior year, an increase of \$6.3 million, or 5%. As with quarterly results, the year-to-date results reflect a \$349 million, or 9%, increase in the average balance of interest-earning assets, partially offset by a 16 basis point reduction in the yield on interest-earning assets.

The combined average balance of mortgage-backed securities, other investment securities, and daily interest-bearing deposits decreased to \$751 million for the quarter ended September 30, 2014 (excluding the effect of fair value adjustments), compared to \$769 million for the quarter ended September 30, 2013; however, the interest and dividend income from those investments increased by \$184,000 compared to the same quarter in the prior year. The average yield on the combined portfolio increased to 1.73% for the quarter ended September 30, 2014, from 1.59% for the same quarter one year earlier. Portfolio yields improved from higher rates on new purchases and from the maturity or sale of some lower yielding securities. The yield on this portfolio also benefited from a \$5 million reduction in the average balance of FHLB stock which had a very low 0.10% dividend yield. For the quarter ended September 30, 2014, the yield on mortgage-backed securities increased 27 basis points to 1.70% compared to the quarter ended September 30, 2013, and for the nine months ended September 30, 2014, the yield on mortgage-backed

securities increased 12 basis points to 1.68% compared to the same period in the previous year. For the quarter ended September 30, 2014, the yield on other securities increased one basis point to 2.34% compared to the quarter ended September 30, 2013, and for the nine months ended September 30, 2014, the yield on other securities increased 22 basis points to 2.41% compared to the same period in the previous year.

**Interest Expense.** Interest expense for the quarter ended September 30, 2014 was \$2.7 million, compared to \$3.1 million for the same quarter in the prior year, a decrease of \$444,000, or 14%. The decrease in interest expense occurred as a result of an eight basis point decrease in the average cost of all funding liabilities to 0.25% for the quarter ended September 30, 2014, from 0.33% for the same quarter one year earlier, partially offset by a \$487 million increase in average funding liabilities. This increase in average funding liabilities reflects increases in transaction and savings accounts including non-interest-bearing accounts partially offset by a continued decline in the average balance of certificates of deposit as well as decreased average advances from FHLB and other borrowings compared to one year ago. Interest expense for the nine months ended September 30, 2014 and 2013 was \$8.2 million and \$10.0 million, respectively, and similar to quarterly results, the reduction is reflective of a decrease in the average rate paid for most interest-bearing liabilities, partially offset by an increase in their average balances over that time period.

Deposit interest expense decreased \$427,000, or 18%, to \$1.9 million for the quarter ended September 30, 2014, compared to \$2.3 million for the same quarter in the prior year, as a result of a seven basis point decrease in the cost of deposits. Average deposit balances increased to \$3.995 billion for the quarter ended September 30, 2014, from \$3.496 billion for the quarter ended September 30, 2013, and the average rate paid on deposit balances decreased to 0.19% in the third quarter of 2014 from 0.26% for the quarter ended September 30, 2013. The cost of interest-bearing deposits decreased by nine basis points to 0.28% for the quarter ended September 30, 2014 compared to 0.37% in the same quarter a year earlier despite a \$225 million increase in the average balance of interest-bearing accounts. Also contributing to the decrease in total deposit costs was a \$274 million increase in the average balances of non-interest-bearing accounts. While we do not anticipate further reductions in market interest rates, we do expect additional modest declines in deposit costs over the near term as maturities of certificates of deposit will present further repricing opportunities and competitive pricing should remain restrained in the current economic environment. Further, continuing changes in our deposit mix, especially growth in lower cost transaction and savings accounts, in particular non-interest-bearing deposits, have meaningfully contributed to the decrease in our funding costs compared to earlier periods, and should also result in lower deposit costs going forward. However, it is clear that the pace of decline in deposit costs compared to prior periods has slowed and that the opportunity for future reductions is limited.

For the nine months ended September 30, 2014, deposit interest expense decreased \$1.7 million to \$5.8 million compared to \$7.5 million for the same period one year ago. Similar to the quarter, average deposit costs decreased by nine basis points and the average balance of deposits increased \$277 million for the nine months ended September 30, 2014 compared to the same period one year ago.

Average FHLB advances (excluding the effect of fair value adjustments) were \$23 million for the quarter ended September 30, 2014, compared to \$31 million for the same quarter one year earlier, and the average rate paid on FHLB advances for the quarter ended September 30, 2014 decreased to 0.35% from 0.36% for the same quarter one year earlier. Interest expense on FHLB advances decreased to \$20,000 for the quarter ended September 30, 2014 from \$28,000 for the quarter ended September 30, 2013. For the nine months ended September 30, 2014, interest expense on FHLB advances increased by \$18,000 to \$110,000 compared to \$92,000 for the same period in the prior year. Average FHLB advances excluding the effect of fair value adjustments increased \$24 million to \$47 million over that same time period compared to \$23 million for the nine months ended September 30, 2013. The average rate paid on FHLB advances decreased 22 basis points to 0.31% for the nine months ended September 30, 2014, compared to 0.53% for the same period a year ago.

Other borrowings consist primarily of retail repurchase agreements with customers secured by certain investment securities. The average balance for other borrowings decreased \$4 million to \$82 million during the current quarter



from \$86 million during the same quarter a year earlier, while the rate on other borrowings increased to 0.21% from 0.20% a year earlier. As a result, interest expense for other borrowings decreased to \$43,000 for the quarter ended September 30, 2014, compared to \$44,000 for the quarter ended September 30, 2013. For the nine months ended September 30, 2014, the average balance for other borrowings decreased \$1 million to \$86 million compared to \$87 million during the same period a year earlier, while the rate on other borrowings decreased to 0.21% from 0.23% a year earlier.

Junior subordinated debentures which were issued in connection with our issuance of trust preferred securities had an average balance of \$124 million (excluding the effect of fair value adjustments) and an average cost of 2.35% and 2.36%, respectively, for the quarter and nine months ended September 30, 2014. Junior subordinated debentures outstanding in the same periods in the prior year had the same average balance of \$124 million (excluding the effect of fair value adjustments) with higher average costs of 2.38% and 2.40%, respectively, for the quarter and nine months ended September 30, 2013. The junior subordinated debentures are adjustable-rate instruments with repricing frequencies of three months based upon the three-month LIBOR index.

Analysis of Net Interest Spread. The following tables present for the periods indicated our condensed average balance sheet information, together with interest income and yields earned on average interest-earning assets and interest expense and rates paid on average interest-bearing liabilities with additional comparative data on our operating performance (dollars in thousands):

	Three Months Ended September 30, 2014				Three Months Ended September 30, 2013			
	Average Balance	Interest and Dividends	Yield/ Cost <sup>(3)</sup>		Average Balance	Interest and Dividends	Yield/ Cost <sup>(3)</sup>	
Interest-earning assets:								
Mortgage loans	\$2,787,519	\$34,944	4.97	%	\$2,391,123	\$31,152	5.17	%
Commercial/agricultural loans	928,171	9,710	4.15		795,905	9,239	4.61	
Consumer and other loans	118,317	1,842	6.18		104,922	1,562	5.91	
Total loans <sup>(1)</sup>	3,834,007	46,496	4.81		3,291,950	41,953	5.06	
Mortgage-backed securities	340,999	1,459	1.70		355,104	1,281	1.43	
Other securities	294,402	1,740	2.34		298,165	1,749	2.33	
Interest-bearing deposits with banks	85,090	61	0.28		79,607	45	0.22	
FHLB stock	30,961	8	0.10		35,988	9	0.10	
Total investment securities	751,452	3,268	1.73		768,864	3,084	1.59	
Total interest-earning assets	4,585,459	49,764	4.31		4,060,814	45,037	4.40	
Non-interest-earning assets	213,045				190,621			
Total assets	\$4,798,504				\$4,251,435			
Deposits:								
Interest-bearing checking accounts	\$433,884	88	0.08		\$395,701	94	0.09	
Savings accounts	881,225	334	0.15		769,602	400	0.21	
Money market accounts	509,881	203	0.16		409,205	226	0.22	
Certificates of deposit	892,094	1,278	0.57		917,154	1,610	0.70	
Total interest-bearing deposits	2,717,084	1,903	0.28		2,491,662	2,330	0.37	
Non-interest-bearing deposits	1,278,367	—	—		1,004,532	—	—	
Total deposits	3,995,451	1,903	0.19		3,496,194	2,330	0.26	
Other interest-bearing liabilities:								
FHLB advances	22,646	20	0.35		30,983	28	0.36	
Other borrowings	82,362	43	0.21		86,307	44	0.20	
Junior subordinated debentures	123,716	734	2.35		123,716	742	2.38	
Total borrowings	228,724	797	1.38		241,006	814	1.34	
Total funding liabilities	4,224,175	2,700	0.25		3,737,200	3,144	0.33	
Other non-interest-bearing liabilities <sup>(2)</sup>	2,026				(13,016	)		
Total liabilities	4,226,201				3,724,184			
Stockholders' equity	572,303				527,251			
Total liabilities and stockholders' equity	\$4,798,504				\$4,251,435			
Net interest income/rate spread		\$47,064	4.06	%		\$41,893	4.07	%
Net interest margin			4.07	%			4.09	%
Additional Key Financial Ratios:								
Return on average assets			1.23	%			1.09	%
Return on average equity			10.29				8.78	
Average equity / average assets			11.93				12.40	
Average interest-earning assets / average interest-bearing liabilities			155.66				148.60	
			108.55				108.66	

Average interest-earning assets / average funding liabilities		
Non-interest (other operating) income / average assets	1.10	0.95
Non-interest (other operating) expense / average assets	3.18	3.22
Efficiency ratio <sup>(4)</sup>	63.72	66.28

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	Nine Months Ended September 30, 2014				Nine Months Ended September 30, 2013			
	Average Balance	Interest and Dividends	Yield/ Cost <sup>(3)</sup>		Average Balance	Interest and Dividends	Yield/ Cost <sup>(3)</sup>	
Interest-earning assets:								
Mortgage loans	\$2,636,614	\$98,447	4.99	%	\$2,371,825	\$93,899	5.29	%
Commercial/agricultural loans	883,242	27,656	4.19		777,458	28,492	4.90	
Consumer and other loans	114,134	5,336	6.25		103,660	3,343	4.31	
Total loans <sup>(1)</sup>	3,633,990	131,439	4.84		3,252,943	125,734	5.17	
Mortgage-backed securities	347,657	4,376	1.68		329,952	3,847	1.56	
Other securities	300,361	5,421	2.41		327,609	5,368	2.19	
Interest-bearing deposits with banks	66,208	148	0.30		85,125	158	0.25	
FHLB stock	33,041	26	0.11		36,331	9	0.03	
Total investment securities	747,267	9,971	1.78		779,017	9,382	1.61	
Total interest-earning assets	4,381,257	141,410	4.32		4,031,960	135,116	4.48	
Non-interest-earning assets	203,432				206,789			
Total assets	\$4,584,689				\$4,238,749			
Deposits:								
Interest-bearing checking accounts	\$427,032	259	0.08		\$396,353	286	0.10	
Savings accounts	842,424	968	0.15		755,904	1,168	0.21	
Money market accounts	448,742	575	0.17		410,129	722	0.24	
Certificates of deposit	899,112	3,974	0.59		962,068	5,363	0.75	
Total interest-bearing deposits	2,617,310	5,776	0.30		2,524,454	7,539	0.40	
Non-interest-bearing deposits	1,155,896	—	—		971,455	—	—	
Total deposits	3,773,206	5,776	0.20		3,495,909	7,539	0.29	
Other interest-bearing liabilities:								
FHLB advances	46,780	110	0.31		23,299	92	0.53	
Other borrowings	86,170	133	0.21		86,816	151	0.23	
Junior subordinated debentures	123,716	2,180	2.36		123,716	2,225	2.40	
Total borrowings	256,666	2,423	1.26		233,831	2,468	1.41	
Total funding liabilities	4,029,872	8,199	0.27		3,729,740	10,007	0.36	
Other non-interest-bearing liabilities <sup>(2)</sup>	(3,040 )				(12,931 )			
Total liabilities	4,026,832				3,716,809			
Stockholders' equity	557,857				521,940			
Total liabilities and stockholders' equity	\$4,584,689				\$4,238,749			
Net interest income/rate spread		\$133,211	4.05	%		\$125,109	4.12	%
Net interest margin			4.07	%			4.15	%
Additional Key Financial Ratios:								
Return on average assets			1.24	%			1.10	%
Return on average equity			10.17				8.97	
Average equity / average assets			12.17				12.31	
Average interest-earning assets / average interest-bearing liabilities			152.45				146.18	
Average interest-earning assets / average funding liabilities			108.72				108.10	
Non-interest (other operating) income / average assets			1.23				0.97	

Non-interest (other operating) expense / average assets	3.28	3.28
Efficiency ratio <sup>(4)</sup>	64.09	66.75

- (1) Average balances include loans accounted for on a nonaccrual basis and loans 90 days or more past due. Amortization of net deferred loan fees/costs is included with interest on loans.
- (2) Average other non-interest-bearing liabilities include fair value adjustments related to FHLB advances and junior subordinated debentures.
- (3) Yields and costs have not been adjusted for the effect of tax-exempt interest.
- (4) Other operating expense divided by the total of net interest income (before provision for loan losses) and other operating income (non-interest income).

Provision and Allowance for Loan Losses. As a result of adequate reserves already in place representing 1.95% of total loans outstanding, as well as declining delinquencies and net charge-offs, we did not record a provision for loan losses in either the quarter or the nine months ended September 30, 2014. Similarly, we did not record a provision in either the quarter or the nine months ended September 30, 2013, as we also had adequate reserves at the end of each of those periods and were experiencing improving credit quality trends during those periods. As discussed in the Summary of Critical Accounting Policies section above and in Note 1 of the Selected Notes to the Consolidated Financial Statements in this Form 10-Q, the provision and allowance for loan losses is one of the most critical accounting estimates included in our Consolidated Financial Statements.

The provision for loan losses reflects the amount required to maintain the allowance for losses at an appropriate level based upon management's evaluation of the adequacy of general and specific loss reserves, trends in delinquencies and net charge-offs and current economic conditions. Reflecting lingering weakness in the economy, we continue to maintain a substantial allowance for loan losses at September 30, 2014; however, non-performing loans remained modest at \$20 million at September 30, 2014, and have declined 20% from \$25 million at September 30, 2013. Overall, our credit quality indicators have continued to improve, eliminating the need for a provision for loan losses for the first nine months of 2014.

We recorded net recoveries of \$21,000 for the quarter ended September 30, 2014, compared to net charge-offs of \$196,000 for the same quarter in the prior year. A comparison of the allowance for loan losses at September 30, 2014 and 2013 reflects a decrease of \$2 million to \$74 million at September 30, 2014, from \$76 million at September 30, 2013. Included in our allowance at September 30, 2014 was an unallocated portion of \$4 million, which is based upon our evaluation of various factors that are not directly measured in the determination of the formula and specific allowances. The allowance for loan losses as a percentage of total loans (loans receivable excluding allowance for losses) decreased to 1.95% at September 30, 2014, from 2.32% at September 30, 2013. However, with the decrease in problem loans, the allowance as a percentage of non-performing loans increased to 376% at September 30, 2014, compared to 300% of non-performing loans at December 31, 2013 and 305% a year earlier.

As of September 30, 2014, we had identified \$50 million of impaired loans. Impaired loans are comprised of loans on nonaccrual, TDRs that are performing under their restructured terms and loans that are 90 days or more past due, but are still on accrual. Impaired loans may be evaluated for reserve purposes using either a specific impairment analysis or collectively evaluated as part of homogeneous pools. For more information on these impaired loans, refer to Note 11 of the Selected Notes to the Consolidated Financial Statements, Fair Value Accounting and Measurement, in this Form 10-Q.

We believe that the allowance for loan losses as of September 30, 2014 was adequate to absorb the known and inherent risks of loss in the loan portfolio at that date. While we believe the estimates and assumptions used in our determination of the adequacy of the allowance are reasonable, there can be no assurance that these estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact our financial condition and results of operations. In addition, the determination of the amount of the allowance for loan losses is subject to review by bank regulators as part of the routine examination process, which may result in the establishment of additional reserves based upon their judgment of information available to them at the time of their examination.

Other Operating Income. Other operating income, which includes changes in the valuation of financial instruments carried at fair value, OTTI charges and recoveries, and net gain on sale of securities, as well as non-interest revenues from core operations, was \$13.4 million for the quarter ended September 30, 2014, compared to \$10.1 million for the same quarter in the prior year. Our other operating income for the three months ended September 30, 2014 included a \$1.5 million net gain for fair value adjustments as a result of changes in the valuation of our securities portfolios. During the quarter ended September 30, 2013, fair value adjustments resulted in a net loss of \$352,000. For a more

detailed discussion of our fair value adjustments, please refer to Note 11 in the Selected Notes to the Consolidated Financial Statements in this Form 10-Q.

Other operating income, including changes in the valuation of financial instruments carried at fair value, OTTI charges and recoveries, net gain on sale of securities, and the Branch Acquisition bargain purchase gain was \$42.3 million for the nine months ended September 30, 2014, compared to \$30.8 million for the same period in the prior year. Our other operating income for the nine months ended September 30, 2014 included the \$9.1 million Branch Acquisition bargain purchase gain, a net gain on the sale of securities of \$41,000, and fair value adjustments resulting in a gain of \$1.7 million, compared to a net gain on sale of securities of \$1.0 million, an OTTI recovery of \$409,000, and fair value adjustments resulting in a loss of \$2.0 million during the same period one year ago.

Excluding the fair value and OTTI adjustments and net gain on sale of securities, other operating income from core operations increased by \$1.4 million, or 13%, to \$11.9 million for the quarter ended September 30, 2014, compared to \$10.5 million for the quarter ended September 30, 2013, largely as a result of increased revenues from deposit fees and other service charges. Deposit fees and other service charges increased by \$1.3 million compared to the third quarter a year ago reflecting growth in the number of deposit accounts, increased transaction activity and our decision to change our debit card relationship to MasterCard®. The current quarter also included a \$560,000 adjustment related to the under-accrual of interchange income in prior periods. Mortgage banking revenues increased by \$252,000 reflecting a strong home purchase market and our increased market presence as a result of additions to our production staff.

Excluding the fair value and OTTI adjustments, net gain on sale of securities and Branch Acquisition bargain purchase gain, other operating income from core operations increased by \$272,000, or 1%, to \$31.6 million for the nine months ended September 30, 2014. Deposit fees and service charges increased by \$2.3 million compared to the first nine months of the prior year while mortgage banking operations decreased by \$1.7 million. Revenues from mortgage banking operations for the nine months ended September 30, 2013 included \$1.0 million as a result of reversing prior period valuation adjustments for mortgage servicing rights.

**Other Operating Expenses.** Other operating expenses increased by \$4.0 million, to \$38.5 million for the quarter ended September 30, 2014, compared to \$34.5 million for the quarter ended September 30, 2013, largely as a result of increases in salary and employee benefits, advertising and marketing, payment and card processing, occupancy and equipment, information and computer data services expenses and a decrease in the net credit from REO operations. These were partially offset by decreased professional services expense as well as an increase in the credit for capitalized loan origination costs. Branch Acquisition-related costs reflect a net credit of \$494,000 for the quarter ended September 30, 2014 as certain expenses incurred were below original amounts estimated at the end of the prior quarter. There were no acquisition-related costs in the same quarter one year ago.

Salary and employee benefits expense increased \$1.7 million, or 8%, to \$23.0 million for the quarter ended September 30, 2014, compared to \$21.2 million for the quarter ended September 30, 2013, in part reflecting the incremental staffing associated with the Branch Acquisition. The increased expense also was the result of salary and wage adjustments and increased incentive compensation accruals, health insurance and other benefit costs and mortgage banking commissions.

Partially offsetting the increase in compensation, the credit for capitalized loan origination costs increased by \$289,000 compared to the same quarter a year earlier reflecting increased loan production. Advertising and marketing expenses increased \$898,000, or 58%, to \$2.5 million for the quarter ended September 30, 2014, compared to \$1.6 million for the quarter ended September 30, 2013 as a result of increased direct mail advertising and expanded market areas, as well as certain front-loaded costs for new media campaigns. Payment and card processing expenses increased \$671,000 (27%) compared to the same period one year earlier reflecting increased transactions as a result of the significant growth in core deposits. Occupancy expense increased \$502,000, or 9%, to \$5.8 million for the quarter ended September 30, 2014, compared to \$5.3 million for the quarter ended September 30, 2013 in part reflecting the six additional branch locations from the Branch Acquisition, but also as a result of increased depreciation expense related to computer hardware and software upgrades and building repair and maintenance expenses. Information and computer data services increased \$421,000, or 25%. The net credit from REO operations was \$190,000 for the quarter ended September 30, 2014 compared to a net credit of \$601,000 for the quarter ended September 30, 2013. Professional services expense was \$290,000 (27%) lower than in the prior year.

Other operating expenses for the nine months ended September 30, 2014 increased \$8.5 million, or 8%, to \$112.5 million compared to \$104.0 million for the nine months ended September 30, 2013. Branch Acquisition-related costs added \$1.5 million to other operating expenses in the first nine months of this year compared to no acquisition-related costs in the same period last year. Salary and employee benefits expense increased \$3.3 million, or 5%, to \$66.5 million for the nine months ended September 30, 2014 compared to \$63.2 million for the nine months ended September 30, 2013, again reflecting salary and wage adjustments and other benefit costs, partially offset by reduced mortgage banking commissions. In addition, the credit for capitalized loan origination costs increased by \$176,000 compared to the same nine-month period a year earlier. Reflecting the significant growth in core deposits, expenses for payment and card processing increased by \$1.2 million, or 16%, to \$8.5 million for the nine months ended September 30, 2014, compared to \$7.3 million for the same period in the prior year. Occupancy and equipment expenses increased \$1.0 million, or 6%, to \$17.1 million for the nine months ended September 30, 2014, compared to \$16.1 million for the same period in the prior year. REO operations for the nine months ended September 30, 2014 resulted in a net credit of \$260,000, compared to a net credit of \$1.0 million for the prior-year period, and included \$37,000 of valuation adjustments and \$680,000 of net gains on the sale of properties. Information and computer data services expense for the nine months ended September 30, 2014 increased \$631,000, or 12%, compared to one year ago. Partially offsetting those increases was a decrease in state/municipal business and use taxes of \$441,000 (30%). Most other operating expenses were little changed from a year earlier.

**Income Taxes.** In the quarter ended September 30, 2014, we recognized \$7.1 million in income tax expense for an effective tax rate of 32.3%, which reflects our normal statutory tax rate reduced by the impact of tax-exempt income



and certain tax credits. Our normal, expected statutory income tax rate is 36.3%, representing a blend of the statutory federal income tax rate of 35.0% and apportioned effects of the 7.6% Oregon and 7.4% Idaho income tax rates. For the quarter ended September 30, 2013, we recognized \$5.9 million in income tax expense for an effective tax rate of 33.5%. For the nine months ended September 30, 2014, we recognized \$20.6 million in income tax expense for an effective tax rate of 32.7%. For the nine months ended September 30, 2013, we recognized \$16.8 million in income tax expense for an effective tax rate of 32.5%. For more discussion on our income taxes, please refer to Note 12 in the Selected Notes to the Consolidated Financial Statements in this report on Form 10-Q.

#### Asset Quality

Achieving and maintaining a moderate risk profile by employing appropriate underwriting standards, avoiding excessive asset concentrations and aggressively managing troubled assets has been and will continue to be a primary focus for us. As a result, our non-performing assets declined substantially in 2013 and have decreased further in the first nine months of 2014. Our key credit quality metrics have improved compared to a year ago, including modest improvement during the most recent quarter, and as a result our collection costs have been further reduced. In addition, our reserve levels are substantial and, as a result of our impairment analysis and charge-off actions, reflect current appraisals and valuation estimates as well as recent regulatory examination results. While our non-performing assets and credit costs have been materially reduced, we continue to be actively engaged with our borrowers in resolving remaining problem assets and with the effective management of real estate owned as a result of foreclosures.

**Non-Performing Assets:** Non-performing assets decreased to \$24 million, or 0.50% of total assets, at September 30, 2014, from \$29 million, or 0.66% of total assets, at December 31, 2013, and \$30 million, or 0.70% of total assets, at September 30, 2013. Construction and land development loans, including related REO, represented approximately 14% of our non-performing assets at September 30, 2014. Reflecting lingering weakness in the economy and property values which now have generally stabilized but are lower than when many of the related loans

were originated, we continued to maintain a substantial allowance for loan losses even though non-performing loans declined. At September 30, 2014, our allowance for loan losses was \$74 million, or 1.95% of total loans and 376% of non-performing loans, compared to \$74 million, or 2.17% of total loans and 300% of non-performing loans at December 31, 2013. Included in our allowance at September 30, 2014 was an unallocated portion of \$4 million, which is based upon our evaluation of various factors that are not directly measured in the determination of the formula and specific allowances. We believe our level of non-performing loans and assets, which declined significantly during the past two years, is manageable and further believe that we have sufficient capital and human resources to manage the collection of our non-performing assets in an orderly fashion. The primary components of the \$24 million in non-performing assets were \$15 million in nonaccrual loans, \$4 million in loans more than 90 days delinquent and still accruing interest, and \$4 million in REO and other repossessed assets.

Loans are reported as restructured when we grant concessions to a borrower experiencing financial difficulties that we would not otherwise consider. As a result of these concessions, restructured loans or TDRs are impaired as the Banks will not collect all amounts due, both principal and interest, in accordance with the terms of the original loan agreement. If any restructured loan becomes delinquent or other matters call into question the borrower's ability to repay full interest and principal in accordance with the restructured terms, the restructured loan(s) would be reclassified as nonaccrual. At September 30, 2014, we had \$30 million of restructured loans currently performing under their restructured terms.

The following table sets forth information with respect to our non-performing assets and restructured loans at the dates indicated (dollars in thousands):

	September 30, 2014	December 31, 2013	September 30, 2013	
Nonaccrual Loans: <sup>(1)</sup>				
Secured by real estate:				
Commercial	\$2,701	\$6,287	\$4,762	
Multifamily	397	—	333	
Construction and land	1,285	1,193	1,660	
One- to four-family	8,615	12,532	10,717	
Commercial business	1,037	723	963	
Agricultural business, including secured by farmland	229	—	—	
Consumer	1,138	1,173	1,634	
	15,402	21,908	20,069	
Loans more than 90 days delinquent, still on accrual:				
Secured by real estate:				
Commercial	993	—	—	
Multifamily	—	—	1,701	
Construction and land	—	—	242	
One- to four-family	2,777	2,611	2,774	
Commercial business	301	—	24	
Agricultural business, including secured by farmland	—	105	—	
Consumer	306	144	52	
	4,377	2,860	4,793	
Total non-performing loans	19,779	24,768	24,862	
REO, net <sup>(2)</sup>	3,928	4,044	4,818	
Other repossessed assets held for sale	69	115	119	
Total non-performing assets	\$23,776	\$28,927	\$29,799	
Total non-performing loans to loans before allowance for loan losses	0.52	% 0.72	% 0.76	%

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Total non-performing loans to total assets	0.42	% 0.56	% 0.58	%
Total non-performing assets to total assets	0.50	% 0.66	% 0.70	%
Restructured loans <sup>(3)</sup>	\$30,387	\$47,428	\$50,430	
Loans 30-89 days past due and on accrual	\$6,925	\$8,784	\$9,313	

(1) Includes \$2.0 million of non-accrual restructured loans. For the nine months ended September 30, 2014, \$439,000 in interest income would have been recorded had nonaccrual loans been current.

Real estate acquired by us as a result of foreclosure or by deed-in-lieu of foreclosure is classified as real estate held for sale until it is sold. When property is acquired, it is recorded at the lower of the estimated fair value of the property, less expected selling costs, or the carrying value of the defaulted loan. Subsequent to foreclosure, the property is carried at the lower of the foreclosed amount or net realizable value. Upon receipt of a new appraisal and market analysis, the carrying value is written down through the establishment of a specific reserve to the anticipated sales price, less selling and holding costs.

(3) These loans are performing under their restructured terms.

The following table sets forth the Company's non-performing assets by geographic concentration at September 30, 2014 (dollars in thousands):

	Washington	Oregon	Idaho	Total	
Secured by real estate:					
Commercial	\$3,693	\$—	\$—	\$3,693	
Multifamily	397	—	—	397	
Construction and land					
Residential land acquisition & development	—	750	—	750	
Residential land improved lots	—	536	—	536	
Total construction and land	—	1,286	—	1,286	
One- to four-family	9,903	947	542	11,392	
Commercial business	1,294	39	5	1,338	
Agricultural business, including secured by farmland	—	229	—	229	
Consumer	1,233	81	130	1,444	
Total non-performing loans	16,520	2,582	677	19,779	
REO	1,515	2,380	33	3,928	
Other repossessed assets	69	—	—	69	
Total non-performing assets	\$18,104	\$4,962	\$710	\$23,776	
Percent of non-performing assets	76	% 21	% 3	% 100	%

In addition to the non-performing loans as of September 30, 2014, we had other classified loans with an aggregate outstanding balance of \$60 million that are not on nonaccrual status, with respect to which known information concerning possible credit problems with the borrowers or the cash flows of the properties securing the respective loans has caused management to be concerned about the ability of the borrowers to comply with present loan repayment terms. This may result in the future inclusion of such loans in the nonaccrual loan category.

We have no non-performing lending relationships with aggregate loan exposures in excess of \$1 million. There were five non-performing lending relationships, each above \$500,000, that collectively comprise \$3.8 million, or 19.4% of our total non-performing loans as of September 30, 2014. At that date the single largest non-performing lending relationship consisted of one \$992,600 loan that is secured by commercial real estate located in the greater Seattle-Puget Sound area. The second largest non-performing lending relationship consisted of one \$840,000 loan that is secured by commercial real estate in the greater Seattle-Puget Sound area. The third largest non-performing lending relationship consisted of one \$750,000 loan that is secured by real estate being developed for residential purposes in the greater Portland, Oregon area. The remaining balance of our non-performing loans consists of 124 lending relationships with borrowers located throughout our market areas.

We record REO (acquired through a lending relationship) at fair value on a non-recurring basis. All REO properties are recorded at the lower of the estimated fair value of the property, less estimate selling costs, or the carrying value of the loan. From time to time, non-recurring fair value adjustments to REO are recorded to reflect partial write-downs based on an observable market price or current appraised value of property. The individual carrying values of these assets are reviewed for impairment at least annually and any additional impairment charges are expensed to operations. For the quarter ended September 30, 2014, we had no impairment charges, compared to the quarter ended September 30, 2013 in which we recognized \$191,000 of impairment charges related to these types of assets. For the nine months ended September 30, 2014 and 2013, we recognized \$37,000 and \$490,000, respectively, of these impairment charges.

At September 30, 2014, we had \$3.9 million of REO, the most significant components of which are a commercial office building in the greater Spokane, Washington area with a book value of \$935,000; a subdivision in the greater Portland, Oregon area consisting of eight residential buildable lots and 33.2 acres of undeveloped land with a book

value of \$798,000; and three residential lots in the greater Portland, Oregon area with a book value of \$504,000. All other REO holdings have individual book values of less than \$500,000. The geographic distribution of REO included approximately \$2.4 million, or 61%, in the greater Portland market area, \$297,000, or 7%, in the Puget Sound region, \$33,000, or 1%, in the greater Boise market area, and \$1.2 million, or 31%, in other areas of Washington, Oregon and Idaho.

#### Liquidity and Capital Resources

Our primary sources of funds are deposits, borrowings, proceeds from loan principal and interest payments and sales of loans, and the maturity of and interest income on mortgage-backed and investment securities. While maturities and scheduled amortization of loans and mortgage-backed securities are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by market interest rates, economic conditions, competition and our pricing strategies.

Our primary investing activity is the origination and purchase of loans and, in certain periods, the purchase of securities. During the nine months ended September 30, 2014 and 2013, our loan originations exceeded our loan repayments by \$414 million and \$412 million, respectively. During those periods we purchased loans of \$152 million and \$166,000, respectively. During the nine months ended September 30, 2014 and 2013, we sold \$267 million and \$374 million, respectively, of loans. Securities purchased during the nine months ended September 30, 2014 and 2013

totaled \$86 million and \$234 million, respectively, and securities repayments, maturities and sales were \$108 million and \$215 million, respectively.

Our primary financing activity is gathering deposits. Deposits increased by \$373 million during the first nine months of 2014, including a \$20 million decrease in certificates of deposits. The Branch Acquisition contributed \$217 million to the increase in deposits, including \$78 million in non-interest bearing deposits, \$105 million in interest-bearing transaction and savings accounts, and \$34 million in certificates of deposit as of September 30, 2014. The decrease in certificate balances in the nine months ended September 30, 2014 includes a \$37 million increase in brokered deposits issued to provide additional funding to support the strong loan growth. Certificates of deposits are generally more price sensitive than other retail deposits and our pricing of those deposits varies significantly based upon our liquidity management strategies at any point in time. At September 30, 2014, certificates of deposit amounted to \$853 million, or 21% of our total deposits, including \$641 million which were scheduled to mature within one year. While no assurance can be given as to future periods, historically, we have been able to retain a significant amount of our deposits as they mature.

FHLB advances (excluding fair value adjustments) decreased \$27 million from December 31, 2013 to \$250,000 at September 30, 2014, and decreased \$20 million from September 30, 2013 as a result of increased deposits available to fund lending needs. As of September 30, 2014, FHLB advances consisted of one long-term borrowing tied to a specific loan customer's outstanding loan balance. Other borrowings decreased \$15 million to \$68 million for the nine months ended September 30, 2014 and decreased \$15 million from one year ago. The decrease in other borrowings in the nine months ended September 30, 2014 was due to a decrease of retail repurchase agreements.

We must maintain an adequate level of liquidity to ensure the availability of sufficient funds to accommodate deposit withdrawals, to support loan growth, to satisfy financial commitments and to take advantage of investment opportunities. During the nine months ended September 30, 2014 and 2013, we used our sources of funds primarily to fund loan commitments, purchase securities, and pay maturing savings certificates and deposit withdrawals. At September 30, 2014, we had outstanding loan commitments totaling \$1.266 billion, including undisbursed loans in process and unused credit lines totaling \$1.235 billion. While representing potential growth in the loan portfolio and lending activities, this level of commitments is proportionally consistent with our historical experience and does not represent a departure from normal operations.

We generally maintain sufficient cash and readily marketable securities to meet short-term liquidity needs; however, our primary liquidity management practice to supplement deposits is to increase or decrease short-term borrowings, including FHLB advances and Federal Reserve Bank of San Francisco (FRBSF) borrowings. We maintain credit facilities with the FHLB-Seattle, which at September 30, 2014 provide for advances that in the aggregate may equal the lesser of 35% of Banner Bank's assets or adjusted qualifying collateral (subject to a sufficient level of ownership of FHLB stock), up to a total possible credit line of \$957 million, and 25% of Islanders Bank's assets or adjusted qualifying collateral, up to a total possible credit line of \$23 million. In addition, Banner Bank has been approved for participation in the FRBSF's Borrower-In-Custody (BIC) program. Under this program Banner Bank had available lines of credit of approximately \$636 million as of September 30, 2014, subject to certain collateral requirements, namely the collateral type and risk rating of eligible pledged loans. We had no funds borrowed from the FRBSF at September 30, 2014 or December 31, 2013. Management believes it has adequate resources and funding potential to meet our foreseeable liquidity requirements.

Banner Corporation is a separate legal entity from the Banks and, on a stand-alone level, must provide for its own liquidity and pay its own operating expenses and cash dividends. Banner's primary sources of funds consist of capital raised through dividends or capital distributions from the Banks, although there are regulatory restrictions on the ability of the Banks to pay dividends. At September 30, 2014, the Company (on an unconsolidated basis) had liquid assets of \$44.0 million.

As noted below, Banner Corporation and its subsidiary banks continued to maintain capital levels significantly in excess of the requirements to be categorized as “Well-Capitalized” under applicable regulatory standards. During the nine months ended September 30, 2014, total equity increased \$35 million, or 7%, to \$574 million. Total equity at September 30, 2014 is entirely attributable to common stock. At September 30, 2014, tangible common stockholders’ equity, which excludes other intangible assets, was \$571 million, or 12.00% of tangible assets. See the discussion and reconciliation of non-GAAP financial information in the Executive Overview section of Management’s Discussion and Analysis of Financial Condition and Results of Operation in this Form 10-Q for more detailed information with respect to tangible common stockholders’ equity. Also, see the capital requirements discussion and table below with respect to our regulatory capital positions.

### Capital Requirements

Banner Corporation is a bank holding company registered with the Federal Reserve. Bank holding companies are subject to capital adequacy requirements of the Federal Reserve under the Bank Holding Company Act of 1956, as amended and the regulations of the Federal Reserve. Banner Bank and Islanders Bank, as state-chartered, federally insured commercial banks, are subject to the capital requirements established by the FDIC.

The capital adequacy requirements are quantitative measures established by regulation that require Banner Corporation and the Banks to maintain minimum amounts and ratios of capital. The Federal Reserve requires Banner Corporation to maintain capital adequacy that generally parallels the FDIC requirements. The FDIC requires the Banks to maintain minimum ratios of Tier 1 total capital to risk-weighted assets as well as Tier 1 leverage capital to average assets. At September 30, 2014, Banner Corporation and the Banks each exceeded all regulatory capital requirements. (See Item 1, “Business–Regulation,” and Note 18 of the Notes to the Consolidated Financial Statements included in the 2013 Form 10-K for additional information regarding regulatory capital requirements for Banner and the Banks.)

The actual regulatory capital ratios calculated for Banner Corporation, Banner Bank and Islanders Bank as of September 30, 2014, along with the minimum capital amounts and ratios, were as follows (dollars in thousands):

	Actual		Minimum for Capital Adequacy Purposes		Minimum to be Categorized as “Well-Capitalized” Under Prompt Corrective Action Provisions		
	Amount	Ratio	Amount	Ratio	Amount	Ratio	
Banner Corporation—consolidated							
Total capital to risk-weighted assets	\$679,311	16.59	% \$327,607	8.00	% n/a	n/a	
Tier 1 capital to risk-weighted assets	627,828	15.33	163,803	4.00	n/a	n/a	
Tier 1 leverage capital to average assets	627,828	13.14	191,146	4.00	n/a	n/a	
Banner Bank							
Total capital to risk-weighted assets	599,617	15.32	313,137	8.00	\$391,421	10.00	%
Tier 1 capital to risk-weighted assets	550,395	14.06	156,568	4.00	234,852	6.00	
Tier 1 leverage capital to average assets	550,395	12.14	181,369	4.00	226,711	5.00	
Islanders Bank							
Total capital to risk-weighted assets	36,132	19.44	14,866	8.00	18,582	10.00	
Tier 1 capital to risk-weighted assets	33,850	18.22	7,433	4.00	11,149	6.00	
Tier 1 leverage capital to average assets	33,850	13.54	10,001	4.00	12,501	5.00	



## ITEM 3 – Quantitative and Qualitative Disclosures About Market Risk

### Market Risk and Asset/Liability Management

Our financial condition and operations are influenced significantly by general economic conditions, including the absolute level of interest rates as well as changes in interest rates and the slope of the yield curve. Our profitability is dependent to a large extent on our net interest income, which is the difference between the interest received from our interest-earning assets and the interest expense incurred on our interest-bearing liabilities.

Our activities, like all financial institutions, inherently involve the assumption of interest rate risk. Interest rate risk is the risk that changes in market interest rates will have an adverse impact on the institution's earnings and underlying economic value. Interest rate risk is determined by the maturity and repricing characteristics of an institution's assets, liabilities and off-balance-sheet contracts. Interest rate risk is measured by the variability of financial performance and economic value resulting from changes in interest rates. Interest rate risk is the primary market risk affecting our financial performance.

The greatest source of interest rate risk to us results from the mismatch of maturities or repricing intervals for rate sensitive assets, liabilities and off-balance-sheet contracts. This mismatch or gap is generally characterized by a substantially shorter maturity structure for interest-bearing liabilities than interest-earning assets, although our floating-rate assets tend to be more immediately responsive to changes in market rates than most funding deposit liabilities. Additional interest rate risk results from mismatched repricing indices and formula (basis risk and yield curve risk), and product caps and floors and early repayment or withdrawal provisions (option risk), which may be contractual or market driven, that are generally more favorable to customers than to us. An exception to this generalization is the beneficial effect of interest rate floors on a substantial portion of our performing floating-rate loans, which help us maintain higher loan yields in periods when market interest rates decline significantly. However, in a declining interest rate environment, as loans with floors are repaid they generally are replaced with new loans which have lower interest rate floors. As of September 30, 2014, our loans with interest rate floors totaled approximately \$1.7 billion and had a weighted average floor rate of 4.78%. An additional source of interest rate risk, which is currently of concern, is a prolonged period of exceptionally low market interest rates. Because interest-bearing deposit costs have been reduced to nominal levels, there is very little possibility that they will be significantly further reduced and our non-interest-bearing deposits are an increasingly significant percentage of total deposits. By contrast, if market rates remain very low, loan and securities yields will likely continue to decline as longer-term instruments mature or are repaid. As a result, a prolonged period of very low interest rates will likely result in further compression of our net interest margin. While this pressure on the margin may be mitigated by further changes in the mix of assets and deposits, particularly increases in non-interest-bearing deposits, a prolonged period of low interest rates will present a very difficult operating environment for most banks, including us.

The principal objectives of asset/liability management are: to evaluate the interest rate risk exposure; to determine the level of risk appropriate given our operating environment, business plan strategies, performance objectives, capital and liquidity constraints, and asset and liability allocation alternatives; and to manage our interest rate risk consistent with regulatory guidelines and policies approved by the Board of Directors. Through such management, we seek to reduce the vulnerability of our earnings and capital position to changes in the level of interest rates. Our actions in this regard are taken under the guidance of the Asset/Liability Management Committee, which is comprised of members of our senior management. The Committee closely monitors our interest sensitivity exposure, asset and liability allocation decisions, liquidity and capital positions, and local and national economic conditions and attempts to structure the loan and investment portfolios and funding sources to maximize earnings within acceptable risk tolerances.

### Sensitivity Analysis

Our primary monitoring tool for assessing interest rate risk is asset/liability simulation modeling, which is designed to capture the dynamics of balance sheet, interest rate and spread movements and to quantify variations in net interest income resulting from those movements under different rate environments. The sensitivity of net interest income to changes in the modeled interest rate environments provides a measurement of interest rate risk. We also utilize economic value analysis, which addresses changes in estimated net economic value of equity arising from changes in the level of interest rates. The net economic value of equity is estimated by separately valuing our assets and liabilities under varying interest rate environments. The extent to which assets gain or lose value in relation to the gains or losses of liability values under the various interest rate assumptions determines the sensitivity of net economic value to changes in interest rates and provides an additional measure of interest rate risk.

The interest rate sensitivity analysis performed by us incorporates beginning-of-the-period rate, balance and maturity data, using various levels of aggregation of that data, as well as certain assumptions concerning the maturity, repricing, amortization and prepayment characteristics of loans and other interest-earning assets and the repricing and withdrawal of deposits and other interest-bearing liabilities into an asset/liability computer simulation model. We update and prepare simulation modeling at least quarterly for review by senior management and the directors. We believe the data and assumptions are realistic representations of our portfolio and possible outcomes under the various interest rate scenarios. Nonetheless, the interest rate sensitivity of our net interest income and net economic value of equity could vary substantially if different assumptions were used or if actual experience differs from the assumptions used.

The following table sets forth, as of September 30, 2014, the estimated changes in our net interest income over one-year and two-year time horizons and the estimated changes in economic value of equity based on the indicated interest rate environments (dollars in thousands):

Change (in Basis Points) in Interest Rates <sup>(1)</sup>	Estimated Increase (Decrease) in						Economic Value of Equity					
	Net Interest Income Next 12 Months			Net Interest Income Next 24 Months								
+400	\$(191	)	(0.1	)%	\$11,516	3.10	%	\$(59,415	)	(7.7	)%	
+300	(53	)	—		9,382	2.60		(38,131	)	(4.9	)	
+200	80		—		7,184	2.00		(21,621	)	(2.8	)	
+100	(614	)	(0.3	)	2,934	0.80		(6,236	)	(0.8	)	
0	—		—		—	—		—		—		
-25	18		—		(1,386	)	(0.40	)	(9,060	)	(1.2	)
-50	(1,041	)	(0.6	)	(5,247	)	(1.40	)	(33,154	)	(4.3	)

(1) Assumes an instantaneous and sustained uniform change in market interest rates at all maturities; however, no rates are allowed to go below zero. The current federal funds rate is 0.25%.

Another (although less reliable) monitoring tool for assessing interest rate risk is gap analysis. The matching of the repricing characteristics of assets and liabilities may be analyzed by examining the extent to which assets and liabilities are interest sensitive and by monitoring an institution's interest sensitivity gap. An asset or liability is said to be interest sensitive within a specific time period if it will mature or reprice within that time period. The interest rate sensitivity gap is defined as the difference between the amount of interest-earning assets anticipated, based upon certain assumptions, to mature or reprice within a specific time period and the amount of interest-bearing liabilities anticipated to mature or reprice, based upon certain assumptions, within that same time period. A gap is considered positive when the amount of interest-sensitive assets exceeds the amount of interest-sensitive liabilities. A gap is considered negative when the amount of interest-sensitive liabilities exceeds the amount of interest-sensitive assets. Generally, during a period of rising rates, a negative gap would tend to adversely affect net interest income while a positive gap would tend to result in an increase in net interest income. During a period of falling interest rates, a negative gap would tend to result in an increase in net interest income while a positive gap would tend to adversely affect net interest income.

Certain shortcomings are inherent in gap analysis. For example, although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as ARM loans, have features that restrict changes in interest rates on a short-term basis and over the life of the asset. Further, in the event of a change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed in calculating the table. Finally, the ability of some borrowers to service their debt may decrease in the event of a severe change in market rates.

The following table presents our interest sensitivity gap between interest-earning assets and interest-bearing liabilities at September 30, 2014 (dollars in thousands). The table sets forth the amounts of interest-earning assets and interest-bearing liabilities which are anticipated by us, based upon certain assumptions, to reprice or mature in each of the future periods shown. At September 30, 2014, total interest-earning assets maturing or repricing within one year exceeded total interest-bearing liabilities maturing or repricing in the same time period by \$686 million, representing a one-year cumulative gap to total assets ratio of 14.41%. Management is aware of the sources of interest rate risk and in its opinion actively monitors and manages it to the extent possible. The interest rate risk indicators and interest sensitivity gaps as of September 30, 2014 are within our internal policy guidelines and management considers that our current level of interest rate risk is reasonable.

	Within 6 Months	After 6 Months Within 1 Year	After 1 Year Within 3 Years	After 3 Years Within 5 Years	After 5 Years Within 10 Years	Over 10 Years	Total
Interest-earning assets: (1)							
Construction loans	\$217,944	\$5,216	\$17,819	\$2,492	\$225	\$28	\$243,724
Fixed-rate mortgage loans	125,997	94,661	277,204	161,453	180,881	96,532	936,728
Adjustable-rate mortgage loans	530,127	159,685	462,045	256,225	15,098	—	1,423,180
Fixed-rate mortgage-backed securities	60,468	45,964	153,864	38,401	13,313	15,419	327,429
Adjustable-rate mortgage-backed securities	2,481	—	—	—	—	—	2,481
Fixed-rate commercial/agricultural loans	46,952	41,826	99,276	35,676	15,167	1,671	240,568
Adjustable-rate commercial/agricultural loans	588,576	8,146	30,600	21,062	1,549	—	649,933
Consumer and other loans	189,839	25,903	63,305	23,524	15,662	1,637	319,870
Investment securities and interest-earning deposits	171,768	9,168	43,618	71,557	54,631	43,159	393,901
Total rate sensitive assets	1,934,152	390,569	1,147,731	610,390	296,526	158,446	4,537,814
Interest-bearing liabilities: (2)							
Regular savings and interest checking accounts	210,158	197,574	461,006	461,006	—	—	1,329,744
Money market deposit accounts	251,830	151,098	100,732	—	—	—	503,660
Certificates of deposit	412,038	224,464	173,098	37,982	5,376	38	852,996
FHLB advances	198	—	—	—	—	—	198
Junior subordinated debentures	123,716	—	—	—	—	—	123,716

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Retail repurchase agreements	67,605	—	—	—	—	—	67,605	
Total rate sensitive liabilities	1,065,545	573,136	734,836	498,988	5,376	38	2,877,919	
Excess (deficiency) of interest-sensitive assets over interest-sensitive liabilities	\$868,607	\$(182,567)	\$412,895	\$111,402	\$291,150	\$158,408	\$1,659,895	
Cumulative excess (deficiency) of interest-sensitive assets	\$868,607	\$686,040	\$1,098,935	\$1,210,337	\$1,501,487	\$1,659,895	\$1,659,895	
Cumulative ratio of interest-earning assets to interest-bearing liabilities	181.52	% 141.87	% 146.30	% 142.14	% 152.17	% 157.68	% 157.68	%
Interest sensitivity gap to total assets	18.25	% (3.84	)% 8.68	% 2.34	% 6.12	% 3.33	% 34.88	%
Ratio of cumulative gap to total assets	18.25	% 14.41	% 23.09	% 25.43	% 31.55	% 34.88	% 34.88	%

(Footnotes on following page)

Footnotes for Table of Interest Sensitivity Gap

(1) Adjustable-rate assets are included in the period in which interest rates are next scheduled to adjust rather than in the period in which they are due to mature, and fixed-rate assets are included in the period in which they are scheduled to be repaid based upon scheduled amortization, in each case adjusted to take into account estimated prepayments. Mortgage loans and other loans are not reduced for allowances for loan losses and non-performing loans. Mortgage loans, mortgage-backed securities, other loans and investment securities are not adjusted for deferred fees, unamortized acquisition premiums and discounts.

Adjustable-rate liabilities are included in the period in which interest rates are next scheduled to adjust rather than in the period they are due to mature. Although regular savings, demand, interest checking, and money market deposit accounts are subject to immediate withdrawal, based on historical experience management considers a substantial amount of such accounts to be core deposits having significantly longer maturities. For the purpose of the gap analysis, these accounts have been assigned decay rates to reflect their longer effective maturities. If all of (2) these accounts had been assumed to be short-term, the one-year cumulative gap of interest-sensitive assets would have been \$(337) million, or (7.07)% of total assets at September 30, 2014. Interest-bearing liabilities for this table exclude certain non-interest-bearing deposits which are included in the average balance calculations in the table contained in Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations—Comparison of Results of Operations for the Three and Nine Months Ended September 30, 2014 and 2013" of this report on Form 10-Q.

#### ITEM 4 – Controls and Procedures

The management of Banner Corporation is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rule 13a-15(f) of the Securities Exchange Act of 1934 (Exchange Act). A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that its objectives are met. Also, 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. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures 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. As a result of these inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Further, projections of any evaluation of effectiveness to future periods are subject to risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Evaluation of Disclosure Controls and Procedures: An evaluation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Exchange Act) was carried out under the supervision and with the participation of our Chief Executive Officer, Chief Financial Officer and several other members of our senior management as of the end of the period covered by this report. Based on their evaluation, our Chief Executive Officer and Chief (a) Financial Officer concluded that, as of September 30, 2014, our disclosure controls and procedures were effective in ensuring that the information required to be disclosed by us in the reports it files or submits under the Exchange Act is (i) accumulated and communicated to our 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.

Changes in Internal Controls Over Financial Reporting: In the quarter ended September 30, 2014, there was no (b) change in our internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II – OTHER INFORMATION

## ITEM 1 – Legal Proceedings

In the normal course of business, we have various legal proceedings and other contingent matters outstanding. These proceedings and the associated legal claims are often contested and the outcome of individual matters is not always predictable. These claims and counter claims typically arise during the course of collection efforts on problem loans or with respect to actions to enforce liens on properties in which we hold a security interest. We are not a party to any pending legal proceedings that management believes would have a material adverse effect on our financial condition or operations.

## ITEM 1A – Risk Factors

There have been no material changes in the risk factors previously disclosed in Part 1, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013 (File No. 0-26584) or otherwise previously disclosed in our Form 10-Q reports filed subsequently.

## ITEM 2 – Unregistered Sales of Equity Securities and Use of Proceeds

(a) Not applicable

(b) Not applicable

(c) The following table provides information about repurchases of common stock by the Company during the quarter ended September 30, 2014:

Period	Total Number of Common Shares Purchased	Average Price Paid per Common Share	Total Number of Shares Purchased as Part of Publicly Announced Plan	Maximum Number of Remaining Shares that May be Purchased at Period End under the Plan
July 1, 2014 - July 31, 2014	6,325	\$39.69	n/a	978,826
August 1, 2014 - August 31, 2014	1,318	40.08	n/a	978,826
September 1, 2014 - September 30, 2014	—		n/a	978,826
Total for quarter	7,643	39.76	n/a	978,826

The 7,643 shares were surrendered by employees to satisfy tax withholding obligations upon the vesting of restricted stock grants.

On March 26, 2014, the Company announced that its Board of Directors had authorized the repurchase of up to 978,826 shares of the Company's common stock, or 5% of the Company's outstanding shares. Under the plan, shares may be repurchased by the Company in open market purchases. The extent to which the Company repurchases its shares and the timing of such repurchases will depend upon market conditions and other corporate considerations.

## ITEM 3 – Defaults upon Senior Securities

Not Applicable.

## ITEM 4 – Mine Safety Disclosures



Not Applicable

ITEM 5 – Other Information

Not Applicable.

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ITEM 6 – Exhibits

Exhibit	Index of Exhibits
3{a}	Amended and Restated Articles of Incorporation of Registrant [incorporated by reference to the Registrant’s Current Report on Form 8-K filed on April 28, 2010 (File No. 000-26584)], as amended on May 26, 2011 [incorporated by reference to the Current Report on Form 8-K filed on June 1, 2011 (File No. 000-26584)].
3{b}	Bylaws of Registrant [incorporated by reference to Exhibit 3.2 to the Current Report on Form 8-K filed on April 1, 2011 (File No. 000-26584)].
4{a}	Warrant to purchase shares of the Company’s common stock dated November 21, 2008 [incorporated by reference to the Registrant’s Current Report on Form 8-K filed on November 24, 2008 (File No. 000-26584)].
10{a}	Executive Salary Continuation Agreement with Gary L. Sirmon [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended March 31, 1996 (File No. 000-26584)].
10{b}	Amended and Restated Employment Agreement with Mark J. Grescovich [incorporated by reference to Exhibit 10.1 to the Current Report on Form 8-K filed on June 4, 2013 (File No. 000-26584)].
10{c}	1996 Stock Option Plan [incorporated by reference to Exhibit 99.1 to the Registration Statement on Form S-8 dated August 26, 1996 (File No. 333-10819)].
10{d}	Supplemental Retirement Plan as Amended with Jesse G. Foster [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended March 31, 1997 (File No. 000-26584)].
10{e}	Supplemental Executive Retirement Program Agreement with D. Michael Jones [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 000-26584)].
10{f}	Form of Supplemental Executive Retirement Program Agreement with Gary Sirmon, Lloyd W. Baker, Cynthia D. Purcell, and Richard B. Barton [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2001 and the exhibits filed with the Form 8-K on May 6, 2008 (File No. 000-26584)].
10{g}	1998 Stock Option Plan [incorporated by reference to exhibits filed with the Registration Statement on Form S-8 dated February 2, 1999 (File No. 333-71625)].
10{h}	2001 Stock Option Plan [incorporated by reference to Exhibit 99.1 to the Registration Statement on Form S-8 dated August 8, 2001 (File No. 333-67168)].
10{i}	Form of Employment Agreement entered into with Lloyd W. Baker, Cynthia D. Purcell, Richard B. Barton, and Douglas M. Bennett [incorporated by reference to exhibits filed with the Form 8-K on June 25, 2014 (File No. 000-26584)].
10{j}	2004 Executive Officer and Director Stock Account Deferred Compensation Plan [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2005 (File No. 000-26584)].

10{k}	2004 Executive Officer and Director Investment Account Deferred Compensation Plan [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2005 (File No. 000-26584)].
10{l}	Long-Term Incentive Plan and Form of Repricing Agreement [incorporated by reference to the exhibits filed with the Form 8-K on May 6, 2008 (File No. 000-26584)].
10{m}	2005 Executive Officer and Director Stock Account Deferred Compensation Plan [incorporated by reference to exhibits filed with the Annual Report on Form 10-K for the year ended December 31, 2008 (File No. 000-26584)]
10{n}	Entry into an Indemnification Agreement with each of the Registrant's Directors [incorporated by reference to exhibits filed with the Form 8-K on January 29, 2010 (File No. 000-26584)].
10{o}	2012 Restricted Stock and Incentive Bonus Plan [incorporated by reference as Appendix B to the Registrant's Definitive Proxy Statement on Schedule 14A filed on March 19, 2013 (File No. 000-26584)].
10{p}	Form of Performance-Based Restricted Stock Award Agreement [incorporated by reference to Exhibit 10.1 included in the Registrant's Current Report on Form 8-K filed on June 4, 2013 (File No. 000-26584)].
10{q}	Form of Time-Based Restricted Stock Award Agreement [incorporated by reference to Exhibit 10.1 included in the Registrant's Current Report on Form 8-K filed on June 4, 2013 (File No. 000-26584)].
10{r}	2014 Omnibus Incentive Plan [incorporated by reference as Appendix C to the Registrant's Definitive Proxy Statement on Schedule 14A filed on March 24, 2014 (File No. 000-26584)].

10{s}	Forms of Equity-Based Award Agreements: Incentive Stock Option Award Agreement, Non-Qualified Stock Option Award Agreement, Restricted Stock Award Agreement, Restricted Stock Unit Award Agreement, Stock Appreciation Right Award Agreement, and Performance Unit Award Agreement [incorporated by reference to Exhibits 10.2 - 10.7 included in the Registration Statement on Form S-8 dated May 9, 2014 (File No. 333-195835)].
31.1	Certification of Chief Executive Officer pursuant to the Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to the Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32	Certificate of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	The following materials from Banner Corporation's Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, formatted in Extensible Business Reporting Language (XBRL): (a) Consolidated Statements of Financial Condition; (b) Consolidated Statements of Operations; (c) Consolidated Statements of Comprehensive Income (Loss); (d) Consolidated Statements of Stockholders' Equity; (e) Consolidated Statements of Cash Flows; and (f) Selected Notes to Consolidated Financial Statements.*
	* Pursuant to Rule 406T of Regulations 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.

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.

Banner Corporation

November 6, 2014      /s/ Mark J. Grescovich  
Mark J. Grescovich  
President and Chief Executive Officer  
(Principal Executive Officer)

November 6, 2014      /s/ Lloyd W. Baker  
Lloyd W. Baker  
Treasurer and Chief Financial Officer  
(Principal Financial and Accounting  
Officer)